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ASSESSING AND RESPONDING TO

AUDIT RISK

INTERNATIONAL AUDITING STANDARDS

ASSESSING AND RESPONDING TO AUDIT RISK: INTERNATIONAL AUDITING STANDARDS

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INTERNATIONAL AUDITING STANDARDS

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Preface

About This Publication

The purpose of this AICPA audit publication is to help auditors fulfill their responsibilities for assessing risk in a financial statement audit that is performed in accordance with the International Standards on Auditing (ISAs) as established by the International Auditing and Assurance Standards Board (IAASB). ISAs established by the IAASB are applicable to all audits of financial statements.

Auditing guidance included in this publication is recognized as an interpretive publication as defined in ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. Interpretive publications are recommendations on the application of the ISAs in specific circumstances, including engagements for entities in specialized industries.

Although interpretive publications are not auditing standards, ISA 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of ISAs in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of the ISAs were complied with in the circumstances addressed by such auditing guidance.

Status of Other Material Included in This Publication

This publication includes numerous illustrative examples, interpretative flowcharts, observations, and suggestions. These materials have no authoritative status; however, they may help the auditor understand and apply the ISAs. These materials have been reviewed by the AICPA Audit and Attest Standards staff and are presumed to be appropriate for the performance of an audit in accordance with the standards established by the IAASB.

Recognition

The AICPA gratefully acknowledges Hiram Hasty, Senior Technical Manager, Audit and Attest Standards, who reviewed and contributed to this edition of the publication.

AICPA Staff

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Technical Manager
Accounting and Auditing Publications

Guidance Considered in This Edition

Authoritative guidance issued through September 1, 2013, has been considered in the development of this inaugural edition of the publication.

References to Professional Standards

When listing auditor requirements in accordance with the ISAs, the term *shall* used within the ISAs has been replaced with the term *should*, in accordance with the AICPA's professional requirements.

AICPA.org Website

The AICPA encourages you to visit its website at www.aicpa.org and the Financial Reporting Center at www.aicpa.org/FRC. The Financial Reporting Center was created to support members in the execution of high-quality financial reporting. Whether you are a financial statement preparer or a member in public practice, this center provides exclusive member-only resources for the entire financial reporting process, and provides timely and relevant news, guidance, and examples supporting the financial reporting process, including accounting, preparing financial

statements, and performing compilation, review, audit, attest, or assurance and advisory engagements. Certain content on the AICPA's websites referenced in this publication may be restricted to AICPA members only.

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Part 1

Guidance on the Auditor's Risk Assessment in a Financial Statement Audit

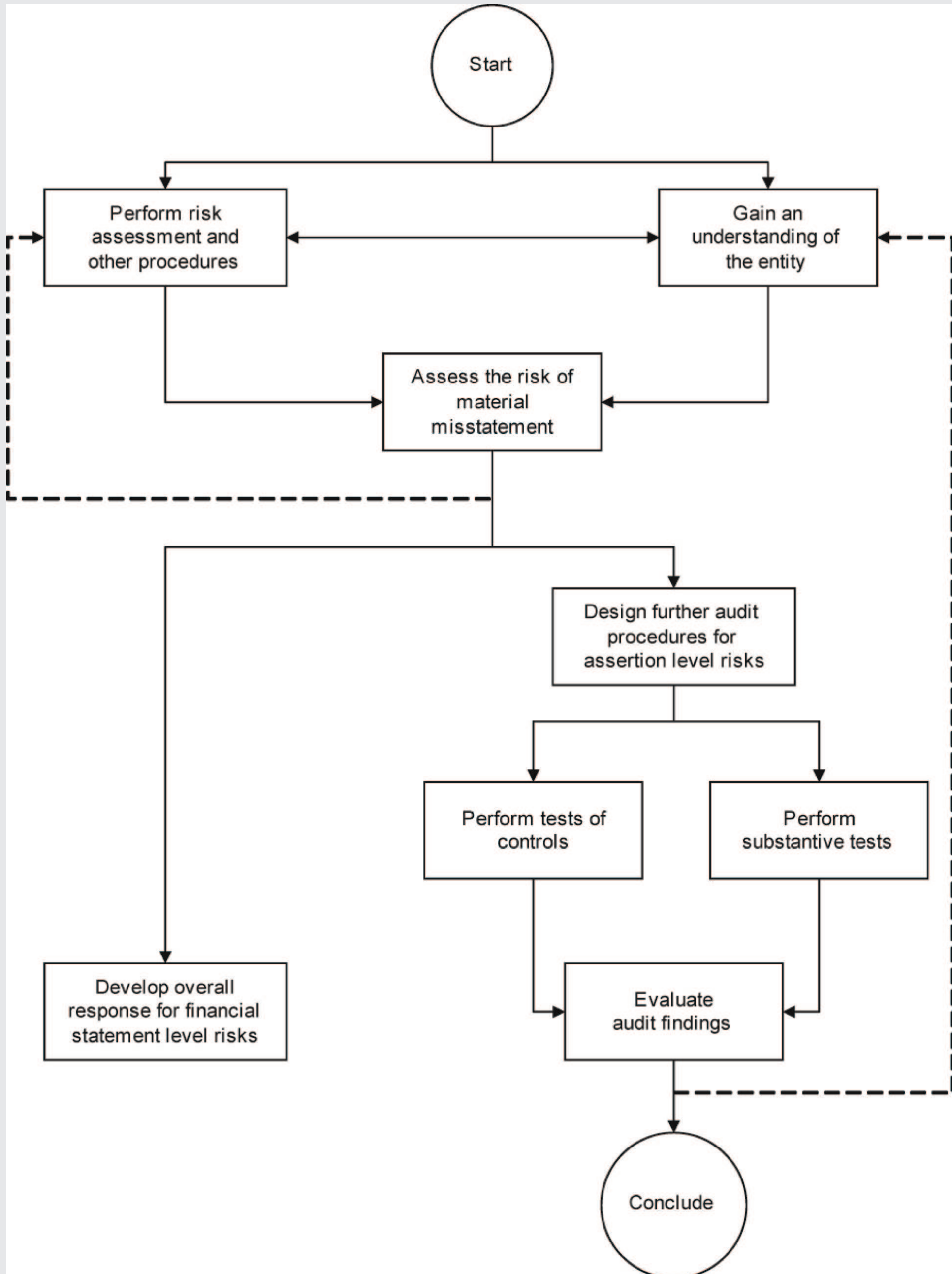
Chapter 1

Overview of Applying the Audit Risk Standards

Observations and Suggestions

Illustration 1-1

Overview of Applying the Audit Risk Model



(continued)

This illustration describes a high-level approach to the process that you follow to apply the audit risk standards to your audits by (1) assessing the risks of material misstatement, (2) using this risk assessment to plan and perform further audit procedures, and (3) evaluating the results of your procedures and reaching conclusions about the financial statements.

An Iterative Process

Although the flowchart may indicate to some a linear audit process, an audit is, in fact, an iterative process in which you may repeat as the audit progresses the steps described in the flowchart as a result of new information obtained. In the flowchart, the dotted line connecting later steps in the process to earlier steps illustrates the potential iterative nature of the audit process.

As indicated by the dotted line, the results of further audit procedures provide you with information that you use to confirm or modify your original risk assessment, which in turn, may lead to additional audit procedures or to a conclusion.

Perform Risk Assessment Procedures to Gain an Understanding of the Entity

The first step in the process is to perform risk assessment procedures (for example, inquiry, observation, or inspection of documents) to gather information and gain an understanding of your client and its environment, including its internal control.

Gain an Understanding of the Entity and Its Environment, Including Internal Control

You are required to gain an understanding of the entity and its environment, including internal control, to identify and assess risks of material misstatement and to design further audit procedures. As you gather information about your client, you will begin to form an understanding of its business and the environment in which it operates. An important part of this understanding is your evaluation of the design of internal control and a determination of whether controls have been implemented (that is, placed in operation). This knowledge of the client, including the design of its internal control, may prompt you to seek additional information until you are satisfied with your level of understanding. Specifically, this knowledge and understanding of the client will enable you to assess whether there are risks of material misstatement in the financial statements that you are auditing. These risks should be expressed in terms of what can go wrong in specific accounts and disclosures and their related assertions.

Materiality

As you gather information and perform risk assessment procedures, you will want to have a materiality threshold in mind. Your risk assessment is responsive to judgments about financial statement materiality. Materiality is a critical judgment that affects all steps in the audit process. Because this judgment is not clearly associated with a specific phase, and is responsive to some information you will be gathering before assessing the risks of material misstatement, it is not separately depicted in the illustration.

Assess the Risks of Material Misstatement

After identifying risks you will (1) relate them to what can go wrong in preparing the financial statements and (2) assess the likelihood and significance of the risk. When making these risk assessments, consider that

- *the risks of material misstatement can be a combination of inherent and control risk. This publication, consistent with the underlying auditing standards, describes a combined inherent and control risk assessment. However, you are not required to perform a combined risk assessment, and you may choose to make separate assessments of inherent and control risk.*
- *risks of material misstatement can reside at either the financial statement level or the assertion level for specific accounts. For example, a risk relating to the regulatory environment in which your client operates is a pervasive risk that affects many of the financial statement assertions in many accounts. On the other hand, a risk related to the valuation of inventory is restricted to that account and assertion and the related determination of cost of sales. Understanding the differences between the two types of risks is important because these differences drive your audit response. You will perform different procedures to understand and respond to financial statement level risks than you will need to understand and respond to assertion level risks.*
- *your assessment of risk at the assertion level should be specific to the unique circumstances of the entity. For example, assessing the risk relating to the existence assertion of an account to be high generally would not be sufficient to design effective further audit procedures.*

Instead, in this example, your assessment of risk should describe how the existence assertion could contain a material misstatement, given the specific business processes, information processing, and controls in use at the particular client. It is common to use standard audit programs and example audit practice aids to complete your engagement. However, when using these standard programs and examples, it is important to consider carefully whether they appropriately reflect the unique circumstances of your client.

- *it is important that your risk assessments are supported by sufficient appropriate audit evidence. It is not appropriate to simply designate a risk to be at a given level without any support for the risk assessment.*
- *to the extent possible, even risks that reside at the financial statement level should be related to what can go wrong at the assertion level.*

Design Further Audit Procedures to Respond to Assessed Risks

Once you have assessed the risks of material misstatement, you will design further audit procedures in response to these risks. There are two types of further audit procedures: tests of controls and substantive procedures. Often, you will perform a combination of these two types of procedures. Of critical importance in performing an effective audit is to develop a clear link between the identified risks, the assessment of those risks, and the further audit procedures performed in response to the assessed risks. By relating risks of material misstatement to specific assertions, you will be able to establish this necessary linkage.

Evaluate Audit Findings and Evidence

At the conclusion of the audit, you are required to evaluate the results of your audit procedures and reach a conclusion concerning whether the financial statements are free of material misstatement. You also should determine whether you have obtained sufficient appropriate audit evidence to support your audit opinion at a high level of assurance. Finally, you are required to evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies.

On every audit you are required to assess the risks that individual financial statement assertions are materially misstated. This assessment of risk then serves as the basis for the design of further audit procedures. This chapter provides an overview of this process, beginning with the information about the client and its environment that is necessary for you to identify risks, how you use that information to assess risk at the assertion level, and how that risk assessment helps you determine further audit procedures.

This chapter provides only a summary of the risk assessment process. Subsequent chapters provide additional detail, as well as examples and illustrations of how the general guidance described here might be applied. Please refer to subsequent chapters for those details.

The Purpose of This Audit Publication

1.01 You, as the auditor, are required to 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. (Throughout this publication the auditor is referred to as "you.") This risk assessment then serves as the basis for you to design the nature, timing, and extent of further audit procedures. (ISA 315 par. 5 and ISA 300 par. 9)

1.02 The further audit procedures you design and perform should be appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence to be able to draw a reasonable conclusion on which to base your opinion. (ISA 500 par. 1 and 6)

1.03 This publication provides guidance, primarily on performing risk assessment procedures referred to in paragraph 1.01 and obtaining sufficient appropriate audit evidence referred to in paragraph 1.02. As such, this publication illustrates how to gather information needed to assess risk, evaluate that information to assess risk at the assertion level, and design and perform further audit procedures based on that assessed risk, evaluate the results, and reach conclusions. In addition, guidance on evaluating and communicating findings is also included.

Observations and Suggestions

The preceding paragraph describes a process in which there is a link between information gathering, the identification and assessment of risk, and the design and performance of further audit procedures. Each step in this process serves as the basis for performing the subsequent step. For example, your determination of what can go wrong at the assertion level helps you determine the nature, timing, and extent of your substantive procedures.

This linkage between the various stages in the risk assessment process is vital to performing an effective and efficient audit.

Financial statement assertions allow you to develop this link between the various stages of the risk assessment process. For example, your substantive procedures and tests of controls are directed at what could go wrong in specific assertions. For those audit procedures to be clearly linked to risks of material misstatement, those risks also should be expressed at that same level of detail: what could go wrong in the financial statement assertions.

Your documentation of the risks and associated procedures should be clear to enable an experienced auditor with no prior association with the audit to understand the intended linkage.

1.04 Understanding the entity and its environment includes obtaining an understanding of its internal control. (This publication uses the term *client* to refer to the entity being audited.) This understanding of internal control should be sufficient to allow you to evaluate the design of controls and to determine whether they have been implemented (placed in operation). (Unless otherwise indicated, this publication uses the term *internal control* to mean "internal control over financial reporting [including the relevant controls over safeguarding assets].")

Overview of the Risk Assessment Process

1.05 This chapter provides a summary of the risk assessment process followed in an audit. Even though some requirements and guidance are presented in a way that suggests a sequential process, risk assessment involves a continuous process of gathering, updating, and analyzing information throughout the audit. Accordingly, you may implement the requirements and guidance in a different sequence from that presented in this publication or you may revisit steps when updated information is available.

Observations and Suggestions

Auditing is a nonlinear process, and different auditors may have different judgments about which steps should be performed first. For example, some auditors may determine that it first is necessary to obtain an understanding of the client and its environment to develop an appropriate audit strategy. Other auditors may determine that it first is necessary to determine appropriate materiality levels, which then serve to guide them through the information gathering process.

Neither approach is inherently more effective or efficient than the other. Within the audit process, it is common for different steps to interact dynamically with one or more other steps. The determination of materiality drives audit procedures, which produce results, which in turn influence materiality levels.

In that sense, it may not matter where you start in the process as long as you continue to revisit the procedures you performed and confirm the judgments made earlier in your engagement as you discover new information. For example, a practical point at which to revisit the judgments made to date and their interactions is when assessing the risks of material misstatement. At that point, the materiality and risk assessment procedures come together and the assessment of the risks of material misstatement is an important determinant of the procedures to be applied to the audit risks.

1.06 The following is an overview of the audit process described in this publication, based on guidance provided in ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*:

- Perform risk assessment procedures by *gathering information about the entity and its environment, including internal control*. You should gather information about those aspects of the client and its environment that will allow you to identify and assess risks of material misstatements of the client's financial statements. The client's internal

control is an integral part of its operations, and your evaluation of the design of internal control is an important part of your understanding of the client.

- *Gain an understanding of the entity and its environment, including its internal control*. You need to develop an understanding of specific aspects of the entity, its environment, and internal control to identify and assess risk and design and perform further audit procedures. Based on the information gathered, you should be able to identify what could go wrong in specific accounts and disclosures and their assertions.
- *Assess risks of material misstatement*. Next, you will use your understanding of the client and its environment to assess the risks of material misstatement that relate to specific assertions. To assess risks, you will need to
  - identify risks of material misstatement;
  - describe the identified risks in terms of what can go wrong in specific assertions; and
  - consider the significance and likelihood of material misstatement for each identified risk.
- *Design further audit procedures (an audit response)*. You should address the risks of material misstatement at both the financial statement and the assertion level. These risks are described subsequently:
  - Risks of material misstatement at the financial statement level have a more pervasive effect on the financial statements and affect many accounts and assertions. In addition to developing assertion-specific responses, these types of risks may require you to develop an overall, audit-wide response, such as your choice of audit team members.
  - Assertion level risk pertains to specific accounts and assertions and should be considered when you design and subsequently perform further audit procedures. These further procedures often encompass a combined approach using both tests of activity-level controls (this publication uses the term *activity-level controls* to refer to the controls that pertain to assertion level risks) and substantive procedures directed at individual accounts and disclosures and their assertions. It is important that auditors are mindful that some risks may relate to more than one assertion.
- *Perform further audit procedures*. Further audit procedures include tests of controls and substantive procedures. The nature, timing, and extent of these procedures should be designed in a way that is responsive to your assessed risks. Once designed, you will perform these procedures to gather sufficient appropriate audit evidence to support your opinion on the financial statements.
- *Evaluate audit findings*. You will evaluate the results of further audit procedures and the audit evidence obtained to reach a conclusion about whether the client's financial statements are free of material misstatement or whether such a conclusion can be reached.

Audit documentation is an important part of every audit, and each chapter in this publication summarizes the documentation requirements that pertain to each phase in the audit.

(ISA 300 par. 9, ISA 315 par. 3, and ISA 500 par. 6)

Information Gathering

Information Needed About the Client and Its Environment to Identify and Assess Risks of Material Misstatement

1.07 Obtaining an understanding of your client and its environment, including internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. This understanding establishes a framework that allows you to plan the audit and exercise professional judgment throughout the audit when, for example, you are

- assessing risks of material misstatement of the financial statements;
- determining materiality in accordance with ISA 320, *Materiality in Planning and Performing an Audit*;

- considering the appropriateness of the client's selection and application of accounting policies and adequacy of its financial statement disclosures;
- identifying areas where special audit consideration may be necessary (for example, related party transactions);
- developing expectations for 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.

1.08 Not all information about a client or its environment is relevant for your audit. In general, the information you are required to gather about your client is that which allows you to assess the risk that specific assertions could be materially misstated. ISA 315 defines the aspects of the client for which you should gather information and obtain an understanding. Table 1-1 summarizes these aspects. Chapter 3, "Planning and Performing Risk Assessment Procedures," of this publication provides more detail and examples of the information you should gather.

Table 1-1

Understanding the Client and Its Environment

On every audit you are required to gather (or update) information and obtain an understanding of the client and its environment including an understanding of the

- relevant industry, regulatory, and other external factors including the applicable financial reporting framework;
- nature of the entity;
- entity's selection and application of accounting policies;
- client's objectives and strategies and those related business risks that may result in risks of material misstatement; and
- measurement and review of the client's financial performance.

(ISA 315 par. 11)

Relevant industry factors may include the market and competition, supplier and customer relationships, energy supply and cost, and technological developments.

Regulatory factors may include relevant accounting pronouncements, the regulatory framework, laws, taxation, governmental policies, and environmental requirements that affect the industry and client.

Other external factors may include general economic conditions, interest rates, inflation, and availability of financing.

Understanding the nature of the client, may include, among other matters, its operations, ownership, governance, the types of investments it makes and plans to make, how it is financed, and how it is structured. Numerous other matters you may consider are included in paragraph A24 of ISA 315.

The client's selection and application of accounting policies may encompass the methods used for significant and unusual transactions, changes in accounting policies, new accounting standards and their adoption, and the financial reporting competencies of personnel. You should evaluate whether the client's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and those used in the client's industry. (ISA 315 par. 12)

The client sets strategies in the context of its industry, regulatory, and other external factors. Those strategies are the approaches to achieving its objectives. Objectives and strategies are related to business risks. An understanding of business risks increases the likelihood of identifying risks of material misstatement because most business risks eventually have financial consequences that in turn affect the client's financial statements. You are not responsible to identify or assess all business risks because not all of them give rise to risks of material misstatement. Paragraph A32 of ISA 315 includes numerous examples of objectives, strategies, and business risks.

The metrics used by management to measure and review financial performance provide you with information about the aspects of the entity that management considers to be important.

Internal Control

1.09 Not all of the client's internal controls are relevant to your audit. When performing a financial statement audit, your consideration of internal control is limited to those controls that are deemed to be "relevant to the audit." Operational controls, for example, over production and other business functions, may affect but often are not directly related to financial reporting. Accordingly, early in the audit process, you will determine which controls are relevant to the audit. For example, production quality control issues may affect estimates of warranty costs. Paragraph A61 of ISA 315 lists many factors that you might consider in making a professional judgment about whether a control, individually or in combination with others, is relevant to the audit. The factors include materiality, the size of the entity, the diversity and complexity of its operations, and how a specific control prevents, or detects and corrects, material misstatements.

1.10 There are some controls that are relevant to every audit. These controls relate to

a. elements of the COSO framework components that chapter 2, "Key Concepts Underlying the Auditor's Risk Assessment Process," of this publication describes. That framework includes five separate components. On each audit, you should gain an understanding of certain, specified elements relating to each of the five COSO components.

b. controls related to "significant risks." Some significant risks arise on most audits, and the controls related to these risks are relevant to your audit. Significant risks are discussed in paragraph 1.30.

c. controls related to circumstances when substantive procedures alone will not provide sufficient appropriate audit evidence.

d. other controls that you determine to be relevant to your audit.

In addition, when obtaining an understanding of the company and its environment, the design and implementation of controls over the most significant revenues and significant expenditures will also generally be relevant. Chapter 3 and chapter 4, "Understanding the Client, Its Environment, and Its Internal Control," further describe these categories of relevant controls in more detail.

Risk Assessment Procedures

1.11 You should perform risk assessment procedures to provide a basis for your identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures include

a. inquiries of management and others at the client,

b. analytical procedures, and

c. observation and inspection.

(ISA 315 par. 6)

Observations and Suggestions

You should perform risk assessment procedures to support your assessment of the risks of material misstatement. Your risk assessment procedures provide the audit evidence necessary to support your risk assessments, which, in turn, drive the nature, timing, and extent of further audit procedures. Thus, the results of your risk assessment procedures are an integral part of the audit evidence you obtain to support your opinion on the financial statements. It is not acceptable to simply deem risk to be "at the maximum" without evidence or support unless such an assessment is supported by the facts. By defaulting to maximum risk without adequate understanding of actual controls in place, you are not determining specifically what, exactly, the risks are, and which assertions they affect. For example, is it likely that all assertions of accounts payable are equally risky? If that were so, extensive tests of existence and valuation would be required as well as the common tests of completeness and accuracy, and this is unlikely to result in an efficient audit. You may also overlook conditions or weaknesses that indicate a fraud risk.

(continued)

Example or illustrative audit programs may not be sufficient to address all possible engagement risks.

Further, even at the assertion level, for example, an inventory existence risk could be high, but it could result from a number of different causes, not all of which may be applicable to your client (for example, theft, shrinkage, cut-off issues, short deliveries). Without understanding and documenting what, exactly, is the source of this risk, you are not necessarily able to design the appropriate nature, timing, and extent of procedures to address the risk. Procedures designed to address a risk of theft may be different from procedures designed to address a risk of short deliveries or cut-off, even though both could be described as high risk pertaining to existence of inventory.

A Mix of Procedures

1.12 You are not required to perform *all* the risk assessment procedures (for example, inquiries, analytical procedures, observations, and so on) for *each* aspect of the client's internal control and its environment listed in table 1-1. However, in the course of obtaining the required understanding about the client, you should perform all the risk assessment procedures.

Procedures to Obtain an Understanding of Internal Control

1.13 Inquiry may allow you to gather information about internal control design, but inquiry alone is not sufficient to determine whether the control has been implemented (placed in operation). Thus, when inquiry is used to obtain information about the design of internal control, you should corroborate the responses to your inquiries by performing at least one other risk assessment procedure to determine that client personnel are using the control. That additional procedure may be further observations of the control operating, inspecting documents and reports, or tracing transactions through the information system relevant to financial reporting.

1.14 Although ISA 500, *Audit Evidence*, notes that corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about the control environment and "tone at the top," the information available to support management's responses to inquiries may be limited. When better audit evidence is not available from any other sources, corroborative inquiries made of multiple sources may sometimes be a source of evidence available to determine whether a control has been implemented (that is, placed in operation). When no more effective procedures can be identified, corroborating inquiries of different knowledgeable persons can be an effective procedure when the results of the inquiries are consistent with observed behaviors or past actions. For example, making inquiries of an owner-manager about the implementation of the company's code of conduct will not, by itself, allow the auditor to obtain a sufficient understanding of that aspect of the control environment. However, corroborating the owner manager's response with additional inquiries or a survey of other company personnel, and observing consistent behaviors or other evidence with respect to the results of those inquiries, may provide the auditor with the requisite level of understanding. As another example, if it is represented to the auditor that no instances of ethics code violations were reported and evidence of that is not otherwise observable, corroborating inquiry and the lack of contradictory evidence or observations may be the only viable alternative evidence. The auditor may consider his or her experience in dealing with management in this area as well as other areas, and consider whether any results from applying audit procedures are consistent with or might contradict such evidence before accepting the inquiries.

Observations and Suggestions

As will be discussed later, although inquiry is often the starting point for understanding controls, observation, examining documentary evidence, or performing a walkthrough are common audit procedures that provide evidence that a control is in place and confirm the inquiry.

Other Procedures That Provide Relevant Information About the Client

1.15 *Assessing the risks of material misstatement due to fraud.* ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, directs you to perform certain audit procedures to assess the risks of material misstatement due to fraud. Some of these

procedures also may help gather information about the entity and its environment, particularly its internal control. For this reason, it usually is helpful to

- coordinate the procedures you perform to assess the risks of material misstatement due to fraud with your other risk assessment procedures, and
- consider the results of your assessment of fraud risk when identifying the risks of material misstatement.

1.16 *Other information.* When relevant to the audit, you also should consider other knowledge you have of the client that can help you assess risk. This other information may include either or both of the following:

- Information obtained from prior audits or from your client acceptance or continuance process (ISA 315 par. 7)
- Experience gained on other engagements performed by the engagement partner for the client, for example, the audit of the client's pension plan

Updating Information From Prior Periods

1.17 If you intend to use information about the client you obtained from previous experience with the client and from audit procedures performed in previous audits, you should determine whether changes have occurred since then that may affect the relevance of the information to the current audit. To make this determination, you may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems. (ISA 315 par. 9)

Gaining an Understanding of the Client and Its Environment

1.18 The gathering of information by itself does not provide you with the understanding of the client that is necessary for you to assess risk. For you to assess the risks of material misstatement and design further audit procedures, you will want to assimilate and synthesize the information gathered to determine how it might affect the financial statements. For example:

- Information about the client's industry may allow you to identify characteristics of the industry that could give rise to specific misstatements. For example, if your client is a construction contractor that uses long-term contract accounting, your understanding of the client should be sufficient to allow you to recognize that the significant estimates of revenues and costs create risk, and without proper controls, there would be risks of material misstatement.
- Information about the ownership of your client, how it is structured, and other elements of its nature assists you to identify related-party transactions that, if not accounted for properly and adequately disclosed, could lead to a material misstatement.
- Your identification and understanding of the business risks facing your client increase the chance that you will identify financial reporting risks. For example, your client may face an imminent risk that a new company has recently entered its market, and that new entrant could have certain business advantages (for example, economies of scale, greater brand recognition). The potential risk related to this business risk might be obsolescence or overproduction of inventory that could only be sold at a discount. Thus, you might need to understand how the client understands and controls the risk in order to assess the risks of material misstatement.
- Information about the performance measures used by client management may lead you to identify differences in internal control or pressures or incentives that could motivate client personnel to misstate the financial statements.
- Information about the design and implementation of internal control may lead you to identify a deficiency in control design. Such an improperly designed control may represent a significant deficiency.
- Appendix B, "Understanding the Entity and Its Environment," of this publication suggests factors that may be relevant in understanding the entity and its environment.

Understanding Internal Control

Observations and Suggestions

The "extent" of your understanding of controls describes the level of knowledge you should obtain about the controls. There are two basic levels of knowledge:

a. The design of the controls and whether they have been implemented. You should obtain this level of understanding on all engagements.

b. The operational effectiveness of those controls. You should obtain this level of understanding only when you plan to rely on internal control to modify the nature, timing, and extent of your substantive procedures or in the circumstance when substantive procedures alone do not provide sufficient audit evidence.

Level 2, the operational effectiveness of controls, requires a more in-depth testing of internal control that addresses how well the control performed during the audit period. To determine operational effectiveness, you first need to understand how the controls are designed and assess whether they appear to have been implemented (that is, placed in operation). In other words, any knowledge of operational effectiveness builds upon your evaluation of control design and implementation.

1.19 At a minimum, your understanding of internal control allows you to do the following:

a. *Evaluate control design*. Evaluating the design of a control involves determining whether the control is capable of either

i. effectively preventing material misstatements, or

ii. effectively detecting and correcting material misstatements.

b. *Determine whether a control has been implemented*. Implementation of a control means that the control exists and that the entity is using it.

(ISA 315 par. 13)

Procedures Related to Controls at a Service Organization

1.20 When your client uses a service organization to process some of its transactions, you may need to obtain an understanding of the information system and related controls that reside at the service organization. To help obtain that understanding, you may wish to obtain a report on the service organization's controls, prepared by the service organization's auditors.

1.21 Just because your client uses a service organization to process some of its transactions does not, in itself, require you to obtain a service auditor's report. If certain conditions are met, such as sufficient company input and output controls on the information processed by the service organization, you may meet the requirements for understanding internal control without obtaining a service auditor's report on controls at a service organization. Paragraphs 3.77–.84 of this publication provide additional guidance on this matter.

Discussion Among the Audit Team

1.22 The engagement partner and other key members of the audit engagement team should discuss the susceptibility of the client's financial statements to material misstatement. The engagement partner should determine which matters are to be communicated to the engagement team members not involved in the discussion. (ISA 315 par. 10)

This discussion

- provides an opportunity for more experienced team members to share their insights;
- allows team members to exchange information about the client's business risk;
- assists team members to gain a better understanding of the potential for material misstatement resulting from fraud or error in areas assigned to them; and

- provides a basis upon which the 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 to address those risks.

1.23 This discussion among the audit team could be held at the same time as the discussion among the team related to fraud, as described by ISA 240. In many cases this discussion may be held after the auditor obtains the understanding of the entity and its controls. If held earlier, the brainstorming might need to be repeated or updated.

Assessing the Risks of Material Misstatement

Observations and Suggestions

To assess the risk of "material" misstatement, you will need to determine an appropriate materiality level. Over the course of your audit, as you perform audit procedures and evaluate the results, you may revise your determination of materiality. If your judgments of materiality do change, you also may want to reevaluate your assessment of the risks of material misstatement. For example, if your audit procedures result in you lowering your materiality level for a particular assertion, certain conditions that you previously did not consider to result in a risk of a material misstatement could be reassessed as risks of material misstatement.

1.24 The *risk of material misstatement* of the financial statements prior to the audit consists of the following two components:

- *Inherent risk* is the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls (that is, assuming that there are no related controls). For example, the inherent risk of uncollectible accounts receivable might be high but such risk might be mitigated with effective controls over the granting of credit and the collection of outstanding accounts receivable.
- *Control risk* is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal control.

(ISA 200 par. 13)

1.25 Inherent risk and control risk are the client's risks; that is, they exist independently of your audit. Thus, your risk assessment procedures help you better assess these client risks, but they do not alter the client's existing inherent or control risks. This publication refers to the *risk of material misstatement* as your combined assessment of inherent risk and control risk; however, you may make separate assessments of inherent risk and control risk.

Observations and Suggestions — Assessing Versus Testing Controls

There is a difference between assessing and testing controls. For example, say that you have assessed the controls as effective based on your review of their design and an observation that they have been implemented (that is, placed in operation). Based solely on that assessment, you would not necessarily have an adequate basis for considering control risk is low (or even moderate) as part of your audit strategy, as you would need further evidence of the effective operation of the controls through sufficient tests of controls to reach that conclusion.

Observations and Suggestions — The Audit Risk Model

Chapter 2 of this publication provides a model of audit risk (AR) in which:

$$AR = RMM \times DR$$

where RMM is the risk of material misstatement and DR is detection risk.

(continued)

The risk of material misstatement is described as "the client's risk," which means that it is independent of your audit. You can control detection risk by changing the nature, timing, and extent of your substantive procedures. For example, to decrease the planned level of detection risk, you could perform more extensive and detailed analytical procedures and detailed substantive procedures, such as increasing sample sizes.

You cannot control the risk of material misstatement as you can detection risk. The risk of material misstatement exists separately from your audit procedures. However, to properly control detection risk, you are required to assess the risk of material misstatement. The risk assessment process described in this publication is designed to allow you to gather information and assess the risk of material misstatement so you can design further audit procedures.

The Risk Assessment Process

1.26 You use your understanding of the client and its environment—which includes your evaluation of the design and implementation of internal control—to identify and assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances, and disclosures. (ISA 315 par. 25) To make this assessment, you should

a. identify risk throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements;

b. assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially to many assertions;

c. relate the identified risks to what could go wrong at the assertion level, considering relevant controls that you intend to test; and

d. consider the likelihood of misstatement and whether the potential misstatement is of a magnitude that could result in a material misstatement.

(ISA 315 par. 26)

Financial Statement Level and the Assertion Level Risks

1.27 You should identify and assess the risks of material misstatement at both the financial statement level and the assertion level for classes of transactions, account balances, and disclosures.

a. *Financial statement level risk and controls*. Some risks of material misstatement relate pervasively to the financial statements as a whole and potentially affect many relevant accounts and assertions. The risk at the financial statement level may be identifiable with specific assertions at the class of transaction, account balance or disclosure level. In this publication, we use the term *entity-level controls* to describe those controls that pertain to financial statement level risk.

b. *Assertion level risk and controls*. Other risks of material misstatement relate to specific classes of transactions, account balances, and disclosures at the assertion level, for example, the valuation of a long-term unconditional promise to give in a not-for-profit organization. Your assessment of risk at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures, which include substantive procedures and may also include tests of controls. This publication uses the term *activity-level controls* to refer to the controls that pertain to assertion level risk.

Observations and Suggestions

You express an audit opinion on the financial statements *as a whole*, and the audit risk model describes audit risk for the overall financial statements (and for assertions). However, in executing the audit, you apply the audit risk model and assess risk at a more granular level, namely the assertion level. To accomplish this detailed level of risk assessment, you will consider what can be misstated in specific accounts and disclosures and their assertions.

Risks that exists at the financial statement level, for example, those that pertain to a weak control environment or to management's process for making significant accounting estimates, should be related to specific assertions, if possible. For example, risk related to the client's process for making accounting estimates would affect those assertions where an accounting estimate was necessary (for example, the valuation of assets).

In other instances, it may not be possible for you to relate your financial statement level risk to a particular assertion or group of assertions. For example, it may not be possible for you to determine which assertions will or will not be affected by an overall weak control environment. Financial statement level risk, such as a weak control environment that cannot be related to specific assertions, often will require you to make an overall engagement response, such as the way in which the audit is staffed or supervised, or the timing of further audit procedures. It might also mean that risk might be assessed as high for many or all accounts and assertions.

Careful consideration of potential financial statement level risk during the brainstorming may indicate that there are cost-effective ways to limit your response to the risk. For example, a weak accounting function may only be a significant risk for unusual or new transactions or when new accounting standards are implemented. Effective accounting for routine transactions may be well evidenced. By focusing audit procedures on the points in the accounting process where these issues can create risk, a more cost- and risk-effective audit can be designed.

How to Consider Internal Control When Assessing Risks

1.28 Your evaluation of internal control design and the determination of whether controls have been implemented are integral components of the risk assessment process. When making risk assessments, you should identify the controls that are likely to either prevent, or detect and correct, material misstatements in specific assertions. For example, procedures relating to the client's physical inventory count may relate specifically to the existence or completeness of inventory.

1.29 Individual controls often do not address a risk completely by themselves. Often, only multiple control activities, together with other components of internal control (for example, the control environment, risk assessment, information and communication, or monitoring), will be sufficient to address a risk. For this reason, when determining whether identified controls are likely to prevent or detect and correct material misstatements, you may organize your risk assessment procedures according to significant transactions and business processes, rather than general ledger accounts.

Identification of Significant Risks

1.30 Paragraph 4 of ISA 315 defines *significant risk* as follows: "A significant risk is an identified and assessed risk of material misstatement that, in the auditor's professional judgment, requires special audit consideration." (The defined term *significant risk* is italicized in this publication to remind readers of its definition and limited application.) As part of your risk assessment, you should determine whether any risks identified are, in your professional judgment, a significant risk. In making this judgment you exclude the effects of identified related controls (that is, assume there are no related controls). Significant risks are those that require special audit consideration. For example, because of the nature of your client and the industry in which it operates, you might determine that revenue recognition requires special audit consideration. For other clients, the valuation of intangible assets or the identification and required disclosure of related party transactions may be considered significant risks. Significant risk often arises with unusual transactions. Moreover, one or more significant risks arise on most audits. (*Note:* In practice, auditors frequently confuse significant risk and high risk. Not all high risks are also significant risks. For example, the collectability of accounts receivable may be a high risk but not a significant risk; that is, no special audit consideration is required beyond extensive but customary substantive procedures of collectability.) (ISA 315 par. 27)

1.31 Special audit consideration for significant risks means you should

a. obtain an understanding of your client's controls, including control activities, relevant to that risk. (ISA 315 par. 29)

b. perform other appropriate procedures that are linked clearly and responsive to the risk. Moreover, when your approach to significant risks consists *only* of substantive

procedures, you should include tests of details. (ISA 330 par. 21) Substantive procedures related to significant risks should not be limited solely to analytical procedures. For other risks, effective analytical procedures alone may sometimes provide sufficient evidence. Note that if you *are* testing controls over significant risks, you may be able to limit your substantive procedures to only analytical procedures.

c. if you tend to rely on controls related to a significant risk, test the operating effectiveness of those controls in the current period. (ISA 330 par. 15) Reliance on tests of controls performed in a prior period is not appropriate for a significant risk.

d. document those risks you have identified as significant.

1.32 The determination of significant risks is a matter for your professional judgment. In exercising that judgment, you should first consider only inherent risk and not control risk. Paragraphs 5.30–.37 of this publication provide more guidance on how to determine significant risks. (ISA 315 par. 28)

Responding to Assessed Risks

1.33 The risk assessment process culminates with your articulation of the account balances, classes of transactions, or disclosures where material misstatements are most likely to occur and how those misstatements may occur, given the unique circumstances of your client. This assessment of the risk of material misstatement, which relates identified risks to what can go wrong at the assertion level, provides a basis for designing and performing further audit procedures.

1.34 You perform further audit procedures to obtain the audit evidence necessary to support your audit opinion. Further audit procedures are defined as tests of controls and substantive procedures. Often, a combined approach using both tests of controls and substantive procedures is an effective approach.

1.35 In determining the nature, timing, and extent of further audit procedures, you should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level. You should provide a clear linkage between the risk assessments and the nature, timing, and extent of the further audit procedures. (ISA 330 par. 6)

1.36 Audit procedures performed in previous audits and suggested procedures provided by illustrative audit programs may help you understand the types of further audit procedures it is possible for you to perform. However, prior year procedures and example audit programs do not provide a sufficient basis for determining the nature, timing, and extent of audit procedures to perform in the current audit. Your assessment of the risks of material misstatement in the current period is the primary basis for designing further audit procedures in the current period.

Identification and Communication of Internal Control Matters

1.37 Your objective in an audit is to form an opinion on the client's financial statements as a whole. Your objective is not to identify deficiencies in internal control, and you are not required to perform procedures to identify all deficiencies in internal control. Nevertheless, your application of audit procedures or communications with management or others may make you aware of deficiencies in the client's internal control. (ISA 265 par. 2)

1.38 A deficiency in internal control exists when a control is designed, implemented, or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing. (ISA 265 par. 7) You should evaluate the deficiencies in internal control you identify during the course of your audit and determine whether these deficiencies, individually or in combination, are significant deficiencies. (ISA. 265 par. 8) You are required to communicate in writing to those charged with governance those deficiencies in internal control that, in your judgment, constitute significant deficiencies. (ISA 265 par. 9)

Audit Documentation

1.39 ISA 230, *Audit Documentation*, provides requirements that apply to the risk assessment process. Your audit documentation should be sufficient to enable an experienced auditor, having no previous connection to the audit, to understand

- the nature, timing, and extent of the audit procedures performed;
- the results of the audit procedures performed, and the evidence obtained; and
- the significant matters, and conclusions reached, and professional judgments made.

Subsequent chapters of this publication illustrate the application of the audit documentation requirements.

(ISA 230 par. 8)

1.40 The form and extent of audit documentation is for you to determine using professional judgment. ISA 230 provides general guidance regarding the purpose, content, and ownership and confidentiality of audit documentation. Examples of common documentation techniques include narrative descriptions, questionnaires, checklists, and flowcharts. These techniques may be used alone or in combination.

1.41 The form and extent of your documentation are influenced by the following:

- The nature, size, and complexity of the entity and its environment
- The availability of information from the entity
- The specific audit methodology and technology used in the course of the audit

Observations and Suggestions

For example, documentation of the understanding of a complex information system in which a large volume of transactions are electronically initiated, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an information system for which few transactions are processed (for example, long-term debt), documentation of the system in the form of a memorandum may be sufficient. Generally, the more complex the entity and its environment, and the more extensive the audit procedures performed by the auditor, the more extensive your documentation should be.

The existence of good client documentation can also help reduce the extent of required audit documentation as you document your understanding of the controls. Where the client has good documentation, it can minimize the cost of producing audit documentation through leveraging the existing documentation and focusing auditor documentation on the assessment of the controls.

You may relate your client's controls to control objectives and assertions for the most significant processes of an entity, regardless of the way control processes are documented by the client. By documenting your evaluation of controls using control objectives and assertions, you will more easily identify objectives that are not fully addressed by the client's system of internal control (gaps). When your client directly relates its documentation to COSO objectives and assertions, savings in audit time can be achieved.

The specific audit methodology and technology used in the course of the audit will also affect the form and extent of documentation. For example, a firm may require the use of a risk matrix (for example, by account and by assertion) to summarize the elements of the risks of material misstatement. That may simplify the documentation and linkage process. Also, firms may require the use of electronic working papers and the use of active electronic links, which may facilitate the documentation process and navigation between working papers.

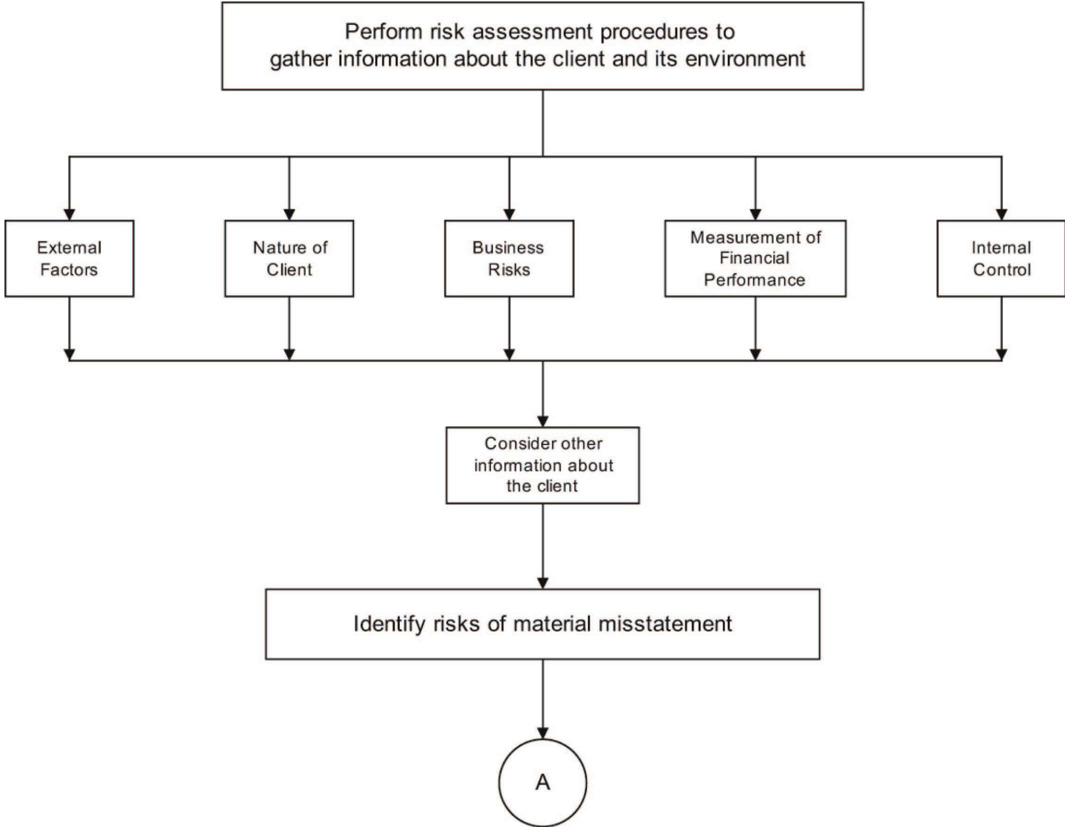
Summary

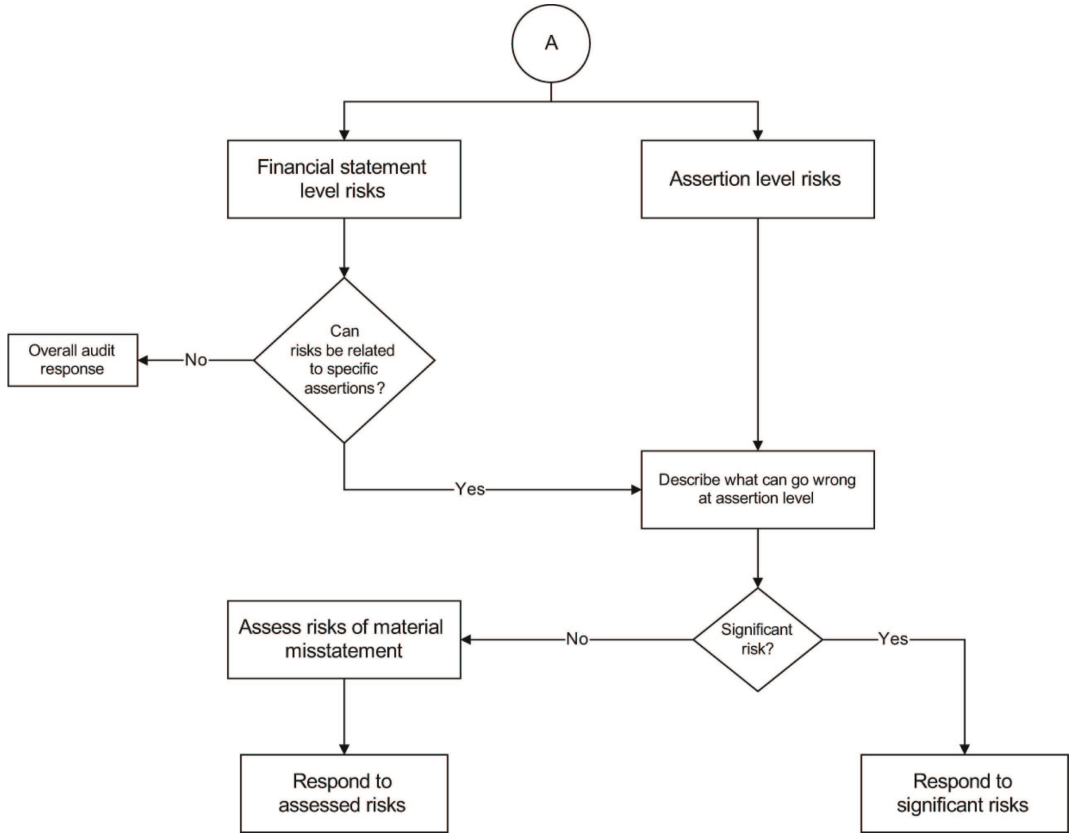
1.42 Illustration 1-2 summarizes the guidance provided in this chapter.

Chapters 3–6 of this publication provide more detailed guidance, examples, and illustrations of the overview material described in this chapter. To apply this guidance on your audit, you will need to have a working knowledge of key risk assessments and terms. The next chapter of this publication provides you with this knowledge.

Illustration 1-2

Summary of the Risk Assessment Process





1.42

Chapter 2

Key Concepts Underlying the Auditor's Risk Assessment Process

This publication describes how you as the auditor assess and respond to audit risk in a financial statement audit in practice. It describes a process to gather information, assess and respond to identified risks, and evaluate evidence on your audits.

To appropriately apply this process to your audits, you will need to have a working knowledge of the key concepts upon which the process is built. The purpose of this chapter is to provide working definitions of those key concepts.

Reasonable Assurance

2.01 The auditing standards make numerous references to your responsibility for obtaining *reasonable assurance*. For example, your audit opinion states that ISAs require you to "obtain reasonable assurance about whether the financial statements are free of material misstatement." For this reason, it is important that you have a working knowledge of the term.

2.02 Reasonable assurance is a high level of assurance. Put another way, you should plan and perform your audit in such a way that audit risk is reduced to an acceptably low level. The auditor is not expected to obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. (ISA 200 par. 5)

Audit Risk and the Risks of Material Misstatement

2.03 *Audit risk* is the risk that the financial statements are materially misstated and the auditor expresses an inappropriate opinion. You should perform your audit to reduce audit risk to an acceptably low level. You will consider audit risk at all stages of your audit. (ISA 200 par. 13)

2.04 Audit risk is a function of two components:

a. *Risks of material misstatement*, which are the risks that an assertion, account, or disclosure item contains a material misstatement.

b. *Detection risk*, which are the risks that the auditor will not detect such misstatements.

(ISA 200 par. 13)

2.05 To reduce audit risk to an acceptably low level you will

a. assess the risks of material misstatement, and

b. based on that assessment, design and perform further audit procedures to detect material misstatements.

Assessing the Risks of Material Misstatement

2.06 To assess the risks of material misstatement you should obtain an understanding of the client and its industry. The understanding should include the following:

- The industry, its regulatory environment, and other external factors
- The nature of the entity, for example its operations, ownership, and financing
- The entity's selection and application of accounting policies
- The entity's objectives, strategies, and related business risks
- How management measures and reviews the entity's financial performance
- The entity's internal control

(ISA 315 par. 12–13)

Thus, the first step in assessing the risks of material misstatement is to gather information and gain an understanding of these matters.

2.07 You are required to assess risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures: (ISA 315 par. 25)

- 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 different assertions. For example, a lack of qualified personnel in financial reporting roles (an element of the client's control environment) may affect many different accounts and several assertions.
- Risks of material misstatement at the assertion level relate to one or more specific assertions in an account or in several accounts, for example, the valuation of inventory or the occurrence of sales.

2.08 Your specific response to assessed risk may differ depending on whether the risk resides at the financial statement or assertion level:

- Financial statement level risk typically requires an overall response, such as providing more supervision to the engagement team or incorporating additional elements of unpredictability in the selection of your audit procedures.
- Assertion level risk is addressed by the nature, timing, and extent of further audit procedures, which may include substantive procedures or a combination of tests of controls and substantive procedures.

For this reason, you should assess the risks of material misstatement at both the financial statement and the assertion level. (ISA 315 par. 25)

Observations and Suggestions

In many instances, it may be possible to relate financial statement level risk to an individual assertion or small group of assertions. For example, the selection and application of accounting policies typically is thought of as a financial statement level risk because it has the potential to affect the financial statements as a whole. However, at your client, you may determine that the selection and application of accounting policies is a risk only for revenue recognition, as all other accounting policies that are relevant to the client (for example, depreciation policies) do not pose a risk.

To the extent possible, you will want to relate financial statement level risk to individual assertions, as this will help you design more effective further audit procedures.

As mentioned previously, building unpredictability into audit procedures is a way to respond to some risks. Unpredictability can be achieved by varying the nature, extent, and timing of the audit procedures applied to various accounts, even when risks appear to be consistent from period to period. Inventory test counts present significant opportunities for applying this concept when inventories are significant to operations. Payroll tests may also be varied to reduce predictability.

2.09 Your assessment of the risks of material misstatement (at both the financial statement and the assertion level) should be directly linked to your overall audit response and to the design and performance of further audit procedures. For example, if your understanding of the client, its environment, and its internal control leads you to assess that there is a significant risk that inventory quantities are overstated, you would design further audit procedures to specifically respond to that risk.

Risks of Material Misstatement at the Assertion Level

2.10 The risks of material misstatement consist of two components:

a. *Inherent risk*, which is the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. Inherent risk is higher for some assertions and related account balances, classes of transactions, and disclosures than for others. Table 2-1 provides examples of some factors that affect inherent risk.

b. *Control risk*, which is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure, and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. Control risk is a function of the effectiveness of the design, implementation, and maintenance of the client's internal control.

(ISA 200 par. 13)

Table 2-1

Inherent Risk Factors

Factor	*Comments*	*Example*
Volume	Voluminous transactions may increase the risk of misstatement.	High volume may create a strain on most processing systems.
Complexity	Complex calculations used to determine the account balance or disclosure are more likely to be misstated than simple calculations.	The accuracy assertion of a sales transaction that involves a stated number of items at a set price is less likely to be misstated than the same assertion for gain on the sale of a loan that requires present value calculations of variable cash flow streams.
Susceptibility of the asset to theft	Accounts that report the balance of assets that are highly susceptible to theft or misappropriation are more likely to be misstated than other accounts.	The existence assertion related to an office building is less likely to be materially misstated because of theft than the existence of inventory items that are small and easily transportable, such as microprocessors.
Estimates	Accounts consisting of amounts derived from accounting estimates that are subject to significant measurement uncertainty pose a greater risk than do accounts consisting of relatively routine, factual data.	The valuation assertion related to fixed assets such as a building is less likely to be materially misstated than the valuation assertion for technology-sensitive inventory.
Industry circumstances	Industry or general economic conditions may create risks of material misstatement.	Technological developments, changes in processes, or regulatory action might make a particular product obsolete, thereby increasing the inherent risk related to the valuation assertion of inventory.
Other external circumstances	Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may influence the inherent risk related to a specific assertion.	For example, a company that provides goods to a declining industry characterized by a large number of business failures may have increased inherent risk related to the valuation assertion of accounts receivable.

2.10

The Primary Direction of Inherent Risk

2.11 Your evaluation of inherent risk also might indicate the primary direction of the risk, that is, whether an account will most likely be overstated or understated. For example, you may determine that inherent risk for inventory is related primarily to overstatement, whereas the risk for accounts payable is understatement. Understanding the direction of inherent risk for an account or a class of transactions can help you evaluate control design and plan and perform further audit procedures.

2.12 Inadvertent, random errors rarely favor one direction or another. However, in most audits, there is a primary direction of overall inherent risk resulting principally from factors that tend to influence management's judgments with regard to selecting accounting policies or making estimates. (Since the financial statements are often used by investors and lenders to evaluate performance, the primary direction is usually, but not always overstatement of assets and income.) The possibility of management or employee fraud causes other factors to influence the direction of risk.

2.13 To determine the primary direction of inherent risk you may wish to consider factors such as

- how the financial statements are likely to be used (for example, the owners of a privately held company often are concerned with tax savings, particularly when profitable and in strong financial condition, which indicates the potential for understatement of income);
- management's business or financing plans or other objectives (for example, substantial management bonuses based on earnings or the need to present a strong financial position to obtain financing both indicate greater probability of overstatement of income); and
- your prior experience with the client (you may consider the predominant direction of misstatements found in prior audits, and whether they were consistent with the primary direction of your auditing in those years, as a possible predictor of what you can expect to find this year).

In combination with the assessment of the risk of misstatement and an assessment of the magnitude of possible exposure, the primary direction of the misstatement risk can be used to guide you in the selection of efficient and effective procedures when determining their nature, timing, and extent.

Detection Risk

2.14 Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptable low level. It is a function of the effectiveness of your audit procedures and how you apply them. (ISA 200 par. 13)

Observations and Suggestions

Detection risk does not include the risk that the auditor may draw the wrong conclusion from the audit evidence. It also does not include the risk that the auditor will not apply an appropriate procedure or apply a procedure incorrectly. This risk is managed by, for example, effective, engagement planning, proper assignment of personnel to the engagement team, and supervision and review of the audit work performed.

2.15 Detection risk relates to your further audit procedures and is managed by how you respond to the risks of material misstatement at both the financial statement and the assertion level.

- *Financial statement level risks*. Some financial statement level risks affect most, if not all, accounts and their assertions. For those types of pervasive risks, it may not be practicable to develop assertion level risks for all affected assertions. Therefore, in response to pervasive financial statement level risks, you will make choices related to the assignment of personnel to the engagement team, the emphasis of the application of professional skepticism, and the supervision and review of the audit work performed. Appropriate choices related to these matters will help you mitigate the risk

that you might select an inappropriate audit procedure, misapply audit procedures, or misinterpret the results.

- *Assertion level risks*. In response to assertion level risks, you will choose the test you wish to perform, and determine the timing of the test and its extent. The nature, timing, and extent of your further audit procedures should be appropriate to respond to the assessed risk.

Thus, the effectiveness of further audit procedures depends on how closely they are driven by or linked to your assessment of the risks of material misstatements.

2.16 At the assertion level, detection risk has an inverse relationship to the risks of material misstatement at the assertion level. The greater the risks of material misstatement, the less the detection risk that you can accept, and, accordingly, the more persuasive the audit evidence required by the auditor.

2.17 Conversely, when the risks of material misstatement are low, you can accept a greater detection risk. However, you should design and perform substantive procedures for material account balances, classes of transactions, and disclosures, regardless of your assessment of the risks of material misstatement for the assertions. (ISA 330 par. 18)

2.18 The model Audit Risk = Risk of Material Misstatement × Detection Risk expresses the general relationship of audit risk and its components. You may find this model useful when planning appropriate detection risk levels for your audit procedures, keeping in mind your overall desire to reduce audit risk to an acceptably low level.

Materiality, Performance Materiality, and Tolerable Misstatement

The Concept of Materiality

2.19 The concept of materiality recognizes that some matters are more important for the fair presentation of the financial statements than others. In performing your audit, you are concerned with matters that, individually or in the aggregate, could be material to the financial statements. Your responsibility is to plan and perform the audit to obtain reasonable assurance that you detect all material misstatements, whether caused by error or fraud. (ISA 320 par. A1)

2.20 The auditor's determination of materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of the users of the financial statements. Table 2-2 summarizes the assumed characteristics of the users that you should consider when determining materiality. (ISA 320 par. 4) The amount that users may consider material are influenced by several factors including the nature of the entity (for profit or not-for-profit), and its current and past performance. As such, it is unlikely that a single benchmark or percentage, or both could adequately address user needs for all entities and circumstances. Professional judgment considers the various relevant factors when determining materiality for a specific entity. Paragraphs A3–A7 in ISA 320, *Materiality in Planning and Performing the Audit*, include a discussion of the use of benchmarks in determining materiality. Materiality is also addressed in chapter 3, "Planning and Performing Risk Assessment Procedures," of this publication.

Table 2-2

Characteristics of Financial Statement Users

The determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of financial statements. Users are assumed to

a. have a reasonable knowledge of business and economic activities and accounting.

b. have a willingness to study the information in the financial statements with reasonable diligence.

c. understand that financial statements are prepared and audited to levels of materiality.

(continued)

d. recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events.

e. make reasonable economic decisions on the basis of the information in the financial statements.

The determination of materiality, therefore, takes into account how users with such characteristics could reasonably be expected to be influenced in making economic decisions.

(ISA. 320 par. 4)

How Materiality Is Used in Your Audit

2.21 Though defined by the accounting literature, materiality also is an audit concept of critical importance. From the auditor's perspective, materiality represents the maximum amount that you believe the financial statements could be misstated and still fairly present the client's financial position, results of operations, and cash flows. Materiality affects the following:

a. The nature, timing, and extent of audit procedures. During audit planning, you should determine a materiality level for the financial statements as a whole. This initial determination of materiality will help you determine performance materiality, which will help you

i. make judgments when identifying and assessing the risks of material misstatement, and

ii. determine the nature, timing, and extent of your tests of controls (if any) and your substantive audit procedures.

Chapter 3 of this publication provides more detail on how to determine and use materiality and performance materiality for audit planning purposes. Chapter 5, "Risk Assessment and the Design of Further Audit Procedures," of this publication describes how your initial determination of materiality may change as your audit progresses.

b. The evaluation of audit findings. To form an opinion about the financial statements, you will need to evaluate audit findings and determine whether the misstatements that are not corrected by the client are material to the financial statements. Chapter 6, "Performing Further Audit Procedures," of this publication provides detailed guidance on how to use materiality to evaluate audit findings.

Quantitative and Qualitative Considerations

2.22 Although materiality commonly is expressed in quantitative terms, your determination of materiality is a matter of professional judgment that includes both quantitative and qualitative considerations. As described in more detail in chapter 7, "Evaluating Audit Findings, Audit Evidence, and Deficiencies in Internal Control," of this publication, qualitative considerations mostly influence your evaluation of audit findings and the determination of whether uncorrected misstatements are material. During the course of your audit, you should be alert for misstatements that could be qualitatively material. However, it ordinarily is not practical to design audit procedures to detect misstatements that qualitatively are material, and for that reason, materiality used for planning purposes considers primarily quantitative matters.

Performance Materiality

2.23 As described in paragraph 2.21, during audit planning you should determine an initial level of materiality for the purposes of designing and performing your audit procedures. This initial determination of materiality is made for the financial statements as a whole. However, in designing your audit procedures, the possibility exists that several misstatements of amounts less than performance materiality could—in the aggregate—result in a material misstatement of the financial statements. (ISA 320 par. A12)

2.24 For example, suppose that for planning purposes you determined materiality to be $100,000, and you designed your audit to obtain reasonable assurance that misstatements of that magnitude were detected. Because of the way you designed your audit, you may not detect a misstatement of $80,000, which is acceptable because the amount is not considered material.

However, what if you failed to detect two misstatements of $80,000? Individually, each misstatement would not be material, but when aggregated, the total misstatement is greater than materiality. Thus, materiality for the financial statements as a whole would not be appropriate for assessing risk and performing further audit procedures at the assertion level.

2.25 Performance materiality is the adjustment of financial statement materiality to the assertion level. This adjustment is necessary to make an allowance for misstatements that might arise in other accounts as well as make a provision for possible misstatements that might exist in the financial statements, but were not detected by the audit procedures. Performance materiality effectively creates a margin for error in your audit plan to take into consideration misstatements that are not detected as part of the audit.

2.26 *Performance materiality* is defined as the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, *performance materiality* also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. For each class of transactions, account balance, and disclosure, you should determine at least 1 level of performance materiality. For example, if your overall financial statement materiality for audit planning purposes was $100,000, you might determine performance materiality for testing receivables to be $70,000. Some firms use a guideline of, for example, 50 percent to 75 percent of materiality when setting performance materiality at the account or detailed level for the average audit situation. Appendix G, "Matters to Consider in Determining Performance Materiality," of this publication provides further discussion and guidance on this point. Performance materiality can also be used to identify significant accounts as well as design effective, sufficient substantive samples and other audit procedures, and evaluate audit results.

(ISA 320 par. A12)

Tolerable Misstatement

2.27 As described in paragraph A3 of ISA 530, *Audit Sampling*, *tolerable misstatement* is the application of performance materiality to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount smaller than performance materiality.

Observations and Suggestions

When there are multiple samples or procedures involving estimation to be applied to a specific account, balance, or class of transactions, you may set tolerable misstatement for each test at less than performance materiality for the same reasons that performance materiality is specified at less than materiality (for example, to make a provision for possible misstatements that might exist, but were not detected by the audit procedures as discussed in paragraph 2.24). Each test may need to seek misstatements smaller than the performance materiality for the account, balance, or class of transactions, so that when aggregated, the procedures provide the desired assurance that the risk of material misstatement has been reduced to a low level.

For example, in an audit of inventory balances, several procedures may be performed related to the overall balance. Tests may be applied to verify the physical existence of the inventory quantities, other tests may be performed to verify the costs associated with inventory items and independent tests may also be performed to determine whether the inventories might require a write-down for obsolescence or other issues. Setting tolerable misstatement (for example, $60,000) at less than performance materiality (for example, $70,000) for each of the tests provides some assurance that the combined test results will provide the desired assurance that performance materiality has not been exceeded.

The more tests performed, the greater likelihood that some misstatement will be identified and the greater likelihood that misstatements may remain uncorrected in the financial statements, the more "cushion" is needed (lower tolerable misstatement) relative to the performance materiality. For example, the performance of multiple tests, and a likelihood of encountering misstatements may warrant reduction of tolerable misstatement to $50,000 from $60,000.

Financial Statement Assertions

Observations and Suggestions

Your audit is designed to result in an opinion on the financial statements *as a whole*, and audit risk is expressed as a risk that relates to the entire financial statements. However, to reach this opinion on the financial statements, most of your audit procedures should be directed at a much more detailed level, the assertion level.

Put another way, you can view the financial statements as an accumulation of a large number of individual assertions. Individual assertions may be aggregated to form an account or disclosure item, and several accounts or disclosure items may then be aggregated to form a line item on the financial statements or a disclosure. Many of your audit procedures are performed not on the financial statements as a whole nor even at the account or disclosure level, but rather, they are directed at individual assertions.

Relating identified risks of material misstatement to misstatements that might occur at the assertion level is necessary for you to properly link assessed risk to your tests of controls and substantive audit procedures.

Appendix D, "Illustrative Financial Statement Assertions and Examples of Substantive Procedures Illustrations for Inventories of a Manufacturing Company," of this publication may be helpful to you in illustrating the linking of assertions to specific substantive procedures designed to address them.

2.28 An assertion is a declaration or a positive statement. In presenting their financial statements, management makes implicit or explicit assertions about the information presented. For example, by presenting the information "Cash....$XXX" in the financial statements, management makes the following assertions:

- The cash truly exists and company has the right to use it (existence).
- The amount presented represents *all* the company's cash (completeness).
- The amount presented is accurate (accuracy).

2.29 In general, assertions relate to the way in which financial statement information is

- recognized,
- measured,
- presented, and
- disclosed.

2.30 Table 2-3 provides a summary of how assertions might be grouped into various categories. You may express these assertions differently, as long as your descriptions encompass all of the aspects described in table 2-3.

Observations and Suggestions

For example, some auditors may call rights and obligations "ownership" and others may subsume the rights and obligations assertion within the existence assertion. Some may treat cut-off as either an existence or a completeness issue and not identify it as a separate assertion. In any case, as long as the assertions used cover the risks, there is no requirement to use one specific convention for naming assertions.

Table 2-3

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/ Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred and pertain to the entity.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	—
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described and information in disclosures is expressed clearly.

Relevant Assertions

2.31 For any given account, some assertions will be relevant whereas others may not be. For example, valuation typically is not relevant for cash (denominated in the currency that the entity uses for financial reporting, like dollars) or for the physical quantities of inventory. As they relate to cash, completeness and existence/occurrence always are relevant. However, valuation would

be relevant to the allowance for obsolete inventory or for cash if the presentation of cash involved a currency translation.

2.32 To conduct your audit, you will exercise professional judgment to determine what assertions are relevant and whether they have a meaningful bearing on whether the account balance, class of transactions, or disclosures that are the subject of your audit procedures are fairly stated.

2.33 To identify relevant assertions, you may determine the most likely ways that the given account, class of transactions, or disclosure could be misstated by considering the nature of the assertion, the volume of transactions, and nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion. For example, the gross balance of accounts receivable could be misstated if

- one or more individual receivables did not exist at the balance sheet date (existence),
- the client failed to record a receivable that did exist at the balance sheet date (completeness),
- a long-term receivable was presented as a current asset (classification), or
- a long-term receivable was not accurately reported, for example, by inappropriately discounting the receivable (valuation).

Observations and Suggestions

There are often multiple sources of risk that can cause an assertion to be misstated.

For example, completeness may not be achieved if transactions are not captured in the accounting system or if they are captured, but not processed on a timely basis or incorrectly accounted for. Thus the completeness assertion could relate to more than one defined risk. Thus, assertions do not necessarily have a one-to-one correspondence with risks, but are still a helpful aid in ensuring that audit procedures are related to the identified risks.

It may be necessary to design several procedures related to completeness to address the risk in an account for the completeness assertion.

How You Use Assertions on Your Audit

2.34 Most of your tests of controls and substantive audit procedures are directed at specific assertions. For example, observation of inventory provides strong, direct evidence about the existence of inventory and it may provide some evidence about valuation of the allowance for inventory obsolescence.

For this reason, to establish a clear link between your assessment of the risks of material misstatement and further audit procedures, your risk assessment procedures should be performed at the assertion level as well. This will directly assist with determining the nature, timing, and extent of further audit procedures to obtain sufficient appropriate audit evidence.

For example, if the risk of obsolescence (a valuation risk) is important in valuing inventory, the explicit use of the valuation assertion when assessing the risk, documenting the controls, and designing for the audit plan further tests such as evaluating turnover by product, or selecting specific items to test for valuation issues, will help establish the linkage of the risk and the related audit procedures.

Observations and Suggestions

The conceptual audit risk model is expressed at the overall financial statement level. However, in the conduct of your audit, you can apply the model at the account and assertion level. That is, at the assertion level, audit risk is the risk that in an account or transaction stream, the *assertion* is materially misstated and you fail to detect the misstatement.

This is helpful to keep in mind when designing tests. A receivables confirmation procedure may provide no assurance about completeness and little about valuation, but may provide assurance on existence. Other tests and procedures need to be designed to address the assertions not addressed or weakly addressed by the confirmation.

Certain accounts and assertions in accounts may be more susceptible to overstatement than understatement, or vice versa. Consideration of this susceptibility can be helpful in designing appropriate audit procedures to address the risk. For example, in auditing the accuracy of inventory costing, both overstatement and understatement might be encountered, however if testing the existence of inventories, overstatement might be the focus of the risk. Further, to test the completeness of liabilities at year-end, it may be necessary to test subsequent payments for unrecorded liabilities.

As a quick check, every assertion in an account may have a link to one or more of the auditor's procedures as a basis for the auditor's conclusion. The absence of any procedure to address, say, completeness or existence, may indicate an incomplete strategy.

Definition of *Internal Control*

2.35 As defined in paragraph 4 of ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, *internal control* is a process designed, implemented, and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Further, internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. In summary, internal control objectives fall into three categories: financial reporting, operations, and compliance with laws and regulations. In general, when performing a financial statement audit, you are most concerned with the client's financial reporting objectives, which relate to the preparation of reliable published financial statements. Only when operating and compliance activities affect financial reporting are these aspects relevant to you.

How the Definition of Internal Control Is Relevant to Your Audit

A Process

2.36 Internal control is not one event or circumstance, but a series of actions that permeate an entity's activities. These actions are pervasive and are inherent in the way management runs the business. As described more completely in chapter 3 of this publication, your understanding of the client and its environment is audit evidence that ultimately supports your opinion on the financial statements. An understanding of internal control assists you in identifying types of potential misstatements and factors that affects the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures.

Implemented by Entity Personnel

2.37 Internal control is put in place by those charged with governing the client (for example, the board of directors), management, and other client personnel. Client management is responsible for adopting sound accounting policies and for establishing and maintaining effective internal control. The results of your audit procedures may provide evidence about the effectiveness of internal control, but these procedures are not part of the entity's internal control. For example, your detection of a material misstatement in the financial statements that was not identified by the entity indicates that there may be a significant deficiency in internal control, notwithstanding the fact that management of the entity expects the audit to identify and correct such misstatements. The COSO framework indicates that the auditor is not an element in the controls of the entity. Chapter 7 provides additional guidance on the evaluation and communication of control deficiencies.

The Achievement of Management's Objectives

2.38 Every client establishes objectives it wants to achieve. In trying to achieve its objectives, your client faces certain risks. Internal control helps the entity achieve its objectives by mitigating the risk of "what can go wrong" in the pursuit of an entity's objectives. Thus, there is a direct link between your client's objectives, the risk to achieving those objectives, and internal

control. Your assessment of internal control effectiveness is a consideration of whether the controls effectively mitigate financial reporting risks.

Observations and Suggestions

Many entities from different types of industries will share the same control objectives. For example, all entities will want to make sure that their cash disbursements were for legitimate business expenses that were properly authorized; businesses will want to make sure that all legitimate revenue transactions get recorded.

However, the way in which the entity achieves these objectives—that is, the actual control procedures themselves—can vary greatly. For example, the way in which a bank controls its revenue transactions will be much different from the procedures followed by a retail sales business. Even within the same industry, companies can satisfy the control objectives in revenue using different controls.

When evaluating the design of internal control, focus on the achievement of control objectives, not the presence or absence of specific control procedures. The benchmark for evaluating the effectiveness of your client's internal control is to determine whether the control policies and procedures are capable of achieving control objectives.

Typically, your clients will not have stated explicitly all their control objectives. To help articulate their implicit control objectives, consider financial statement assertions. For example, for revenue transactions, implicit control objectives include ensuring that *all* valid sales are captured and processed by the system (completeness assertion) and that *only* valid transactions are captured and processed (occurrence).

2.39 An entity generally has a multitude of objectives and controls. You are not required to gain an understanding of *all* controls, only those that are "relevant to the audit." In most cases, controls that are relevant to an audit pertain to the client's objective of preparing financial statements and disclosures for external purposes that are fairly presented in conformity with generally accepted accounting principles. Relevant controls also may include controls over safeguarding company assets against unauthorized acquisition, use, or disposition. (ISA 315 par. 12)

2.40 Controls relating to operations and compliance objectives may be relevant to an audit if they pertain to information or data the auditor evaluates or uses in applying audit procedures or if they have an effect on financial reporting or disclosure. For example, the following may be relevant to an audit:

a. Controls pertaining to nonfinancial data that management uses to operate the business and that the auditor uses in analytical procedures (for example, production statistics)

b. Controls over compliance with income tax laws and regulations that affect the income tax provision, which pertain to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements

Observations and Suggestions

Often, the situations described in paragraph 2.40 are not easy to identify early in the audit process. Rather, you may identify these situations only later in the audit while performing fieldwork. For example, you may be performing an analytical procedure related to inventory and become aware of production statistics that will help you create more reliable analytical procedures.

In those situations, be sure to consider the completeness and accuracy of the report you are using to perform your analytical procedure. It is helpful to start by understanding, for example, how the report was prepared, the source of the information used to prepare the report, and who or by what means it was prepared. This background information will help you understand "what could go wrong" in maintaining the completeness and accuracy of the report. This process may cause you to identify as relevant some controls that you previously did not think were relevant to the audit.

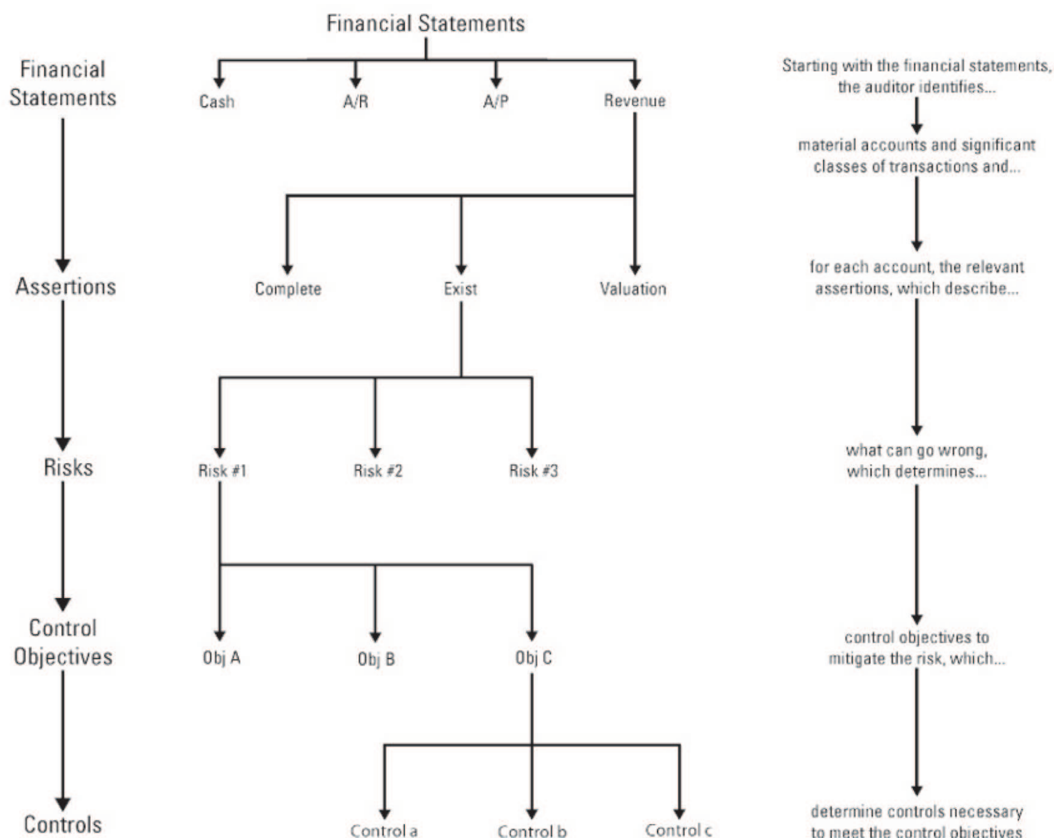
Auditing is iterative. The performance of certain procedures may cause you to revisit procedures you performed or conclusions you reached earlier in the audit.

The Top-Down Approach to Understanding Internal Control

2.41 Although not defined by the standards, you may use the "top-down" approach for understanding internal control. This approach is a framework for applying risk assessment procedures needed to understand the five components of internal control sufficient to assess the risks of material misstatement of the financial statements and to evaluate the design of controls relevant to an audit of financial statements. The top-down approach is helpful in driving both audit effectiveness and audit efficiency. Illustration 2-1 describes this approach.

Illustration 2-1

Diagram of the Top-Down Approach



Applying the Top-Down Approach

2.42 To apply the top-down approach, start with the financial statements at the "top" of the diagram and work "down" to the individual controls.

- The top-down approach begins at the financial statement level and with your understanding of the overall risks of material misstatement.
- The next step is to identify the material accounts and classes of transactions in the client's operations that are significant to the financial statements. Identify the assertions related to those accounts.
- At the assertion level, the risk of material misstatement (or "what can go wrong") is another way of stating the opposite or the reverse of the assertion. For example, the risk associated with the completeness assertion may be phrased as the risk that not all valid transactions are captured by the system.

- Identifying what can go wrong allows you to understand control objectives. In this example, "ensure that all valid transactions are captured" is a control objective that relates to the completeness assertion and the risk is that not all valid transactions are captured.
- Once you understand the control objective and the assertion, you then identify those controls that mitigate the risk that the control objective and the assertion will not be achieved.

2.43 The top-down approach will help you properly scope the audit. You are not required to assess *all* the control activities that exist at the client. By focusing on control objectives related to the assertions for material accounts and significant classes of transactions, the top-down approach helps you identify and focus on key controls that meet the control objectives. (ISA 315 par. 20)

2.44 The top-down approach helps you better assess design effectiveness. If control objectives are not being met, for example because of missing controls or poorly designed ones, then a control deficiency exists and needs to be evaluated pursuant to ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*. Additionally, knowledge of the control deficiency will assist you in designing the nature, timing, and extent of your substantive procedures to appropriately respond to those higher risks.

Observations and Suggestions

In addition, the top-down approach includes the early consideration of entity level controls such as the control environment and common control processes across a complex organization, as well as the effectiveness of IT general controls. By considering the effectiveness of these more pervasive controls, or controls that affect other controls, you may be able to better plan your tests to achieve a low risk at a more efficient cost. Conversely, when deficiencies are identified in such controls, you might reconsider whether testing the more detailed controls that depend on these controls is justified until such deficiencies are corrected.

Key Characteristics of Internal Control

2.45 It is important for you to understand the key characteristics of internal control that serve as the foundation for the way in which you consider internal control in an audit. The purpose of this section is to provide you with that understanding.

The Five Components of Internal Control

2.46 ISA 315 requires you to obtain an understanding of internal control relevant to the audit. Components of internal control described in paragraph A51 of ISA 315 are presented in the following and are consistent with the COSO integrated framework:

a. *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

b. *Risk assessment* is the entity's identification and analysis of relevant risk to achievement of its objectives, forming a basis for determining how the risk should be managed.

c. *Information and communication systems* support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

d. *Control activities* are the policies and procedures that help ensure that management directives are carried out.

e. *Monitoring* is a process that assesses the quality of internal control performance over time.

Appendix C, "Internal Control Components," of this publication contains a discussion of the internal control components.

How to Use the COSO Framework

2.47 This division of internal control into five components provides a useful framework for you to consider how different aspects of your client's internal control may affect the audit. When performing an audit, your objective in considering internal control is not to classify controls into a particular component. Rather, your understanding of internal control centers around whether and how a specific control has been designed and implemented to prevent or detect and correct material misstatements.

2.48 The way in which an entity designs and implements internal control varies with its size and complexity. If your client lacks some of the detailed control elements described in appendix C of this publication, you may consider the absence of these control elements within the context of the circumstances at the entity. For example, a small, relatively noncomplex entity with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures or detailed written policies. Therefore, the components of internal control may not be clearly distinguished within smaller entities, but their underlying purposes are equally valid.

Observations and Suggestions

Occasionally, this publication and the related auditing standards describe how the design of internal control (and therefore your evaluation of the effectiveness of that design) may vary for "smaller entities with *active management involvement in the financial reporting process* [emphasis added]."

When applying the guidance in these paragraphs and others relating to "smaller entities," it is important that you consider whether management truly is involved actively in the financial reporting process. Similarly, you should not mistake an owner-manager's active involvement in the operations of the business with active involvement in financial reporting.

In general, if you base your conclusions about internal control design on the owner-manager's active participation in the financial reporting process, you will need to obtain audit evidence that supports your conclusions about the owner-manager's active participation in financial reporting.

While small entities may sometimes enjoy the benefits of more active and direct management oversight, there is a corresponding risk of management override that must be considered.

Entity Versus Activity-Level Controls

2.49 Your client's financial reporting risk (and therefore its controls) may relate

a. to specific classes of transactions, account balances, and disclosures, or

b. more pervasively to the financial statements taken as a whole.

2.50 Controls designed to address pervasive risks are referred to in this publication as *entity-level* controls. Those that address risk related to specific classes of transactions, accounts, and disclosures are *activity-level* controls.

2.51 For example, the control environment is pervasive to the entity and potentially affects many assertions. In contrast, a control to ensure that all valid purchases are captured and recorded is restricted to specific accounts and classes of transactions and thus operates at the assertion level.

2.52 As described more completely in chapter 5, you should assess the risks of material misstatement at both the financial statement and the assertion level. To appropriately make that assessment, you will evaluate both entity- and activity-level controls.

2.53 Understanding whether a control is an entity- or activity-level control will help you determine the following:

- *The sequencing of your audit procedures*. Because entity-level controls are pervasive, it usually is more effective and efficient to evaluate the design and assess the implementation of entity-level controls *before* evaluating activity-level controls. This is because the failure to satisfy entity-level control objectives undermines any perceived effectiveness of activity-level controls. As an example, suppose there may likely be good

detailed controls over the revenues and cash cycle at the activity level. However, if there is a weak control environment caused by recent management overrides of controls, this factor could negate the potentially effective cash controls. Therefore, even though you still need to understand the controls at the activity level, there is no point in planning to test their operating effectiveness and rely on them.

- *The nature of tests you may perform to gather audit evidence*. Some entity-level controls may not be documented directly. For example, elements of the control environment include management's operating philosophy, their integrity, and ethical values. The range of audit procedures available to you to evaluate the design and implementation of these elements will be much different from the procedures that you may perform to evaluate other control procedures, such as the preparation of a bank reconciliation or the matching of a shipping report to an invoice.
- *An appropriate audit response*. Your further audit procedures (that is, tests of controls and substantive procedures) are performed at the assertion level. Strengths and weaknesses in activity-level controls will shape the further audit procedures directed at the related assertions. For example, if the client has well-designed and implemented controls over the recording of all payables that exist at the balance sheet date, the effectiveness of those controls will affect the design of your search for unrecorded liabilities.

  On the other hand, entity-level controls potentially affect many assertions. To the extent possible, you will first try to relate entity-level controls to what can go wrong at the financial statement level. For example, if the client has poor controls over the preparation of all accounting estimates, you can determine which accounts and related assertions are affected by estimates, and with that knowledge, adjust the nature, timing, and extent of your audit procedures in those areas accordingly.

  However, some entity-level controls may not be able to be related to what can go wrong at the assertion level. Weaknesses in the design or implementation of these controls may require you to develop an overall response to how you perform the audit. For example, if your client has a weak accounting staff, that weakness may cause you to reconsider how you staff the engagement.

Other Characteristics of Internal Control That May Affect Your Audit

Some Controls Are More Critical Than Others

2.54 Individual control policies and procedures are designed to achieve specific internal control objectives. In any internal control system, some controls may be more critical to achieving the control objective than others. For example, suppose that a controller uses an aging of accounts receivable to prepare an estimate of a valuation allowance. That estimate is reviewed for overall reasonableness and approved by the owner-manager of the company. The control performed by the owner-manager is important, but you may determine that the controls over the completeness and accuracy of the aging report are even more critical to achieving a reasonable estimate because without reliable underlying information, the chances for preparing a reasonable estimate are diminished greatly.

2.55 When planning the audit, it is helpful to identify those controls that are most critical to achieving financial reporting objectives. By identifying these critical (or *key*) controls, you can help ensure that the audit team gathers sufficient information about the design and implementation of the most significant aspects of the client's internal control.

2.56 Key controls often have one or both of the following characteristics:

- Their failure could materially affect the assertion, but might not be detected in a timely manner by other controls.
- Their operation might prevent other control failures or detect such failures before they have an opportunity to become material to the organization's objectives.

Complementary Controls

2.57 To evaluate the effectiveness of control design, the auditing standards direct you to determine whether the control "individually or in combination with other controls" is capable of

effectively preventing or detecting and correcting material misstatements. When considering and evaluating a combination of controls, it is helpful to distinguish between controls that are complementary and those that function jointly to achieve the same control objective.

2.58 In some instances, multiple control procedures are required to completely address a given control objective.

2.59 *For example, the City of Anytown collects a tax from each restaurant in the city based on a percentage of revenue. There are a large number of restaurants in the city, many of which go out of business and are replaced by new ones. One of the control objectives for the city is to make sure that all restaurants will report their revenue (completeness) and pay the required tax (accuracy). To address the completeness risk, the city has a list of all restaurants that paid the tax in the previous year. Current year remittances are compared against this list to help ensure that all restaurants required to pay the tax have paid. This control is only partly effective at achieving the completeness control objective because it does not fully address the addition of new restaurants or the closing of restaurants from the previous year. Information from this control needs to be followed up to determine whether nonpayers represent closed restaurants. However, the city has another control procedure that captures the granting of new restaurant licenses. These new licensees are then monitored during their first year of operation to ensure that they comply with a variety of city laws, including the requirement to pay the required tax. In this example, the monitoring of new restaurants and the comparison of remittances to a list of existing restaurants are complementary controls over completeness.*

In this situation, each control has a direct but limited effect on achieving the control objective, but in combination, the two controls do achieve the control objective. Because both of these control procedures are necessary to completely satisfy the control objective, you should determine that both of these controls have been implemented.

2.60 Complementary controls do not directly address a control objective but rather, they enable the effective functioning of the controls that do directly address the objective. In general, you should obtain an understanding of the design and implementation of controls that are directly related to an assertion. However, the effectiveness of controls that are directly related to an assertion may depend on other, complementary controls that are only indirectly related to an assertion. As discussed more completely in chapter 6 of this publication, when designing tests of controls for the purpose of relying on them as part of your audit strategy, you may consider the need to obtain evidence supporting the effective operation of both (*a*) the controls directly related to the assertion and (*b*) other, complementary controls on which these direct controls depend.

2.61 *For example, a credit manager may review an exception report of credit sales that exceed the customer's authorized credit limit. This control is designed to address risk related to unauthorized credit sales. But the effectiveness of this control procedure depends on the completeness and accuracy of the exception report that is reviewed by the credit manager. That is, evidence concerning the completeness and accuracy of the credit report is also relevant when designing tests of the operating effectiveness of the credit manager's review of the exception report.*

Preventive Versus Detective Controls

2.62 Controls can be categorized as one of two types:

- *Preventive controls* are designed to identify misstatements as they occur and prevent them from further processing. Preventive controls are performed more timely and help ensure that misstatements are never recorded in the accounting records to begin with. However, to design and perform preventive controls at each step in the processing stream may be costly.
- *Detective controls* are designed to detect and correct misstatements that already have entered the system. Detective controls often are cheaper to design and perform. However, the drawback to detective controls is that they are performed after the fact, sometimes well after the fact. The lack of timely performance of a detective control could mean that misstatements remain undetected in the accounting records for extended periods of time.

2.63 Whether preventive or detective, an effectively designed control contains both an error-detection and a correction component. The fact that a control procedure can identify a

misstatement does not make the control effective. It is the process of communicating identified misstatements to individuals who can then make corrections that makes the control complete.

2.64 Preventive and detective controls can be equally effective at achieving control objectives. However, as a practical matter, it is considered better by many controls experts to prevent a misstatement from entering the accounting system rather than relying on detecting and correcting one that has entered the system.

2.65 Most internal control systems rely on a combination of preventive and detective controls, and it is common to build some redundancy into the system, in which more than one control meets the same objective, especially when the inherent risk is high.

How IT Affects Internal Control

Observations and Suggestions

Understanding how your client uses and manages IT is central to understanding its internal control. IT is used in many different ways, for example, to initiate transactions, store data, or process information. How the technology is deployed can range from simple, off-the-shelf PC-based applications to much more complex, globally interconnected systems.

The purpose of the following section of this publication is to help you understand the key aspects of IT you may consider when gaining your understanding of internal control.

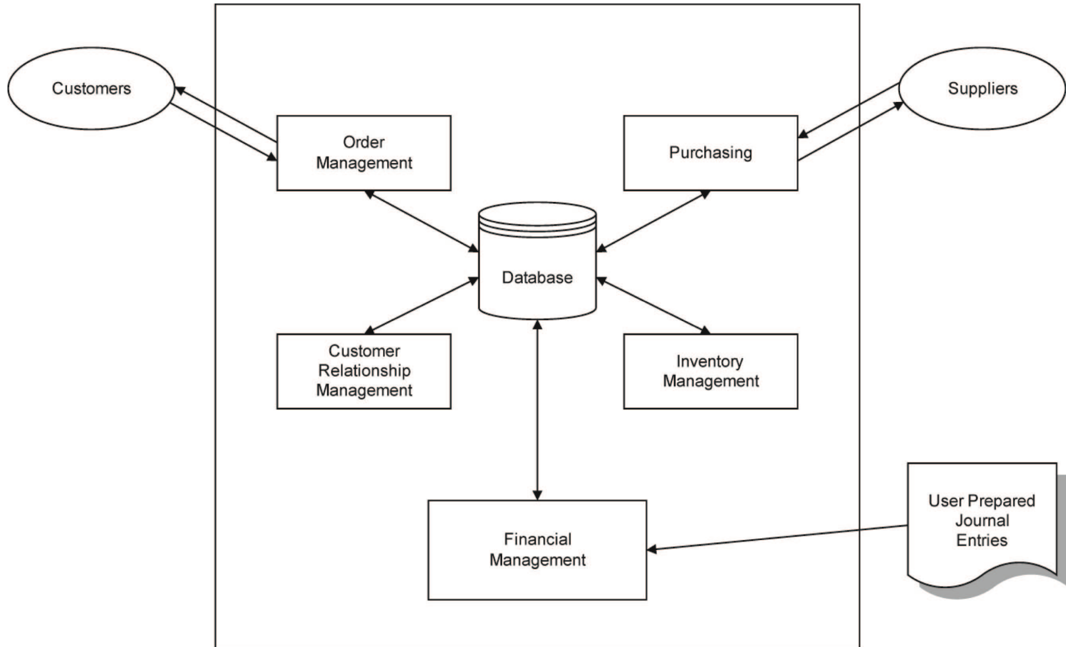
Information Capture, Storage, and Processing

2.66 Understanding how the client's information system captures, stores, and processes information is critical to gain an understanding of the client, evaluate the design of controls, and design further audit procedures. Illustration 2-2 describes one common way in which your client's system may be configured. This diagram does not reflect all systems, but it is useful for the discussion that follows.

- Inside the main box is the client's IT system. The two ovals that reside outside the box illustrate external parties that interface with the system. In this illustration, there are two such parties: customers and suppliers.
- In this system, the diagram depicts four separate applications or *modules* order management, customer relationship management (CRM), purchasing, and inventory management.
- Each of these application modules captures data and may perform some processing. The application then accesses the central database to store the resulting information. For example, if a customer places an order, the order management system captures the relevant data, processes it, and then stores the resulting information in the database.
- Once the information has been stored in the database, it can be used by other applications. For example, the inventory management system may query the database for new orders and process this information to determine if the items are on hand or to take further steps to process the order, such as sending the relevant information to the warehouse.
- The client's financial management system includes the general ledger and other accounting functions such as billing, accounts receivable management, and cash receipts and disbursements.
- The financial management system also interacts with the database to gather and store relevant information. However, the financial management system can be accessed directly through journal entries, bypassing the applications.
- How the previously mentioned steps occur in a given environment can vary, emphasizing the need for you to gain a clear understanding to identify risk and design your audit tests.

Illustration 2-2

Diagram of Typical IT System



2.67 In a system, for example the one described in paragraph 2.66, it is critical that the client retain the integrity of the information contained in the database. Illustration 2-2 shows that only applications access the database. However, a database administrator will have the ability to bypass the applications and make changes directly to the database. This functionality is necessary to maintain the database, but left uncontrolled access or unmonitored changes, it may expose the company to the risk of fraud or error through unauthorized data manipulation.

2.68 The reports you use during your audit may be generated from individual applications. Alternatively, the client may have a separate report-writing application that accesses the database directly. When evaluating controls, such as program change controls or when considering the completeness and accuracy of those reports, you may want to consider how those reports were generated and how system changes are controlled and monitored.

Integration of Applications From Different Vendors

2.69 For a system such as the one in the preceding paragraph to function properly, data that is captured and processed in one application must be properly "mapped" to the data used in other applications. For example, the order processing system may use a unique customer number to identify customers. The CRM system, which provides information about customers such as their address and credit limits, will use the same customer number, assuming the data resides in the same database. To function properly (for example, for the financial management system to prepare an invoice) that unique customer number is used.

2.70 Problems can arise when the numbers assigned to the same customer are not the same. In those situations they can be "mapped" in tables that translate the numbers in one system to another. Without proper mapping, unlike applications, or those using different databases will not be able to share necessary information.

2.71 When your client uses applications that are integrated during their development, the risk related to improper mapping is reduced significantly. This is more commonly found when the same vendor is responsible for different components of the system, such as Oracle Financials or Systems Applications and Products. Typically called an *application suite*, they share a database, so that each customer has one unique set of records, containing a number of data elements. Each application module may not use all of the data elements that relate to a customer, but will access those that are necessary.

2.72 However, it is common for companies to use applications provided by different software vendors. For example, in illustration 2-2, the company may have an order management and CRM application provided by one vendor, a purchasing application from another vendor, and the inventory management system may be a legacy system that the company has had for years.

Server-Client Configurations

2.73 When businesses first started using computers to process data, computer processing was highly centralized. For example, a mainframe computer typically performed all of the processing, which was monitored and controlled by a centralized electronic data processing department. Over time, information processing became more decentralized. Later, as local computers appeared on all users' desks, a central *server* hosted various *clients* that could be other servers or local desktops. As company information systems became more accessible, access was granted to a wide number of users. In this configuration, information can be processed both centrally and remotely. The client/server model is not implemented the same way in each company, so you have to find out where processing actually occurs. In addition, a large number of companies are using Internet-based systems that can change the configuration even more.

2.74 In general, the more visible or usable by outsiders a system is, the greater the risk from threats such as

- unauthorized access to applications or data.
- incorrect or inappropriate processing of information, which then is communicated throughout the entire system.
- lack of physical access controls to computer equipment and other physical risks to the system.
- transmission of computer viruses, which can destroy data.

Information Processed Outside the Accounting Applications

2.75 It is not uncommon for clients to process financial information outside the accounting application, accessing the database to extract information, which they then process independently. For example, accounting department personnel may be responsible for preparing information for the notes to the financial statements. Where the accounting application does not provide this information in a format suitable for preparation of the required disclosures, the individual responsible for the disclosure may access the database and extract the raw data. He or she imports this data into a spreadsheet, which is then used to sort, combine, or otherwise manipulate the data to provide the necessary disclosure information.

2.76 The development and use of spreadsheets may not be supported by the formal IT controls associated with purchased applications. Although auditors understand that spreadsheets are nevertheless processes that should be controlled, in most instances

- people who develop and use spreadsheets are not trained application programmers.
- the spreadsheets often are not tested formally and can contain unknown errors.
- it is impossible to build in data checking routines (called *programmed edit checks*) such as are found in applications, so errors are introduced easily and can be hard to track down.
- access to the spreadsheets (including the underlying formulas) is not controlled.
- changes to spreadsheets are not controlled effectively.
- several versions of the same spreadsheet may be in use at the same time.

For these reasons, depending on the nature and use of the spreadsheet, the risk to the client posed by use of spreadsheets in its financial reporting process may be significant. Greater awareness of the risk associated with spreadsheets has prompted development of procedures and processes by entities to control them better, but due to the intrinsic nature of entering data into the cells of a spreadsheet, no matter how well the client thinks the controls are working, there is a higher risk of error when spreadsheets are being used.

2.77 The term *information system* as used in this publication encompasses both formal accounting applications and the ad hoc information systems that exist outside the accounting application.

Observations and Suggestions

Understanding your client's IT system will help you perform a more knowledgeable risk assessment by identifying risk of fraud or error.

In addition, the client's maintenance of information in electronic format may allow you to use computer assisted auditing techniques to gather highly relevant and reliable audit evidence about an assertion, for example, by examining an entire population of transactions or an account balance.

Benefits and Risks of Using IT

2.78 How IT is deployed varies among entities. For example, your client may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternately, other entities in the same industry may have complex, highly integrated systems that share data and are used to support all aspects of the company.

2.79 Your client's use of IT creates both benefits and risks that are relevant for your audit. Table 2-4 summarizes some of these benefits and risks.

Table 2-4

Benefits and Risks of Using IT

Benefits of Using IT	*Risks of Using IT*
IT can enhance internal control because it enables your client 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. • enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.	IT poses specific risks to your client's internal control, including • reliance on systems or programs that are processing data inaccurately, 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 nonexistent transactions or inaccurate recording of transactions. • unauthorized changes to data in master files may be more difficult to detect than similar changes to manual records. • unauthorized changes to systems or programs. • failure to make necessary changes to systems or programs. • inappropriate manual intervention when security is not effective. • potential loss of data or inability to access data as required.

2.80 In addition to the benefits and risks described in table 2-4, you also may consider that the client's use of IT may affect the availability of information you need for your audit. When client data is processed electronically, you may be

- prevented from using only substantive procedures to obtain audit evidence. For example, if the required evidence regarding the transaction is not maintained or

observable in the historical record, it may not be observable in the transaction record that the transaction was authorized by management electronically, thus requiring that the authorization systems and controls be examined.

- enabled to use electronic data extraction and other computer assisted audit techniques to gather audit evidence, for example, by examining an entire population of an account balance.

How Your Consideration of Fraud Is Related to the Consideration of Internal Control

Observations and Suggestions

Many of the required procedures within ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, can provide you with audit evidence about the design and implementation of internal control, particularly the control environment. To achieve both audit efficiency and effectiveness, you should consider the requirements to understand internal control and to assess fraud risk not as two separate and unconnected audit objectives, but rather, as two objectives whose achievements are interrelated and reinforce each other.

The following section of this publication provides guidance on how you can integrate the ISA 240 requirements with the requirements to understand internal control.

2.81 Fraud is a broad legal concept, and auditors do not make legal determinations of whether fraud has occurred. Rather, your interest primarily relates to acts that result in a material misstatement of the financial statements. That is, you have a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, including misstatements caused by fraud. (ISA 240 par. 3 and 5)

2.82 Ineffective controls or the absence of controls at your client provide an opportunity for a fraud to be perpetrated. Thus, areas of overlap exist between your consideration of internal control and your consideration of fraud.

2.83 The procedures you perform related to internal control may provide audit evidence that is relevant to your assessment of the risks of material misstatement due to fraud. For example, when evaluating the design of internal control or determining whether it has been implemented, you may obtain audit evidence about the existence of events or conditions that indicate opportunities to carry out a fraud. (These conditions are referred to as *fraud risk factors*.)

2.84 Conversely, the performance of audit procedures you perform to assess the risks of material misstatement due to fraud may provide you with an understanding of internal control. For example, ISA 240 directs you to make inquiries of management and others within the entity about the risk of fraud. Responses to these inquiries and further corroborations may provide audit evidence about the design of certain controls, whether those controls have been implemented, or possibly their operating effectiveness.

2.85 Thus, audit procedures performed primarily for one objective (for example, understanding internal control) may provide evidence relating to another audit objective (for example, assessing the risks of material misstatement due to fraud) and vice versa. For this reason, you may choose to consider this relationship when planning and performing related audit procedures. For example, knowing that inquiries of management relating to the risk of fraud at the entity may provide evidence about certain elements of the control environment, you may consider asking follow-up questions and obtaining further evidence that the controls were implemented (that is, placed in operation), in addition to the questions specifically required by ISA 240, directed toward achieving the second audit objective.

Considering Antifraud Programs and Controls

2.86 Paragraph 42 of ISA 240 requires you to communicate with those charged with governance any other matters related to fraud that are, in your professional judgment, relevant to their responsibilities. For example, the absence of programs or controls to address the risks of material misstatement due to fraud that are significant deficiencies should be discussed with those charged with governance.

Deficiencies in Internal Control

2.87 During the course of your audit, you may become aware of deficiencies in internal control. A deficiency in internal control exists when a control is designed, implemented, or operated in such a way that it is unable to prevent, or detect and correct, misstatements on a timely basis, or when a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing. Table 2-5 summarizes the definitions of these two types of deficiencies. (ISA. 265 par. 7)

Table 2-5

Internal Control Design and Operating Deficiencies

Design Deficiencies	*Operating Deficiencies*
A deficiency in internal control design exists when either • a control necessary to meet the control objective is missing or • an existing control is not properly designed so that, even if the control operates as designed, the control objective is not met.	A deficiency in the operation of a control exists when either • a properly designed control does not operate as designed, or • when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

2.88 You *should* evaluate identified deficiencies in internal control and determine whether the deficiencies, individually or in combination, constitute significant deficiencies. (ISA 265 par. 7–8)

2.89 A *significant deficiency* is a deficiency or a combination of deficiencies in internal control, that in the auditor's professional judgment is of sufficient importance to merit the attention of those charged with governance. (ISA 265 par. 6)

2.90 The evaluation of the severity of a deficiency is a matter of professional judgment that depends on the magnitude of the potential misstatement resulting from the deficiency or deficiencies.

Limitations of Internal Control

2.91 Internal control, no matter how effective, can provide an entity only reasonable assurance about achieving the entity's financial reporting objectives. Reasonable assurance is a high level of assurance. The likelihood that an entity will achieve its objectives is affected by limitations inherent to internal control. These inherent limitations include the realities that human judgment in decision making can be faulty and that breakdowns in internal control can occur because of human failures such as simple errors or mistakes. For example

- if an entity's personnel do not sufficiently understand how an order entry system processes sales transactions, they may design changes to the system that will erroneously process sales for a new line of products. On the other hand, such changes may be correctly designed but misunderstood by individuals who translate the design into program code.
- controls may be designed to automatically identify and report transactions over a specified amount for management review, but individuals responsible for conducting the review may not understand the purpose of such reports and, accordingly, may fail to review them or investigate unusual items.
- individuals may perform procedures less attentively on some days than others, based on, for example, the level of distractions, workload, and personal factors such as attitude and health.

2.92 Additionally, controls, whether manual or automated, can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into undisclosed side agreements with customers that alter the terms and conditions of the entity's standard sales contracts that 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.

2.93 By its nature, management override of controls can occur in unpredictable ways. To address the risk of management override, you should

a. test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including entries posted directly to financial statement drafts. In designing and performing audit procedures for such tests, the auditor should

i make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

ii. select journal entries and other adjustments made at the end of a reporting period; and

iii. consider the need to test journal entries and other adjustments throughout the period.

b. review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor should

i. evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor should reevaluate the accounting estimates taken as a whole, and

ii. perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. Estimates selected for review should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management.

c. evaluate, for significant transactions that are outside the normal course of business for the client or that otherwise appear to be unusual given your understanding of the client and its environment and other information obtained during the audit, whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

(ISA 240 par. 32)

Audit Evidence

The Nature of Audit Evidence

2.94 Audit evidence is all the information you use to arrive at the conclusions that support your audit opinion. Audit evidence includes both information obtained in the accounting records underlying the financial statements and other information. Audit evidence is cumulative in nature. For example, your evidence regarding payables begins with you performing risk assessment procedures relating to the client and its environment, including its internal control. These risk assessment procedures provide audit evidence to support your conclusion about the risks of material misstatement for payables. Based on this risk assessment, you then perform further audit procedures, which include substantive procedures and may include tests of controls. The results of these further audit procedures provide audit evidence that, when considered in conjunction with the evidence from risk assessment procedures, allow you to form a supportable conclusion about payables. You then repeat this process for other accounts, classes of transactions, and disclosures, and the aggregation of your conclusions provides a basis for your opinion on the financial statements as a whole.

2.95 You should design and perform audit procedures for the purpose of obtaining sufficient appropriate audit evidence. Appropriate audit evidence is relevant and reliable. The procedures that you perform on your audit provide audit evidence, but they are not the only source of audit evidence. For example, previous audits and your firm's client acceptance and continuance procedures also may be sources of audit evidence. (ISA 500 par. 6)

2.96 You should determine what modifications or additions to audit procedures are necessary if

- audit evidence obtained from one source is inconsistent with that obtained from another, or
- you have doubts about the reliability of the information to be used as audit evidence.

(ISA 500 par. 11)

2.97 A lack of consistency among individual items of audit evidence may indicate that one of the items is not reliable. For example, management may describe the company's year-end financial reporting process as following certain steps, but others at the company may describe the process differently. When audit evidence obtained from one source is inconsistent with that obtained from another, you should document how you resolved the inconsistency. (ISA 230 par. 11)

2.98 You may obtain more assurance from consistent audit evidence obtained from *different* sources or of a different nature than from items of evidence considered individually. For example, reading minutes of the board and other documentation and making inquiries of several individuals about matters included in disclosures usually provides more reliable evidence than that provided by making inquiries of one individual.

Tests of Accounting Records

2.99 As described in subsequent chapters of this publication, you may perform tests of the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, or testing the client's reconciliation of significant accounts. Performing these types of tests may allow you to determine that the accounting records are consistent with one another and that they agree to the financial statements, which provides some audit evidence. However, accounting records alone do not provide sufficient audit evidence on which to base your audit opinion on the financial statements. Table 2-6 provides examples of other information you may use as audit evidence.

Table 2-6

Examples of Information You May Use as Audit Evidence

The tests you perform on the client's accounting records provide some audit evidence but not enough to support an opinion on the financial statements. Other information that you may use as audit evidence includes

- minutes of meetings.
- confirmations from third parties.
- industry analysts' reports.
- comparable data about competitors.
- controls manuals.
- information you obtain from audit procedures, such as inquiry, observation, or inspection.
- other information developed by or available to you that allows you to reach conclusions through valid reasoning.

The Sufficiency and Appropriateness of Audit Evidence

Sufficiency of Audit Evidence

2.100 You are required to design and perform audit procedures to obtain sufficient appropriate audit evidence. The sufficiency of audit evidence relates to its quantity. For example, the

auditor who tests 8 of the 12 monthly reconciliations between a general ledger control account and the related subsidiary ledger will obtain more evidence about the operating effectiveness of the control than the auditor who tests 2 of the 12 reconciliations. (ISA 500 par. 6)

2.101 Paragraph 26 of ISA 330, *The Auditor's Responses to Assessed Risks*, requires you to conclude on whether sufficient appropriate audit evidence has been obtained. The amount of audit evidence you need to support your conclusion is affected by the risks of material misstatement and the quality of the audit evidence obtained as follows:

- The higher the risk of material misstatement, the more audit evidence likely to be required to support a conclusion.
- The higher the quality of the evidence, the less that may be required. However, obtaining more audit evidence may not compensate for its poor quality.

Appropriateness of Audit Evidence

2.102 The appropriateness of audit evidence relates to its quality. The quality of audit evidence is a function of its relevance and its reliability in providing support for, or detecting misstatements in, your audit.

2.103 *Relevance of audit evidence*. Tests of controls may provide audit evidence that is relevant to certain assertions but not others. For example, tests of controls related to the proper authorization of a transaction will provide evidence about the occurrence assertion but not about the completeness assertion. Obtaining audit evidence relating to a particular assertion, in this example, the occurrence of a transaction, is not a substitute for obtaining audit evidence regarding another assertion, in this example, completeness.

2.104 *Reliability of audit evidence*. The reliability of audit evidence is influenced by its source and by its nature. Reliability also depends on the individual circumstances under which it is obtained, including its timing.

2.105 Generalizations about the reliability of various kinds of audit evidence can be made, and these are presented in table 2-7. However, when considering such generalizations, keep in mind that they are subject to important exceptions. Even when audit evidence is obtained from sources external to the client, circumstances may exist that could affect the reliability of the information obtained. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful:

- Audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity.
- Audit evidence that is generated internally is more reliable when the related controls being used by the entity are designed and operate effectively.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence is more reliable when it exists in documentary form then evidence obtained orally (whether paper, electronic, or other medium). For example, a contemporaneously written record of an audit committee meeting that described the actions taken by the members to oversee the financial reporting process is more reliable than a subsequent oral representation of the matters discussed at the meeting.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies, facsimiles, or documents that have been filmed, digitized, or otherwise transformed into electronic form.

The following generalizations about the reliability of audit evidence will be useful to you when designing audit procedures.

Table 2-7

The Reliability of Audit Evidence

	Reliability of Audit Evidence	
Consideration	*Generally More Reliable*	*Generally Less Reliable*
Source of evidence	Knowledgeable, independent sources outside the entity	Sources inside the entity Sources that are not knowledgeable
Reliability of client's internal control (when evidence is generated internally)	Effective	Ineffective
How evidence is obtained	Obtained directly by the auditor	Obtained indirectly or by inference
Format of evidence	Documentary form, either written or electronic	Oral or otherwise undocumented
Availability of evidence	Original evidence available for inspection	Evidence available only as a photocopy or facsimile of original

2.106 You may obtain more assurance from consistent audit evidence obtained from different sources or of a different nature than from audit evidence considered individually. For example, if the company lacks documentation to support its intent with regard to equity securities (which affect how those securities are classified and presented in the financial statements), you may have no choice but to rely on management's verbal statements regarding their intent. Verbal statements may be less reliable than a written record, but if you obtain statements or representations from several sources, and these statements or representations are consistent with the client's past history of selling equity investments, you may find the consistency from different sources to be persuasive.

2.107 An increased quantity of audit evidence cannot compensate for audit evidence that lacks relevance. For example, a confirmation of the existence of an account receivable is not directly relevant to the valuation of the allowance account. Increasing the number of receivables confirmations may not provide you with any additional evidence relating to their collectability and the allowance for doubtful accounts.

Determining Whether You Have Obtained Sufficient, Appropriate Audit Evidence

2.108 Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level and, thereby, enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment.

Assessing and Responding to Risk in a Small Business Audit

2.109 The guidance provided in this publication applies to all audits regardless of the size of the audited entity. However, the nature of a smaller entity, the environment in which it operates, and its internal control may differ from larger entities. These differences may create different types of risks, which in turn may require different audit strategies. Auditor judgment always is needed to apply the guidance provided in this publication to specific situations, including those that may be unique to a small business.

Characteristics of a Small Business

2.110 It is difficult to precisely define a *small business*. As the term is used in this publication, it refers to an entity that has one or more of the following characteristics:[1]

[1] These criteria were adapted from volume II of COSO's "Internal Control over Financial Reporting—Guidance for Smaller Public Companies" document.

- One line of business and few product lines
- A single location
- Led by founders or a small group of owners who dominate management of the business
- Limited in-house accounting resources
- Financial reporting systems built on less sophisticated, general purpose bookkeeping software and supplemented with spreadsheets for sub-ledgers and other accounting records
- Less complex, typically undocumented transaction processing systems
- Fewer personnel, many having a wider range of duties

Internal Control at a Small Business

2.111 Small businesses face certain challenges in implementing effective internal control, particularly if management of the business views internal control as something to be "added on" rather than integrated with core processes. These challenges to implementing effective internal control include

- management's ability to dominate activities. This increases opportunities for improper management override of processes to appear that financial reporting objectives have been met.
- obtaining qualified accounting personnel to prepare and report financial information.
- management's view that the primary value of internal control is in preventing the misappropriation of assets while underestimating the importance of control objectives related to financial reporting.
- obtaining sufficient resources to achieve adequate segregation of duties.
- informal, largely undocumented decision-making processes, including risk assessment and the monitoring of internal control.
- attracting independent, outside parties with financial and operational expertise to serve on the board of directors and on the audit committee.
- controlling IT. Controls over information systems, particularly application and general IT controls, present challenges for smaller businesses.
- ad hoc, undocumented entity-level control policies and procedures.

Observations and Suggestions

Smaller companies often increase reliance on the control environment, as there is more direct oversight and reinforcement of the "tone at the top" by management. Management may rely more on its control environment and their own active participation in or monitoring of the controls over financial reporting. For example, active management oversight may partially compensate for inadequate segregation of duties. For example, management may provide a monitoring and oversight function that would preclude the occurrence of a material skimming of cash receipts, but might not be sufficient to preclude all skimming.

In those instances where management involvement may compensate for deficiencies in the design of other controls, consider that

- management's involvement in the operations of the business (for example, in managing relationships with significant customers, or obtaining financing) is not the same as its involvement in the controls over financial reporting.
- management's active involvement in controls also increases the risk of management override of controls and the manipulation of financial reporting.

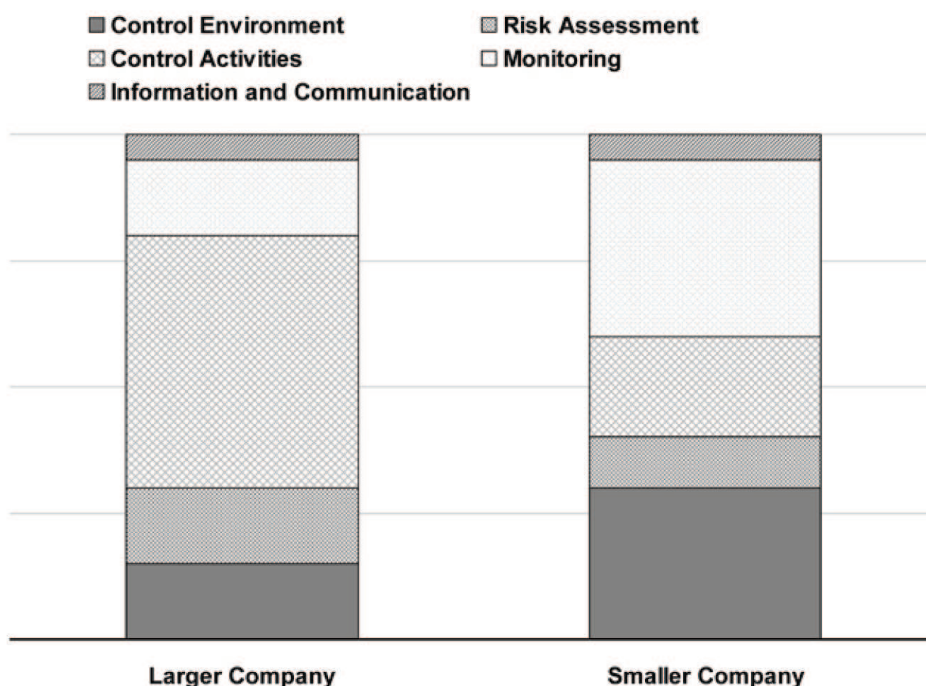
While there may be less direct reliance on control activities in smaller companies, there are certain foundational control activities that need to be in place in every company. Both smaller and larger companies will have similar control activities including reconciliations of material accounts, approvals of large transactions, and various input controls.

2.112 Companies should implement a control structure to reduce risk to an acceptable level. Sometimes, smaller companies do not perceive that they have sufficient resources to fully

implement segregation of duties or other controls that are more preventive in nature. Thus, smaller businesses may rely more on detective rather than preventive monitoring and personal involvement by top management in setting a control environment that brings in sufficient competence and trust to assist in reducing risk. This is illustrated broadly in illustration 2-3. All companies, regardless of size, need to have all five components present and functioning, but the relative reliance on each component may be different in smaller companies than it is in larger companies.

Illustration 2-3

Hypothetical Configuration of Internal Control Larger Versus Smaller Companies



2.113 Notwithstanding the challenges faced by smaller companies in documenting and implementing effective internal control, the fundamental concepts of good control are the same whether the company is large or small. Fundamental controls, such as reconciliations, management review, and basic input controls, remain the same. The COSO framework does not set up a lower standard for small businesses in the form of measures to achieving effective internal control that only apply to small businesses. All components of internal control should be in place—in some form or another—to achieve effective internal control.

2.114 Auditors of small businesses face certain challenges in gathering information about internal control design and implementation, assessing control risk and evaluating deficiencies in internal control. These challenges include those situations where the client

- lacks sufficient documentation of its internal control, particularly, entity-level control policies, performance of control activities, including monitoring of control performance, or policies and procedures for accounting for nonrecurring transactions.
- is highly susceptible to management override of internal control.
- lacks adequate segregation of duties.
- lacks sufficient in-house accounting experience, especially in dealing with nonrecurring transactions, new or complex accounting standards, or new business practices.

Audit Strategy for Audits of a Small Business

2.115 Audit strategies used on larger entities may not be practical for audits of a small business. For example, auditors of a large business with significant in-house resources may be able to rely on client personnel, including its internal auditors, to provide assistance during the audit. Auditors of a small business that lacks such resources would not be able to adopt a similar audit strategy.

2.116 Auditors of a small business may encounter certain challenges that affect their audit strategy. These challenges include

- accounting records that require significant adjustments prior to the start of significant auditing procedures.
- significant transactions with unaudited related parties.
- internal controls that include one or more of the characteristics described in paragraph 2.114.
- the need to adapt standardized audit practice aids developed for larger entities to the conditions that exist on a small business audit.

Observations and Suggestions

The unique demands of a small business audit typically require significant involvement of the most experienced auditors during the audit planning process. More experienced auditors will be able to make important judgments about audit strategy, including

- the nature, timing, and extent of risk assessment procedures designed to gather information about the client and its environment.
- the assessment of risks of material misstatement.
- the nature and extent of the auditor's documentation of assessed risks.
- the nature and extent of the documentation of the client's internal control.
- the choice of further audit procedures that are clearly linked to assessed risks.
- the allocation of audit resources to those areas of the audit that present the most risk.

The significant involvement of the most experienced auditors early in the audit process should improve both audit quality and efficiency.

Summary

2.117 Chapters 3–6 of this publication describe an audit process that revolves around the assessment and response to the risks of material misstatement. This risk of material misstatement begins with the risk that a misstatement exists in an account balance, class of transactions, or disclosure without consideration of internal controls. This *inherent risk* exists independently of the client's internal control.

2.118 For example, suppose that the client has transactions with related parties that should be disclosed in the financial statements. There is a risk—irrespective of any controls—that the person who prepares the financial statements will omit the disclosure or draft one that is incomplete or not understandable.

However, suppose the client has implemented internal controls over financial reporting. These controls have been designed and operate in a way that will either prevent or identify and correct the misstated or omitted related party disclosure. For example, the person responsible for preparing the disclosure may be properly trained and supervised, and client management may review the draft disclosures to make sure they are complete and understandable. In this way, the client's internal control mitigates the risk that is inherent in the account balance, class of transactions, or disclosures.

2.119 The client's internal control is bounded by two important thresholds: accounting materiality and reasonable assurance. Internal control—no matter how well designed and operated—can provide reasonable (but not absolute) assurance that the financial statements are free of material misstatement.

2.120 Thus, the risk that the financial statements are materially misstated—before considering the performance of any audit procedures—is a function of inherent risk and the risk that the client's internal control will fail to either prevent or detect and correct a material misstatement.

2.121 Both the risk assessment procedures and the further audit procedures allow you to gather *audit evidence*, which supports your opinion on the financial statements.

2.122 The performance of risk assessment and further audit procedures also is bounded by two thresholds: audit materiality and reasonable assurance. *Audit materiality* is the maximum amount that you believe the financial statements could be misstated and still fairly present the client's financial position and results of operations.

Reasonable assurance is the fundamental threshold you use to design and perform your audit procedures. Reasonable assurance is a high—but not an absolute—level of assurance. To obtain reasonable assurance, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

2.123 The ideas presented in this chapter are the key concepts underlying the risk assessment process that is central to every audit. Chapters 3–7 of this publication describe that process in detail. The next chapter builds on your understanding of these key concepts to introduce the first step in the risk assessment process, the performance of risk assessment procedures.

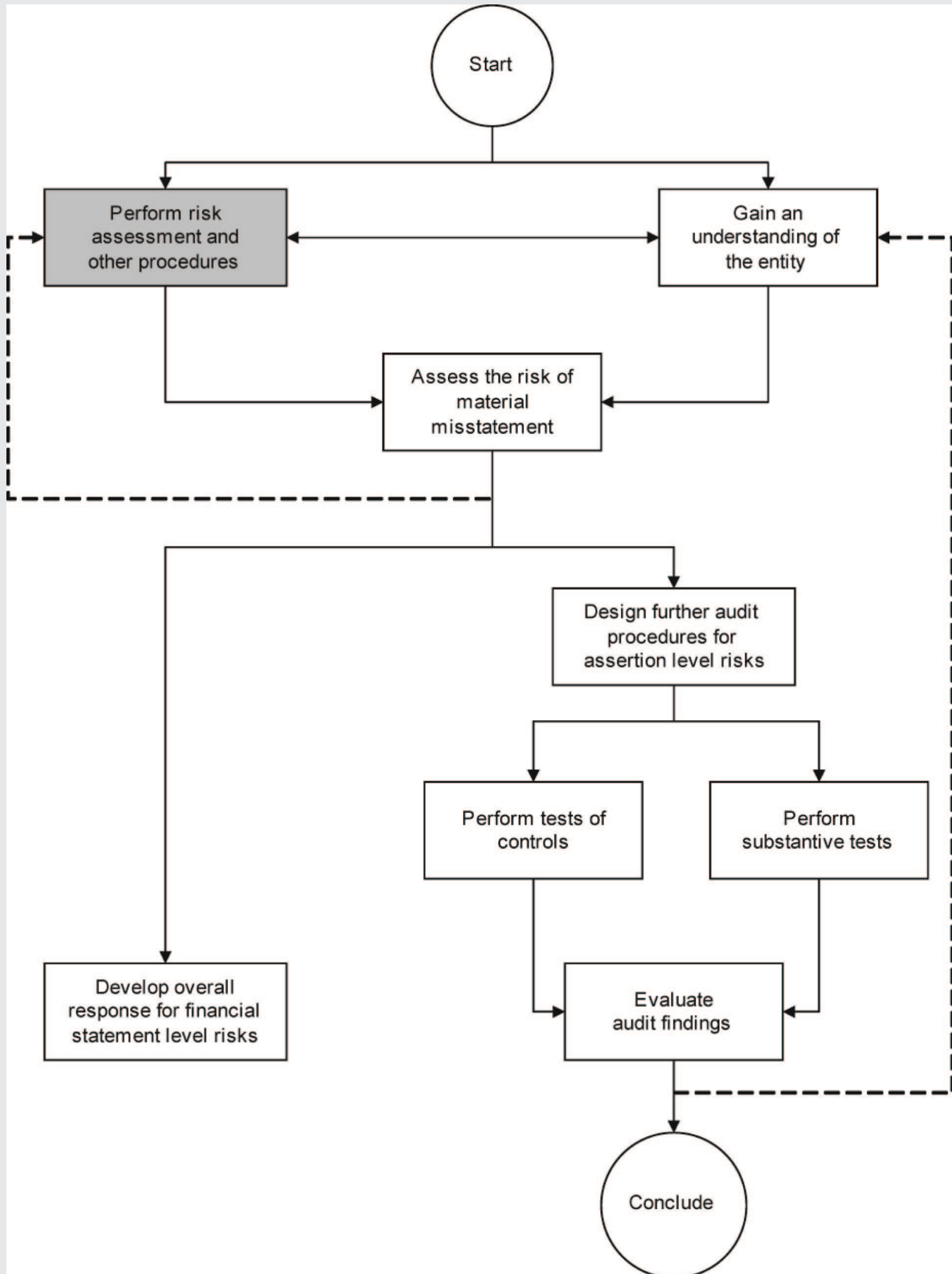
Chapter 3

Planning and Performing Risk Assessment Procedures

Observations and Suggestions

Illustration 3-1

Planning and Performing Risk Assessment Procedures



(continued)

This chapter focuses on planning an audit of financial statements and performing risk assessment procedures.

Your risk assessment procedures include gathering information about a wide range of matters to enable you to understand your client. Some of these matters relate directly to the financial reporting process, but many of them relate to the broader business issues such as the current status of the client's industry and its business objectives and strategies. Your client's internal control is an integral part of its business and as such, your risk assessment procedures will also address the relevant portions of the internal control system.

As sufficient information is gathered, you will begin to form an understanding of the client and how the specific conditions and circumstances pertaining to the client may affect the preparation of the client's financial statements.

Ultimately, the information you gather and the resulting understanding you gain about the client provide audit evidence to support your assessment of the risks of material misstatement and your opinion on the financial statements.

In the early stage in your audit you will gain an understanding of the client and its environment, including internal control. This understanding should be sufficient to allow you to determine a performance materiality and to identify and assess the risks of material misstatement. To form a meaningful understanding of your client, you will perform risk assessment and other procedures to gather the information you need.

This chapter provides guidance on how to gather information about your client and how to use that information to understand the client in a manner that allows you to appropriately assess the risks of material misstatements. This understanding of your client provides audit evidence that is necessary to support your risk assessments.

Audit Planning

3.01 Audit planning is not a discrete phase of the audit, but rather an iterative process that continues throughout the engagement to its completion. A revision of the overall audit strategy or the audit plan may be necessary as a result of evidence obtained from the performance of planned audit procedures. Any modifications to your initial audit strategy should be documented.

An audit strategy developed before you have an understanding of the business and the risks of material misstatement may require updating, or it may require a whole new strategy.

Forming an Overall Audit Strategy

3.02 Forming an overall audit strategy is an integral part of audit planning. You should establish an overall audit strategy on each engagement that sets the scope, timing, and direction of the audit that guides the development of the audit plan. Table 3-1 describes some elements of an overall audit strategy. In addition to the matters in table 3-1, you also should consider the experience you have from performing other engagements by the engagement partner for the client, as well as the results of preliminary audit activities, such as client acceptance and continuance procedures. (ISA 300 par. 7–8)

Table 3-1

Developing an Overall Audit Strategy

The overall audit strategy involves the determination of	*Examples of which include*
the characteristics of the audit that define its scope.	• the basis of reporting. • industry-specific reporting requirements. • the locations of the client.
the reporting objectives of the engagement related to the timing of the audit and the required communications.	• deadlines for interim and final reporting. • key dates for expected communications with management and those charged with governance.

The overall audit strategy involves the determination of	*Examples of which include*
factors significant to directing the audit team's efforts.	• appropriate materiality and performance materiality levels. • preliminary identification of areas where there may be higher risks of material misstatement. • preliminary identification of material locations and account balances. • plans, if any, to obtain evidence about the operating effectiveness of internal control at the assertion level. • how the entity uses IT to capture, store, and process information and whether the use of an IT expert is necessary for the engagement. • recent, significant, and entity-specific developments related to the client's industry, financial reporting requirements, or other relevant matters.

3.03 Your overall audit strategy helps you determine the resources necessary to perform the audit, which include

- the human resources to assign to specific audit areas, such as the use of appropriately experienced team members for high-risk areas or the involvement of experts on complex matters.
- whether an IT expert should be part of the engagement team.
- the resources to assign to specific audit areas, such as the number of team members necessary to observe the inventory count at material locations, the extent of review of other auditors' work, or the audit budget in hours to allocate to high-risk areas.
- when these resources are assigned, such as whether at an interim audit period or at key cut-off dates.
- how such resources are managed, directed, and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

Observations and Suggestions

Establishing an overall audit strategy varies according to the size of the entity and the complexity of the audit.

In audits of small entities, a very small audit team may conduct the entire audit. With a smaller team, coordination and communication between team members is easier. Consequently, establishing the overall audit strategy need not be a complex or time-consuming exercise.

For example, the auditor of Ownco developed her audit strategy for the year X2 audit at the completion of the X1 audit. Based on a review of the audit documentation she highlighted the issues identified in the X1 audit and prepared a brief memo of the overall audit strategy for X2. At the beginning of the X2 audit, she updated and changed the strategy developed in X1 based on discussions with the owner-manager.

Appendix A, "Considerations in Establishing the Overall Audit Strategy," of this publication is a useful practice aid regarding this issue. It was reproduced from an appendix to ISA 300, *Planning an Audit of Financial Statements*.

The Audit Plan

3.04 An audit plan is a more detailed, tactical plan that addresses the various audit matters identified in the audit strategy. You should develop and document an audit plan for every audit. The audit plan includes the nature, timing, and extent of the audit procedures to be performed by your engagement team members. (ISA 300 par. 9)

3.05 Each successive phase of your audit depends on the results of the audit procedures that precede it. For example, your determination of the nature, timing, and extent of your substantive procedures depends on the results of your tests of controls (if any), which in turn depend on the results of your risk assessment. Table 3-2 lists the items that, at a minimum, should be included in your audit plan. (ISA 300 par. 9)

Table 3-2

Items to Be Included in Your Audit Plan

Your audit plan should include the following:

- A description of the nature and extent of planned risk assessment procedures. Because these procedures normally are the first procedures you perform to gather audit evidence to support your opinion, you typically will plan your risk assessment procedures first or early in the audit.
- A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure. The plan for further audit procedures should reflect your decision whether to test the operating effectiveness of controls, and the nature, timing, and extent of planned substantive procedures. Because your design of further audit procedures depends on the results of your assessment of the risks of material misstatement, you may not develop your plan for further audit procedures until you have completed your risk assessment procedures.
- A description of other audit procedures to be carried out for the engagement to comply with ISAs (for example, seeking direct communication with the entity's lawyers). Your plan for these procedures will evolve over the course of the audit as you begin to gather audit evidence.

Observations and Suggestions

It is common for example audit plans to include a step for audit planning. Example forms also are used to facilitate the documentation of the matters listed in table 3-2.

When using these example forms and checklists, it is important to remember the iterative nature of planning. The completion of example forms once, at the beginning of the engagement, is inconsistent with the notion that planning is an iterative process, reassessed continuously throughout the engagement.

Performance Materiality

3.06 As part of developing an overall audit strategy, you should determine a materiality level for the financial statements as a whole, which is used to help you plan your audit. This materiality is used to determine performance materiality, which helps you make judgments about

a. the identification of risks of misstatement,

b. the assessment of whether those risks are material, and

c. the determination of the nature, timing, and extent of further audit procedures. Properly designed further audit procedures increase the likelihood that you will detect any material misstatement that exists in the financial statements.

(ISA 320 par. 10–11)

3.07 Performance materiality may be different from the level of materiality determined for evaluating audit results. Because it is not feasible for you to anticipate *all* the circumstances (for example, final net income) that may influence your determination of materiality at the completion of the audit, the materiality level you use for planning purposes may differ from the materiality level you use to evaluate audit findings. Performance materiality does not establish a threshold below which identified misstatements always are to be considered immaterial when evaluating misstatements. The circumstances related to some identified misstatements (for example, misstatements due to fraud) may cause you to evaluate them as material even though they are below performance materiality.

See chapter 7, "Evaluating Audit Findings, Audit Evidence, and Deficiencies in Internal Control," of this publication for a further discussion of materiality used to evaluate audit findings.

3.08 Your judgments about materiality include both quantitative and qualitative information. However, it ordinarily is not practical to design audit procedures to detect misstatements that qualitatively could be material unless you have identified specific risks of qualitative misstatements. For this reason, the materiality used for planning purposes is primarily determined using quantitative considerations.

3.09 The determination of materiality for planning purposes is a matter of your informed, professional judgment and is affected by your perception of the financial information needs of users of the financial statements. You may apply a percentage to an appropriate benchmark, such as total revenues, income before taxes, or net assets, as a step in determining materiality for the financial statements as a whole.

3.10 The relative appropriateness of a benchmark used to establish performance materiality depends on the nature and circumstances of your client and, in particular, who the users of the financial statements are and how they use the financial statements. For example, income before taxes may be an appropriate benchmark for a for-profit entity but may be inappropriate for a not-for-profit entity or for an owner-managed business where the owner takes much of the pretax income out of the business in the form of compensation. For asset-based entities, an appropriate benchmark might be net assets. Other entities might use other benchmarks. Table 3-3 provides a list of factors that may be relevant when determining an appropriate benchmark for performance materiality.

Observations and Suggestions

As indicated in paragraph 3.10, the determination of performance materiality depends on the nature and circumstances of the client, including how the financial statement users use the financial statements. What may be an appropriate benchmark (or base) for determining performance materiality for one entity may not be appropriate for another.

For example, the auditor of a for-profit entity may use a benchmark of 5 percent of income before taxes as a starting point for determining performance materiality. (However, auditors of for-profit entities operating near breakeven usually would not use income before taxes as a basis.) Users of a not-for-profit organization typically do not make judgments based on the organization's profit, and accordingly, the auditor of the organization may use revenues as a base for determining performance materiality. Governments may find it more appropriate and relevant to its users to use a percentage of expenditures as a base for determining materiality.

Similarly, users of the financial statements of a mutual fund may be most interested in the value of the assets being managed by the fund, and the auditor may use a base of total or net assets, rather than income before taxes, as a starting point for determining performance materiality.

As noted in chapter 2, "Key Concepts Underlying the Auditor's Risk Assessment Process," it is unlikely that a single benchmark and percentage or rule-of-thumb could adequately reflect user perspectives for all entities and circumstances.

Table 3-3

Considerations When Determining a Benchmark for Performance Materiality

Factors that may affect the identification of an appropriate benchmark include

- the elements of the financial statements (for example, assets, liabilities, equity, income, and expenses).
- whether there are financial statement items on which, for the particular entity, users' attention tends to be focused (for example, profit, revenue, or net assets).
- the nature of the entity, where it is in its life cycle, and the industry and economic environment in which it operates.
- the size of the entity, its ownership structure, and the way it is financed.
- the relative volatility of the benchmark.

3.11 When choosing an appropriate benchmark for determining performance materiality, you may consider the circumstances underlying the benchmark and make any adjustments you consider necessary.

For example, suppose that the auditor of Young Fashions determined that total revenue was an appropriate basis for determining performance materiality. However, during the audit period, the company acquired a manufacturer of children's clothes, which had a significant effect on the revenues during the year. Because of the unusual circumstance that gave rise to the revenue increase in the current period, the auditor determined that rather than using current period revenues, a more appropriate benchmark would be normalized revenues based on past results for the aggregate of the two companies that are now together.

3.12 Other factors that you may consider when evaluating the underlying circumstances of a chosen benchmark for performance materiality include the following:

- Who the users of the financial statements are and what they are likely to consider important
- Prior periods' financial results and financial positions
- The period-to-date financial results and financial position
- Budgets or forecasts for the current period
- Significant changes in the client's conditions, or the conditions of the industry and economy as a whole

Observations and Suggestions

Ultimately, you should plan and perform your audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Reasonable assurance is a high level of assurance.

The danger in setting performance materiality too high is that you will not gather sufficient relevant audit evidence to provide that low risk of material misstatement. For that reason, it is important to consider carefully the benchmarks used to determine performance materiality for the financial statements as a whole and also for particular items or elements.

Lesser Performance Materiality for Particular Items

3.13 In some instances it may be appropriate to establish a lower threshold performance of materiality for particular items that is less than performance materiality for the financial statements as a whole. For example, given the specific circumstances of the client and the needs of the users of its financial statements, you should establish a lower threshold for one or more particular classes of transactions, account balances, or disclosures if a lesser amount than performance materiality could reasonably be expected to influence the economic decisions of those users. (ISA 320 par. 9–10)

3.14 In making judgments about whether a lower materiality threshold is appropriate for particular classes of transactions, account balances, or disclosures, you may consider factors such as

- whether the accounting standards, laws, or regulations affect users' expectations regarding the measurement or disclosure of certain items.
- the key disclosures in relation to the industry and the environment in which the client operates.
- whether attention is focused on the financial performance of a particular business segment that is separately disclosed in the financial statements. (For example, revenues might be used to determine royalty payments. As such, revenues might be audited to a higher degree of precision than otherwise appropriate.)

3.15 To identify those particular classes of transactions, account balances, or disclosures for which it may be appropriate to reduce performance materiality, it may be helpful to consider the views and expectations of those charged with governance. However, it is a matter for the auditor's professional judgment.

Observations and Suggestions

Performance materiality is often the mechanism by which the lower materiality threshold is applied to the class of transaction, account, or disclosure to assist in the design of effective, efficient audit procedures.

When performance materiality is reduced for an account, balance, or disclosure then tolerable misstatement used to test a sample from the population is also reduced.

Note that the guidance provided in paragraph 3.15 applies only to the *reduction* of materiality. The views and expectations of management typically do not determine initial levels of performance materiality but may elicit considerations that the auditor had not initially thought about.

Gathering Information About the Client and Its Environment

3.16 Obtaining an understanding of your client and its environment, including internal control, is an essential part of every audit. It is a dynamic process that allows you to exercise professional judgment related to

- assessing risks of material misstatements;
- determining materiality and performance materiality;
- considering the appropriateness of the client's selection and application of accounting policies and the adequacy of its financial statement disclosures;
- identifying areas where special audit consideration may be necessary (for example, related-party transactions);
- developing expectations for performing analytical procedures;
- responding to the assessed risks of material misstatement, including designing and preforming further audit procedures; and
- evaluating the sufficiency and appropriateness of audit evidence obtained.

3.17 It is not acceptable to simply deem risk to be "at the maximum." The risk assessment procedures you perform to gather information and obtain an understanding of the client provide a measure of audit evidence that supports your risk assessment. In turn, your risk assessments support your determination of the nature, timing, and extent of further audit procedures such as your substantive procedures. Thus, the results of your risk assessment procedures are an integral part of the audit evidence you obtain to support your opinion on the financial statements. However, risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base your audit opinion. (ISA 315 par. 5)

Breadth and Depth of Your Understanding

Observations and Suggestions

It can be helpful to think of your understanding of the client consisting of two components: breadth and depth.

The breadth of your understanding describes its span, those aspects of the client and its environment about which you should have some understanding. The depth of your understanding describes the level of knowledge you should have about the subject matter.

Breadth of Understanding

3.18 As described in more detail in paragraphs 4.02–.25 of this publication, your understanding of the client should encompass the following:

- Relevant industry, regulatory, and other external factors, including the financial reporting framework
- The nature of the client, including its operations, ownership, and governance structures, types of investments that it is making or plans to make (including those to accomplish specified objectives), and the way it is structured and how it is financed to enable you to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements
- The client's objectives and strategies and resulting business risks that may result in risks of material misstatement
- The client's measurement and review of the entity's financial performance

3.19 You should obtain an understanding of internal control relevant to the audit. The breadth of your understanding extends to all five components of internal control, and other controls you determine to be relevant to the audit. Paragraphs 3.48–.109 of this publication discuss the breadth of your understanding of internal control in more detail.

Depth of Understanding

3.20 You should use your judgment to determine the depth of the understanding about your client and its environment, including internal control to identify and assess the risks of material misstatement to provide a basis for designing and implementing responses to the assessed risks of material misstatement. Typically, that understanding

- is less than that needed by management to manage the entity, but
- sufficient enough to allow you to
  - assess the risk that specific assertions could be materially misstated (for example, what could go wrong) and
  - plan and perform further audit procedures, which may include tests of controls, substantive analytical procedures, tests of details, or any combination of the three.

3.21 When obtaining an understanding of controls that are relevant to your audit, you evaluate the design of a control and determine whether it has been implemented:

a. *Evaluation of control design*. Evaluating the design of a control involves determining whether the control—either individually or in combination with other controls—is capable of effectively preventing, or detecting and correcting, material misstatements.

b. *Determination of whether a control has been implemented*. Implementation of a control means that the control exists and that the entity is using it.

(ISA 315 par. 13)

Chapter 4, "Understanding the Client, Its Environment, and Its Internal Control," of this publication provides a more detailed discussion of your required understanding of your client's internal control.

Performing Procedures to Gather Information

Observations and Suggestions

ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, requires you to obtain an understanding of your client and its environment, including internal control. The procedures you perform to gain that understanding are referred to as *risk assessment procedures*.

For this publication we have separated the process of obtaining an understanding of your client into two steps: (1) gathering or updating information and (2) using that information to develop an understanding of the client. In practice the two parts are often performed together. The following sections describe the procedures you perform to gather information. Chapter 4 of this publication describes the requirements for using the information gathered to form an understanding of the client.

The separation of the process is done just for the convenience of presenting the material and should not be construed to imply a linear process of discrete steps. Obtaining an understanding of the client, its environment, and its internal control is a continuous dynamic process of gathering, updating, and analyzing information throughout the audit.

3.22 The audit procedures you perform to obtain an understanding of the entity, its environment, and its internal control are referred to as *risk assessment procedures*. Risk assessment procedures include

a. inquiries of management and others at the client,

b. analytical procedures, and

c. observation and inspection.

(ISA 315 par. 6)

3.23 Risk assessment procedures are designed to gather and evaluate information about the client and are not specifically designed as substantive procedures or as tests of controls. Nevertheless, in performing risk assessment procedures, you may obtain evidence about relevant assertions or the effectiveness of controls.

Observations and Suggestions

When risk assessments involve the gathering and weighing of evidence, you can take credit for these procedures and reduce other audit procedures and still achieve the objectives of the audit. When used as audit evidence, such procedures should include support for the assessments. For example, a practice aid listing example risk factors and prompting for risk level ratings may also prompt for the documentation of the procedures performed, evidence examined, and conclusions reached to support these assessments.

The Risk Assessment Procedures

Inquiry of Management and Others

3.24 Although much of the information you obtain by inquiry can be obtained from management, accounting personnel, and others involved in the financial reporting process, it is often helpful to direct inquires to others within the entity. For example, people who work in production, sales, or internal audit, as well as individuals employed at different levels within the organization can provide you with a different perspective that helps identify risks of material misstatement. Inquiries of others can also help corroborate or provide additional details to the statements and representations made by management and accounting personnel. Table 3-4 provides examples of other individuals within the entity who might be able to help you identify and assess the risks of material misstatement.

Table 3-4

Examples of Inquiries of Others Within the Entity

Inquiries of These Individuals (Outside of Management the Financial Reporting Process)	*May help you understand*
Those charged with governance	• the environment in which the financial statements are prepared. • whether they have knowledge of any fraud or suspected fraud. • how they exercise oversight of the entity's programs and controls that address fraud. • their views on where the company is most vulnerable to fraud. • how financial statements are used.
Internal audit personnel	• the design and operating effectiveness of internal control. • internal audit activities related to internal control over financial reporting. • whether management has responded satisfactorily to internal audit findings. • their views on where the company is most vulnerable to fraud.
Employees involved in the initiation, processing, or recording of complex or unusual transactions	• the controls over the selection and application of accounting policies related to those transactions. • the business rationale for those transactions.
IT systems users	• how IT users identify changes to IT systems and how frequently those changes occur. • how users work around IT systems for those circumstances where the IT system does not support them. • how logical access to data and applications is controlled. • how remote access to the system is controlled. • excessive system down time and other indicators that the system is not functioning properly.
In-house legal counsel	• litigation. • compliance with laws and regulations. • fraud or suspected fraud. • warranties. • post sales obligations. • arrangements such as joint ventures. • the meaning of certain contract terms.
Marketing, sales, or production personnel	• marketing strategies. • sales trends. • production strategies. • contractual arrangements with customers. • any pressures to meet budgets or change reported performance measures.

3.24

3.25 Paragraph 17 of ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, states that the auditor should make inquiries of management and others in the entity relating to fraud. As a matter of audit effectiveness, it is helpful to integrate these inquiries with the ones described in paragraph 3.24.

Analytical Procedures

3.26 ISA 520, *Analytical Procedures*, requires the use of analytical procedures in planning the audit. The objective of these procedures is to help you understand the client and its environment and, ultimately, to assess the risks of material misstatement. As such, you should consider the analytical procedures performed during audit planning to be a risk assessment procedure that provides some broad audit evidence to support your opinion on the financial statements. (ISA 315 par. 6)

Observations and Suggestions

When you perform analytical procedures during planning, it is common to use data that is aggregated at a high level. For example, you might base your analysis on total revenues rather than revenues by product line or geographic region.

Analyses that rely on highly aggregated data typically provide only a broad initial indication of 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.

3.27 Please refer to paragraphs A7–A9 of ISA 315 for additional guidance on the performance of analytical procedures in planning the audit.

3.28 The results of analytical procedures may help you obtain an understanding of the entity. For example, analytical procedures may be helpful in identifying the following:

- The existence of unusual transactions or events, which may indicate the presence of significant risks (which are described in more detail in paragraphs 5.30–.37).
- Amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. For example, an unexpected amount, ratio, or trend may be the result of a misstatement that was not prevented or detected and corrected by the client's internal control.

Observations and Inspection of Documents

3.29 You may use observation and the inspection of documents to support the responses you receive to your inquiries of management and others. Additionally, your observations and inspections will provide you with further information about the entity and its environment that you might not otherwise obtain.

3.30 The procedures you perform to observe activities and inspect documents typically include

- observing client activities and operations.
- visiting the client's premises and plant facilities.
- inspecting documents, records, and internal control manuals.
- reading reports prepared by management (such as quarterly management reports and interim financial statements).
- reading minutes of board of directors' meetings and other documents prepared by those charged with governance.
- tracing transactions through the financial reporting information system.

Risk Assessment Procedures for IT Controls

3.31 Table 3-5 provides examples of risk assessment procedures you may perform to assess the design and implementation of IT controls (general controls and application controls).

Table 3-5

Examples of Risk Assessment Procedures to Assess the Design and Implementation of IT Controls

Risk Assessment Procedure	*Application for IT Controls*
Inspection	• Inspecting change management policies and procedures • Inspecting documentation of change management controls • Inspecting log files to determine what user access rights were associated with movement of new objects to production environment • Review of a system-generated administrative access rights list
Observation	• Conducting a walk-through review of the entity's data center to observe physical and environmental controls and general orderliness of the data center • Observing automated controls being performed for situations that are required per the design of the control
Inquiry	• Interviewing personnel to determine if responsibilities regarding performance of control activities are understood and the person(s) are capable of effectively performing the control(s)
Reperformance	• Performing a function within an application (usually a test environment) to confirm the existence of an automated control

A Mix of Procedures

3.32 You are not required to perform *all* the procedures noted in paragraph 3.22 for *each* aspect of the client's internal control and its environment listed in table 1-1. However, in the course of gathering information about the client, you are required to perform all the risk assessment procedures in accordance with ISA 315 paragraph 6.

Other Procedures That Provide Relevant Information About the Client

3.33 *Obtaining information from sources outside the entity.* Information from sources external to the client may be helpful in understanding the client and identifying risks of material misstatement. Examples of information sources external to the client that may be helpful include

- external legal counsel.
- experts that the client has used who may be relevant for financial reporting purposes (for example, a valuation expert). Please refer to ISA 620, *Using the Work of an Auditor's Expert*, for guidance relating to the client's use of an expert. ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, also may provide relevant guidance relating to the client's and auditor's use of an expert to provide information relating to fair values.
- reports prepared by analysts, banks, or rating agencies.
- trade and economic journals.
- regulatory or financial publications.
- reports from service organizations used by the client (see ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*).

3.34 *Assessing the risks of material misstatement due to fraud.* ISA 240 requires you to perform certain audit procedures to assess the risks of material misstatement due to fraud. Some of these procedures also may help you gather information about the entity and its environment, particularly its internal control. For this reason, it is helpful to

- coordinate the procedures you perform to assess the risks of material misstatement due to fraud with your other risk assessment procedures and
- consider the results of your assessment of fraud risk when identifying the risks of material misstatement.

3.35 *Other information.* When relevant to the audit, you also should consider other knowledge you have of the client that can help you assess risk. This other information may result from the following:

- Your client acceptance or continuance process
- Other engagements performed by the engagement partner for the client

(ISA 315 par. 7–8)

Discussion Among the Audit Team

Observations and Suggestions

The gathering of information about aspects of the client and its environment, in and of itself, does not provide audit evidence to support your assessment of risks. When the information gathered is supported by observations and other forms of corroboration, that information becomes audit evidence. From that evidence of the client and its environment, you form the basis for your risk assessment.

In addition to the objectives described in paragraph 3.36, the required discussion among team members also may be used to exchange information about the client and its environment that the team has gathered and to form a common understanding of the client that will be useful for assessing risks of material misstatement. The discussion also provides an opportunity for more experienced team members, including the engagement partner, to share their insights about the client.

ISA 240 directs you to perform a similar discussion among team members to specifically address the risks of material misstatement due to fraud. You are not required to have two separate discussions—the discussion described in paragraph 3.36 can be held concurrently with the discussion required by ISA 240. However, because of the unique characteristics of fraud (for example, it is a result of an intentional act), it is recommended that you clearly distinguish between your discussion of possible material misstatements due to error and your discussion of how and where the client's financial statements might be susceptible to material misstatement due to fraud.

3.36 You and your audit team should discuss the susceptibility of the client's financial statements to material misstatement. The objectives of this discussion are for team members to

- gain a better understanding of the potential for misstatements in the specific areas assigned to them and
- understand how the results of the audit procedures they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures.

(ISA 315 par. 11)

Table 3-6 lists the items that may be the topics of your discussion.

Table 3-6

Topics for Audit Team Discussion

You and your audit team should discuss the susceptibility of the client's financial statements to material misstatements. The extent of this discussion is influenced by the roles, experience, and information needs of the audit team. Matters you may discuss include

- areas of significant risks of material misstatement, including susceptibility to fraud or error.
- unusual accounting procedures used by the client.
- important control systems.
- significant IT applications and how the client's use of IT may affect the audit.
- areas susceptible to management override of controls.
- materiality at the financial level and performance materiality.
- how performance materiality will be used to determine the extent of testing.
- the application of generally accepted accounting principles to the client's facts and circumstances and in light of the entity's accounting policies.
- the need to
  - exercise professional skepticism throughout the engagement.
  - remain alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred.
  - follow up rigorously on any indications of a material misstatement.

3.37 You should exercise your professional judgment to determine logistical matters relating to the audit discussion, such as who should participate, how and when the discussion should occur, and its extent. The engagement partner and other key members of the audit team may be involved in the discussion.

3.38 When considering who should participate in the discussion, you also may determine that an IT expert or other individual possessing specialized skills should be included.

Observations and Suggestions

Multiple discussions among the audit team may help facilitate an ongoing exchange of information that will allow for a more effective assessment of risks of material misstatement and tailored responses to those risks.

Gathering Information About Internal Control

3.39 On all audits you should evaluate the design of your client's internal control relevant to the audit of the financial statements. The procedures you will perform to make this evaluation generally are more complex and comprehensive than those necessary to obtain an understanding of the other elements of the client and its environment listed in paragraph 3.18. The following sections of this publication provide guidance on planning and performing risk assessment procedures directed toward gathering the information necessary to evaluate the design of internal control.

Observations and Suggestions

You should evaluate the design and implementation of your client's internal control on *all* audits, even if you intend to design a substantive audit approach and not rely on the operating effectiveness of controls when designing further audit procedures.

Evaluating internal control design involves more than assigning a value (for example, effective or ineffective) to control risk. Understanding your client's internal control also involves a

subjective consideration of what could go wrong in your clients' processing of its financial information.

See paragraph 4.29 of this publication for an example of how an auditor might consider the qualitative aspects of internal control design.

Understanding what could go wrong is critical if you are to design and perform further audit procedures that are clearly linked to assessed risks, which is why you should evaluate internal control even when you plan a purely substantive audit. Paragraphs 5.24–.25 of this publication describe and provide examples of how your qualitative assessment of internal control design and implementation affect the nature, timing, and extent of substantive procedures.

Management's Documentation of Internal Control

3.40 The form, content, and extent of an entity's documentation of its internal control may affect your assessment of the design of the client's internal control and the nature of your audit procedures. Because of these effects, you may consider the client's documentation when planning your risk assessment procedures and evaluating the design of the client's internal control.

Observations and Suggestions

An entity's documentation of internal control generally achieves two types of objectives:

a. Documenting the design of internal control, for example, through accounting manuals, flowcharts, or descriptions of company policies or control procedures. This type of documentation will help you evaluate the design of the entity's controls.

b. Documentation of the performance of the control, which can help you determine whether the control has been implemented.

It helps to carefully distinguish between these two types of documentation when gaining an understanding of the client's internal control. You often can overcome a lack of detail in the documentation about the design of internal control, for example, by performing inquiries or observations to understand design. However, if the client has not provided documentation showing the performance of the control, it usually is difficult to determine that the control has been implemented (that is, that client employees are applying the control). For example, if the required approvals for all checks over $1,000 are not evidenced, it is difficult to establish that the control was performed.

3.41 Management's documentation of internal control can vary greatly among entities. The quantity of documentation at some entities may be limited; at others it may be more extensive. It may be helpful to think of documentation as existing along a continuum between these two extremes, and neither totally nonexistent nor totally complete. Some smaller companies and organizations may have an accounting or procedures manual, and some may have flowcharts or narratives of procedures.

3.42 In general, the quantity and appropriateness of management's documentation may have several implications for your audit. For example, insufficient or inappropriate documentation may

- limit your ability to assess controls design and to gather audit evidence that the controls are placed in operation.
- result in the need for you to create some documentation about the client's internal control in order to document your understanding of the design of internal control.
- indicate to you that the client's controls are largely ad hoc or not communicated or understood and, therefore, may not operate consistently throughout the year.

Your Ability to Assess Control Design

3.43 Risk assessment procedures related to understanding internal control consist of inquiry, observation, and the inspection of documentation. The client's lack of sufficient or appropriate documentation of internal control may restrict your ability to obtain audit evidence by inspecting documents. For example, if your client has not documented its ethical values, you will have to rely on inquiry and observation to understand the design of this important element

of the company's control environment. In some instances, observation of a control may not be possible, and you will have to determine whether corroborative inquiries made of multiple sources is sufficient to determine whether a control has been implemented. The lack of appropriate evidence that a control is in place and operating effectively may preclude the auditor from relying on that aspect of controls when designing an audit strategy. See paragraphs 3.112–.114 for a further discussion on the limits of inquiry as a risk assessment procedure.

Observations and Suggestions

Risk assessment procedures provide you with direct information about internal control design. *Indirect information* also may be a valuable source for gathering information about your client's internal control.

Indirect information is all other information available to you that may indicate a change or flaw in the design (or operation) of controls. It can include, but is not limited to, (1) operating statistics, (2) key risk indicators, (3) key performance indicators, and (4) comparative industry metrics.

Indirect information can help you identify deviations from normal or expected results that may signal a control change or failure and warrants further investigation. Indirect information does not, however, provide an unobstructed view of control operation, thus it is less able than direct information to identify deficiencies in internal control. Existing deficiencies may not yet have resulted in errors significant enough to be identified as deviations, or the indirect information may have lost its ability over time to identify deviations. Indirect information is therefore limited to the level of evidence it can provide on its own, especially over a long period of time.

The value of indirect information in monitoring depends on several factors, including the following:

- *Its level of precision.* More-precise indirect information is better able to identify anomalies that indicate a control failure.
- *The degree of variability in the outcomes.* Indirect information is better able to identify anomalies in processes that typically generate consistent, predictable results.
- *The adequacy of the follow-up procedures.* The skills and experience of people responsible for investigating anomalies, and the diligence with which they conduct their follow-up procedures, affect the ability of indirect information to identify a control failure.
- *The length of time since the operation of the underlying controls was last validated through persuasive direct information.* As time passes and operating environments change, indirect information loses its ability to detect control failures. Periodically reestablishing the control baseline using direct information helps evaluators validate or modify the nature, timing, and extent of indirect information.

The Auditor's Documentation of the Design of the Entity's Internal Control

3.44 You should document the key elements of your understanding of the client's internal control, including each of the five components of internal control. When management has documented the design of its internal control, you may choose to use management's documentation as a basis for documenting your understanding of internal control design. For example, if the client has prepared flowcharts and other documentation related to the process and controls for significant transactions, you may use that documentation as a base from which to describe your understanding of internal control. (ISA 315 par. 32)

3.45 When management's documentation is insufficient or inappropriate for audit purposes, you will need to create more documentation than you would have had management's documentation been greater or otherwise more appropriate.

Observations and Suggestions

You may wish to encourage your clients to develop basic documentation in advance of your audit. In consultation with its auditor, an entity can develop basic procedures and control documentation that may be more cost effective than if the documentation was developed by the auditor.

As described in paragraphs 3.131–.132, you may use information obtained from prior periods as audit evidence in the current period, provided that you can determine whether changes have occurred either in the client's processes or its controls. The client's maintenance of its documentation of its controls will help you identify changes in subsequent audits, which also may be more cost effective than if you maintain the documentation. In addition, client employees need the documentation to understand the system.

The Design of the Communications Component of the Entity's Internal Control

3.46 The communication component of an entity's internal control involves providing an understanding of individual roles and responsibilities pertaining to internal control. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on. Your understanding of the design of the client's internal control includes evaluating whether the client's communication methods are capable of meeting these control objectives.

3.47 Communication may be written or oral. Absent sufficient or appropriate documentation of internal control, evaluation of internal control design will include a determination of whether management can meet its internal control communication objectives with oral communication alone. That determination is a matter of informed professional judgment that depends on a number of factors, including

- the nature of the entity, including its size and the relative complexity of its operations and financial reporting systems.
- the relative effectiveness of the oral communication, which may be influenced by, among other factors, its content, frequency, and the individual providing the communication.

Observations and Suggestions

Most clients will need some level of documentation of controls for effective communication of internal control roles and responsibilities. This need for documentation is especially true for business continuity, when personnel with key internal control responsibilities leave, retire, or are absent from work.

Under the COSO framework, internal control is not the responsibility of the auditor, and, in fact, COSO principles state the auditor is *not* an element of internal control. As such, the lack of adequate documentation about internal control design can be a control deficiency, and if it rises to the level of a significant deficiency, it should be communicated to management and those charged with governance. Chapter 7 provides additional guidance on evaluating control deficiencies and communications to management about internal control matters.

Making an Initial Determination of the Overall Scope of Your Evaluation of Internal Control

3.48 You do not have to evaluate the design of *all* your client's controls, only those that are relevant to the audit. Early in the audit process, you will need to identify those controls that in your professional judgment are relevant and therefore should be included within the initial scope of your understanding. (ISA 315 par. 12)

3.49 Your professional judgment about whether a control, individually or in combination with others, is relevant to the audit may include factors such as

- materiality.
- significance of the related risk.
- the size of the entity.
- the nature of the client's business, including its organization and ownership characteristics.
- the diversity and complexity of the client's operations.

- applicable legal and regulatory requirements.
- circumstances and the applicable component of internal control.
- the nature and complexity of the systems that are part of the client's internal control, including the use of service organizations.
- whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, material misstatements.

3.50 It is common for some redundancy to be built into a system of internal control. When several control activities all achieve the same control objective, it may not be necessary to obtain an understanding of each of the control activities.

3.51 *For example, one of the control objectives at Ownco is to ensure that all purchases are properly authorized. Several distinct control activities all achieve this objective, including the procedures related to issuing and accounting for purchase orders and the review of all cash disbursements over a stated amount.*

In this situation, the auditor does not have to evaluate all of the control activities related to the given control objective. Rather, the auditor will use judgment to determine the control (or combination of controls) that achieve the objective and may limit his or her evaluation to that control, or combination of controls.

Thus, some auditors prefer to start with control objectives and identify and understand the specific controls that satisfy the control objective.

Consideration of the Client's IT Systems

3.52 To plan your audit you will want to obtain an understanding of the effect of IT on internal control. Information that may be useful for this purpose includes the following:

- *The role of IT in the initiation, recording, processing, and reporting of transactions.* You will want to identify and obtain an understanding of financial reporting and information systems that are, directly or indirectly, the source of financial transactions or the data used to generate financial transactions and financial reporting. These information systems may include
  - packaged applications,
  - custom developed applications, or
  - end-user computing (for example, spreadsheets) that are used for accounting functions or transaction cycles (for example, revenue recognition) that drive accounting data (for example, revenue and A/R entries).
- *How the client manages IT.* This includes the person(s) and third parties that support the IT infrastructure (applications and supporting networks and servers), and the person(s) that have responsibility for managing the deployment and integrity of the IT infrastructure. In general, you would expect to see staffing and skills commensurate with the complexity of the deployed systems and the entity's information system's needs.

3.53 How your client uses IT to process financial information affects its internal control. For example,

- multiple users may access a common database of information. In these circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data.
- when IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This breakdown could result in unauthorized transactions or changes to programs or data that affect the financial statements.

The following paragraphs describe those characteristics of IT use that most typically affect a financial statement audit.

General Versus IT Application Controls

3.54 As discussed previously, controls can operate at two levels, either at the specific assertion level, or more pervasively, at the entity level, with the potential to affect many different accounts and assertions.

3.55 *IT general controls*. General controls are policies and procedures that relate to many applications and support the effective functioning and continued proper operation of information systems. For example, your client's administration of passwords can potentially affect many applications. If passwords for a given user can be stored on that person's unsecured computer, the effectiveness of internal control may be compromised because anyone who gained access to the computer could inappropriately gain access to the application, the related data, or both.

3.56 General controls are internal controls generally implemented and administered by an organization's IT department. The objectives of general controls are to

- ensure the proper operation of the applications and availability of systems.
- protect data and programs from unauthorized changes.
- protect data from unauthorized access and disclosure.
- provide assurance that applications are developed and subsequently maintained, such that they provide the functionality required to process transactions and provide automated controls.

3.57 General controls commonly include controls over data center and network operations; system software acquisition, change, and maintenance; access security; and application system acquisition, development, and maintenance. These controls apply to all types of IT environments. Table 3-7 provides examples of general controls.

3.58 *Application controls*. Application controls are applied only to specific applications (for example accounts payable, payroll, or the general accounting application). Application controls apply to the processing of individual transactions. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Table 3-7 provides examples of application controls that may be relevant to your audit.

3.59 Application controls help ensure

- proper authorization is obtained to initiate and enter transactions.
- applications are protected from unauthorized access.
- users are only allowed access to data and functions in an application they should have access to.
- errors in the operation of an application will be prevented—or detected and corrected—in a timely manner.
- application processing operates as intended.
- application output is protected from unauthorized access or disclosure.
- reconciliation activities are implemented when appropriate to ensure that information is complete and accurate.
- high-risk transactions are appropriately controlled.

Table 3-7

Examples of General and Application Controls

Example General Controls	*Example Application Controls*
Examples of such general controls that may be relevant to your audit are • program change controls that include how changes are made to information systems, applications, and supporting infrastructure. • controls that restrict access to programs or data. • controls over the implementation of new releases of packaged software applications. • 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.	Application controls that may be relevant to the audit include those relating to • the rights granted to specific users to — access the application or data. — delete transactions or data that had previously been processed by the application. — originate a new transaction or record (for example, authorized vendor, approved customer, or new employee). • the integrity of data input into the system. • the completeness and accuracy of the processing of data. • the integrity of reports and information that are the products of the processing.

Observations and Suggestions

Many small- to medium-sized entities choose not to develop a formal access or security framework that describes in detail which individuals should be granted access to which information or applications. As a matter of convenience, entity management may decide that it is faster and easier to grant all users access to all applications and data.

A lack of access control typically is a control deficiency of some magnitude and, depending on the circumstances, may even be a significant deficiency if it is broad enough and serious enough to create a risk that access to the accounting system is "wide open." Lack of access controls should be considered when you evaluate the risks of material misstatement at the entity level. In many cases, a lack of access controls or security may preclude reliance on general and application controls and may preclude reliance on manual (user) controls that depend on information processed by IT. Typically, you will seek to understand what mitigating controls might be in place when you identify a lack of access control.

Access Controls

3.60 Logical access controls may reside at various levels within an IT system. For example, assume that a company's website is maintained on the same network that stores the company's applications and data. To prevent unauthorized logical access, the company may have several different layers of access controls, for example, it may deploy

- a firewall to control access from the external Internet users to the company's network.
- access controls that reside on the company's main computer that control overall access to the system.
- application-level access controls that control the access to individual applications.
- access controls over the database, which limit the applications and individuals who can access data.

3.61 A system needs to be analyzed to understand how access is controlled and the effectiveness of the control. Different approaches can be equally effective in achieving control objectives for IT. Once the initial access to applications and data has been assigned to individuals, the ongoing management and maintenance of these access assignments is a critical component of the control. For example,

- it is common for the software vendor to have universal access to the company's system for a short time after installation to help transition the company to a new system. Once the vendor ceases to help in the transition, the vendor's access to the system should be removed.
- employees who leave the company should have their access privileges terminated.
- individuals who change jobs should have their access reevaluated to ensure that they are granted access only to the data and applications they need to perform their new jobs.

3.62 Unauthorized access to computer equipment also may pose a risk to the company. For example, an individual with physical access to the company's server may be able to inappropriately manipulate data. For this reason, the company will want to control the physical access to its server and other critical hardware components, for example, by keeping such equipment in a locked space.

Observations and Suggestions

Logical access controls may affect the risks of material misstatement in that they can be structured to restrict access to system components such as networks, applications, databases, and end-user computing such as spreadsheets supporting the financial reporting process.

In certain circumstances, the absence of effective logical access controls (for example, access rights to the financial database or access rights to the general ledger) could increase the risks of material misstatement so significantly that a prudent auditor would assign a control risk of maximum for all of the output produced by a business application.

Program Change Controls for Off-the-Shelf Programs

3.63 The objective of program change controls is to help ensure that new or modified programs operate as designed and that they are appropriately tested and validated prior to being placed into production. Program change controls should include changes related to

- the operating system, including updates and patches,
- applications,
- database schemas, and
- how the database presents data to the application.

3.64 Even in circumstances where your client uses unmodified, off-the-shelf programs and does not modify these programs, this control objective still is relevant. For example, your client will want to ensure that

- updated versions of operating systems or application software are properly installed.
- new or modified applications, even if received from the vendor, are tested to ensure they function properly and capture and process the data properly from prior versions before being put into production.
- users are involved in a meaningful way in testing new applications or new versions of existing applications.

Documentation of Mapping of Data Among Different Applications

3.65 As described in paragraph 2.73 of this publication, when a company uses applications developed by different software vendors, data among applications may need to be mapped. It is common for an application vendor to take responsibility for mapping the data to ensure the application integrates properly with the company's system. In other circumstances, company personnel may map the data. Regardless of who performs the task, the mapping or interface between the applications must be documented. Without adequate documentation, the company will have difficulty adding other applications or making other modifications to the system. The importance of general controls over new system development or changes to systems includes controls that require documentation of the mapping and testing to ensure the mapping is implemented correctly.

3.66 For example, this might not be a significant risk or issue if the new program is the next version of the existing software, but more of an issue if the new program is an upgrade from several versions back, is from a different vendor, or is self-developed software. In such cases it may not be appropriate to simply rely on the claims of the vendor or developer regarding importing data from other applications. The completeness, classification, and accuracy of the data may need to be tested before relying on the new software.

The Relationship Between Manual and IT Application Controls

3.67 IT application controls almost always require a complementary manual control to be effective. For example, one of your client's control objectives may be to ensure that items are shipped to customers only if the customer provides a purchase order. Toward that end, your client's IT system may produce an exception report of all shipments for which no purchase order was ever received. By itself, production of the exception report does not satisfy the control objective. To achieve the objective, the client must have a complementary manual control (that is, an individual to perform a timely review of the exception report and follow-up on all reported items).

Similarly, effective functioning of an IT control may depend on the effective functioning of a manual follow up component. For example, suppose the IT system compares key information on a sales order to an approved purchase order. Any differences are identified and placed in a suspense file. That control procedure is effective only if the suspense file is reviewed on a timely basis and the items identified are investigated and resolved in an appropriate manner.

3.68 The effective functioning of a manual control may depend on the effective functioning of certain IT controls. For example, a sales manager periodically reviews the commissions paid to sales people to determine whether the amounts paid seem reasonable. To perform the review, he or she uses a sales report that breaks down sales volume by sales person per month. In this example, the manual control procedure (reviewing commissions paid for reasonableness) depends on the completeness and accuracy of the information provided to the sales manager about sales volumes. Thus, the IT controls related to the accuracy and completeness of this information are relevant to the audit, even though the information itself does not flow directly to the financial statements. Both the manual procedure and the IT controls are relevant.

3.69 Because of the close relationship between manual and IT controls, your understanding of the client's internal control includes consideration of both types of controls.

Consideration of IT When Determining the Skills Needed to Perform the Audit

3.70 The use of professionals possessing IT skills is a significant aspect of many audit engagements. An IT professional may help to

- determine the effect of IT on the audit;
- identify and assess IT risks;
- understand IT controls;
- identify IT control deficiencies that would prevent you from relying on controls to modify the nature, timing, and extent of your substantive procedures;
- design and perform tests of IT controls; or
- design and perform substantive procedures or dual-purpose tests covering both; for example, using computer assisted auditing techniques (CAATs).

3.71 Table 3-8 describes examples of the factors you may consider when determining whether an IT professional is needed on your audit team.

Table 3-8

Examples of Factors to Consider Regarding Use of an IT Professional

	Likelihood of Needing an IT Professional on the Audit	
Factor	*More Likely*	*Less Likely*
Complexity of the client's IT systems	Relatively complex IT systems and custom applications	Relatively simple IT systems and purchased software
Changes to existing systems	Significant changes	Minor, if any, changes
Implementation of new systems	Implementation of significant new systems	Minor or no new systems
Data sharing	Significant sharing of data among systems	Little sharing of data among systems
E-commerce activities	Significant	Minimal
Use of emerging technologies	Significant use of emerging technologies to process financial information	Minimal use of emerging technologies to process financial information
Availability of audit evidence	Significant audit evidence available only in electronic form	Most or all audit evidence available in hard copy

Observations and Suggestions

The more complex the entity's systems and IT environment, the more likely that an IT professional should be an integral part of the audit team during the planning process and may need to be involved in performing the audit. In these cases, an IT professional with sufficient understanding of financial statement audit objectives and methodology may be helpful in determining the need to use additional professionals possessing a sufficient understanding of the technologies being used by the entity in support of its financial processes to understand the effect of IT on the audit.

3.72 When using an IT professional on your engagement, it may be appropriate to include that professional in your audit team discussions to help design those segments of the audit strategy and plan that include the IT audit objectives, resources required, and the timeline. Specific objectives that may be established for the IT professional may include

- assessing the entity-level IT functions and controls.
- assessing the role of third parties including inherent risk and adequacy of mitigating controls.
- documenting the role of IT applications used to support one or more financial statement accounts, financial statement preparation, and the reporting process. This may include the preparation of documentation to depict the flow of financial information from transaction initiation through various stages of processing and reporting.
- assessing activity-level inherent risk and the adequacy of mitigating controls for one or more IT applications used to support one or more financial statement accounts, financial statement preparation, and the reporting process.
- identifying relevant IT processes that support the relevant applications and inherent general control risks, and the adequacy of controls to mitigate these risks.
- planning and performing tests of IT controls.
- identifying opportunities to leverage CAATs in the execution of tests for fraud and substantive procedures.

3.73 It is common for companies to operate several different IT systems, some of which may integrate directly with the accounting system and others that are stand-alone. For the purpose of planning the scope of your risk assessment procedures, it is helpful to obtain an understanding

of the number and types of IT systems the client uses and which of these systems are relevant to the audit. Your consideration of IT systems includes standalone, PC-based applications that process information used in the financial reporting process.

3.74 Ordinarily, IT systems that are relevant to the audit are those that capture, store, access, or process data that is used in the preparation of financial information. On the other hand, systems that pertain exclusively to nonfinancial information that is not used by management in the financial reporting process normally are not within the scope of your audit. However, the example previously mentioned shows the possibility of such systems' effect on the financial statements even when it is not readily apparent.

3.75 *For example, Young Fashions uses the following IT systems to manage its business:*

- Customer relationship management. *This system maintains a database of customer contact information, purchase history, outstanding orders, approved credit limits, and other information needed by sales personnel to service the account. The system captures sales and return information, which it stores and makes available to the company's general accounting software. The system runs off of the company's main server.*
- Garment design system. *The company's designers use a computerized garment design system, in addition to hand drawings, to help design fabrics and individual garment product lines and to determine the quantities and types of materials to order. The system is a standalone, which is producing information that is used by the system only for production planning purposes.*
- Communications systems. *The company has several systems that manage its in-house network and its website, including the e-commerce function. This system captures sales made over the Internet. To date, the company has not been successful at integrating this system with its customer relationship management system or its accounting system. As a result, Internet sales are entered manually into the accounting system (via journal entry) and into the customer relationship management system (by the sales reps).*
- Accounting system. *The company has an off-the-shelf general accounting software package. Except for sales, this system is used to capture all routine business transactions, process these transactions, and maintain the general ledger.*
- Utilities, Online Analytical Processing (OLAP), and Standalone User Systems. *The company uses several utilities and OLAP programs to access data maintained either in the customer database or the various databases maintained by the general accounting system. Certain individuals within the company use these applications to access data for further analysis. Some of these spreadsheets are used to prepare accounting processing in a spreadsheet program, financial statement disclosures, or other financial information.*

3.76 *By obtaining an overall understanding of the various IT systems, the auditor of Young Fashions is better able to plan which of these systems is relevant for the audit and how the use of these systems will affect the audit. For example, controls over the garment design system are used for operational purposes only and have no interaction with financial information. All other systems are involved in the capture, storage, access, or processing of financial information, either directly or indirectly. These systems are relevant to the audit, and the auditor should perform the risk assessment procedures to include obtaining additional information about the general and application specific controls related to them.*

Observations and Suggestions

Your initial determination of which IT systems are relevant to the audit may change as the audit progresses. For example, you may decide to use the information produced by the garment design system to perform analytical procedures relating to purchases or cost of sales.

In that case, when you use information produced by the client's IT system to perform audit procedures, you should obtain audit evidence about the completeness and accuracy of that information, which may require you to evaluate the controls over the system that produces that information. (ISA 500 par. 8)

This may be effectively and efficiently done in conjunction with your required overall assessment of the COSO information and communication components.

Consideration of Controls at a Service Organization

3.77 Services provided by a service organization are relevant to the audit of a user entity's financial statements when those services and the controls over them affect the user entity's information system, including related business processes relevant to financial reporting. Although most controls at the service organization are likely to relate to financial reporting, other controls also may be relevant to the audit, such as controls over the safeguarding of assets. A service organization's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:

a. The classes of transactions in the user entity's operations that are significant to the user entity's financial statements.

b. The procedures within both IT and manual systems by which the user entity's transactions are initiated, authorized, 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 user entity's financial statements that are used to initiate, authorize, record, process, and report the user entity's 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 user entity's 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 user entity's financial statements, including significant accounting estimates and disclosures.

f. Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.

(ISA 402 par. 3)

3.78 The nature and extent of work to be performed by the user auditor regarding the services provided by a service organization depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.

(ISA 402 par. 4)

3.79 The objectives of the user auditor, when the user entity uses the services of a service organization, are to

a. obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement.

b. design and perform audit procedures responsive to those risks.

(ISA 402 par. 7)

3.80 *For example, many entities use a service organization to process their payroll transactions, and for some entities—particularly, not-for-profit entities—payroll is a significant class of transactions. Typically, the payroll processor merely records and processes the transactions and data and does not initiate or authorize payroll. If the entities put into place user controls related to both the information it sends to the payroll processor and the information it receives from the processor, the auditor may choose to gain an understanding of these controls rather than rely on the ones at the payroll processor. However, from a practical standpoint, it is often cost effective to seek assurance from a service organization control type 2 report when it is available and relevant.*

3.81 When obtaining an understanding of the user entity, the user auditor should obtain an understanding of how the user entity uses the services of a service organization in the user entity's operations, including the following:

a. The nature of the services provided by the service organization and the significance of those services to the user entity, including their effect on the user entity's internal control

b. The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organization

c. The degree of interaction between the activities of the service organization and those of the user entity

d. The nature of the relationship between the user entity and the service organization, including the relevant contractual terms for the activities undertaken by the service organization

(ISA 402 par. 9)

3.82 When obtaining an understanding of internal control relevant to the audit in accordance with ISA 315, the user auditor should evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization. (ISA 402 par. 10)

3.83 The user auditor should determine whether a sufficient understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement. (ISA 402 par. 11)

Observations and Suggestions

Usually, the most effective and efficient way to determine the effect a service organization has on your audit is to focus on the complementary user entity controls maintained by your client. A type 2 report under ISA 402 typically includes a discussion of complementary user entity controls the service auditor believes should be in place at your client. This information will be helpful to your evaluation of the design of the client's controls over transactions processed by the service organization.

If the user auditor plans to use a type 1 or type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organization, the user auditor should

a. evaluate whether the type 1 report is as of a date, or in the case of a type 2 report, is for a period that is appropriate for the user auditor's purposes;

b. evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and

c. determine whether complementary user entity controls identified by the service organization are relevant in addressing the risks of material misstatement relating to the relevant assertions in the user entity's financial statements and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

3.84 In certain situations, the transactions processed and the accounts affected by the service organization initially may not appear to be material to your client's financial statements. However, the nature of the transactions processed may require you to obtain an understanding of those controls. For example, assume that a service organization provides third-party administration services to an entity that is self-insured with regard to health insurance benefits to its employees. Although the administrative transactions processed by the service organization may not appear to be material to the user organization's financial statements, the user auditor may need to gain an understanding of the controls at the third-party administrator because improper processing may result in a material understatement of the liability for unpaid claims.

Observations and Suggestions

Outsourcing

It has become increasingly common for entities to outsource some of their operations to third-party service providers. Your client's outsourcing of all or a portion of its information system does not relieve you of your responsibility to understand the controls related to those outsourced functions.

However, it may be difficult to determine whether the functions that your client has outsourced are part of its information system or constitute your client's engagement of an expert to provide a service. This distinction is important because

- if your client has outsourced part of its information system, you should obtain an understanding of the processes and controls directly related to the outsourced system, as described in paragraph 3.79.
- on the other hand, if your client has engaged an expert, you do not need to obtain an understanding of the controls maintained by that expert but instead would consider the controls maintained by the client related to the expert's work, including those related to
  - the selection of the expert (for example, reputation, qualifications, or certifications).
  - the accuracy of data supplied to the expert.
  - the review of the experts work and conclusion that results are reasonable.

To determine whether your client has outsourced a portion of its information system or has engaged an expert, it is helpful to refer to the definition of a*n expert*. As defined in the auditing literature (ISA 620 par. 6), an expert is "an individual or organization possessing expertise in a field other than accounting or auditing..." Using that definition, your client's use of a third-party payroll processor would constitute the outsourcing of a portion of its information system. The payroll processor is not an expert because payroll is a common function within the field of accounting and auditing.

As a general rule, if a client is using an expert, it is in a discipline that requires some sort of certification or licensure other than a CPA (for example, attorneys, actuaries, appraisers, valuation experts, engineers, or geologists). For example, a client that uses an appraiser to determine the fair value of an asset would be engaging an expert, not outsourcing a part of its information system.

The role assumed by the third party is also critical. An outsourced IT function is generally an extension of entity operations, and, as such, the vendor is not acting in the role of an expert.

Consideration of Multiple Operating Units or Business Functions

3.85 Internal control may apply to the entity as a whole or to any of its operating units or business functions. Determining which operating units or business functions should be included in your understanding of internal control is a matter of informed professional judgment. In general, if a segment or operating unit of the company could have a material effect on the income statement or the balance sheet, the unit's controls may be relevant.

3.86 Factors that may influence your judgment about whether to gather information and evaluate the controls of a particular operating unit or business function include

- the significance of the transactions initiated, authorized, recorded, or processed by the operating unit or business function.
- the risks of material misstatement of specific assertions related to the operating unit or business function.

Observations and Suggestions

Once you have made an initial determination of the overall scope of your risk assessment procedures, you will then be able to begin gathering information about specific control objectives and related controls.

Remember that your understanding of the client and assessment of the risks of material misstatement will evolve as the audit progresses and you obtain results from your audit procedures.

This publication distinguishes between controls that operate at the entity-level and address risks to the financial statements as a whole, and those that operate at the activity-level and address risks of misstatement of specific assertions.

(continued)

The auditing standards do not dictate the order in which you gather information and obtain an understanding of these two categories of controls. However, in most cases it usually is more effective and efficient to gain an understanding of entity-level controls *first* before the activity-level controls.

Entity-Level Controls That Are Relevant to Your Audit

3.87 There are several categories of entity-level controls that are relevant to your audit. The following section discusses these categories in the following order:

- Elements of the five control components that are defined by ISA 315 as being relevant to the audit
- Antifraud programs and controls, the understanding of which is required by ISA 240
- IT general controls
- Controls related to significant financial statement level risks
- Other entity-level controls that you determine are relevant

Elements of the COSO Control Components

3.88 On each audit, you should obtain an understanding of certain, specified elements relating to each of the five COSO components of internal control. (Chapter 2 of this publication describes these components in detail.) Table 3-9 summarizes those elements that operate at the entity-level and for which you may gather information.

Table 3-9

Examples of Entity-Level Controls Elements of the COSO Components for Which You May Gather Information[1]

COSO Control Component	*Control Description*
Control Environment	• The attitudes, awareness, and actions of those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting
Management's Risk Assessment Process	• How management considers risks relevant to financial reporting objectives and decides about actions to address those risks
Information and Communication	• How the information system captures events and conditions, other than classes of transactions, that are significant to the financial statements • The procedures the client uses to prepare financial statements and related disclosures, and how misstatements may occur • How the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting
Monitoring	• The major types of activities that the entity uses to monitor internal control over financial reporting, including the sources of the information related to those activities, and how those activities are used to initiate corrective actions to its controls

[1] Nonentity-level components and other information elements are mentioned elsewhere in this chapter.

IT General Controls

3.89 IT general controls 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. IT general controls commonly include controls over

- data center and network operations;
- system software acquisition, change, and maintenance;
- access security; and
- application system acquisition, development, and maintenance.

Antifraud Programs and Controls

3.90 Your client may have antifraud programs and controls that are relevant to the audit. If so, you may evaluate whether they are suitably designed and placed in operation to address identified risks of material misstatement due to fraud.

3.91 At the entity level, your client may have established broad programs designed to prevent, deter, and detect fraud (for example, programs to promote a culture of honesty and ethical behavior). These controls typically function at the financial statement level and often require you to develop an overall response to how you plan, staff, and conduct the audit.

Controls Related to Significant Financial Statement Level Risks

3.92 Significant risks are risks of material misstatement that require special audit consideration. One or more significant risks arise on most audits, and the controls related to these risks are relevant to the audit. At the financial statement level, significant risks often relate to significant nonroutine transactions and judgmental matters such as estimates. Paragraphs 4.65–.66 of this publication provide guidance on the controls related to nonroutine transactions and judgmental matters. Chapter 5, "Risk Assessment and the Design of Further Audit Procedures," of this publication provides more detailed guidance on the identification of significant risks. (ISA 315 par. 28)

Other Entity-Level Controls That May Be Relevant to Your Audit

3.93 Other entity-level controls that typically are relevant to your audit include those relating to the following:

- *The selection and application of significant accounting policies*. Management is responsible for adopting appropriate accounting policies. Risks of material misstatement of the financial statement arise if management's selection or application of its accounting policies is inappropriate. Paragraphs 4.68–.69 of this publication provide guidance on controls relating to the selection and application of significant accounting policies.
- *The participation of those charged with governance*. The responsibilities of those charged with governance are of considerable importance. Their participation in the financial reporting process affects your client's overall control consciousness. Paragraphs 4.70–.71 of this publication provide guidance on controls relating to the responsibilities of those charged with governance.

Observations and Suggestions

The risk assessment standards use the term *those charged with governance*. Governance describes the role of a person or persons entrusted with the supervision, control, and direction of the entity. In a smaller entity, the responsibilities of governance may reside with only one individual, the owner-manager.

This publication uses the phrase *those charged with governance* simply to be consistent with the standards. The use of the word *those* should not be construed to mean that all entities must have a group, independent from management, responsible for governing the entity.

Activity-Level Controls That Are Relevant to Your Audit

3.94 The following section discusses activity-level controls that are relevant to your audit in the following order:

- Elements of the five control components that are defined by ISA 315 as being relevant to the audit
- Activity-level antifraud controls, the understanding of which is required by ISA 240
- Controls related to significant assertion level risks
- Other activity-level controls that you determine are relevant

Observations and Suggestions

Distinguishing Between a Process and a Control

The steps in a financial reporting process are different from the controls related to that process. Understanding these differences will help you design appropriate audit procedures to obtain your understanding of internal control.

Processes

The processing of financial information is transformative in nature. Data or information is changed as a result of a process. For example, an entity may process its sales transactions, and one of the steps in the process may involve preparing an invoice based on the number of units shipped and the price per unit. The extension of unit prices by number of units sold is a process. When information is processed, the risk of misstatement is introduced. For example, the calculation of an invoice may be based on incorrect prices.

Controls

In contrast, the primary objective of a control is not to transform information. The objective of a control is to either (*a*) prevent or (*b*) detect and correct misstatements that may be introduced as a result of performing a process. For example, if one of the things that could go wrong in preparing an invoice is the use of an incorrect price, a procedure involving the check of invoices to make sure that correct prices have been used is a control.

Elements of the COSO Components and Antifraud Controls

Information Systems and Control Activities

3.95 Your knowledge of the presence or absence of control activities obtained from understanding the control environment and other control components assists you in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. Ineffective control environments and unreliable accounting systems may overshadow any benefit of examining controls activities in any significant detail.

3.96 However, when the auditor finds it appropriate to examine relevant control activities, an audit does not require you to obtain an understanding of all the information processing and activity-level controls related to each class of transactions, account balance, and disclosure in the financial statements or to every relevant assertion. Rather, your understanding of activity-level controls should be focused on significant classes of transactions and accounts.

3.97 *Information systems.* For those significant classes of transactions, you should obtain an understanding of

a. how significant transactions are initiated, recorded, processed, and reported and the related accounting records, supporting information, and specific accounts. (ISA 315 par. 18)

b. how the incorrect processing of transactions is resolved.

c. if applicable, control activities relating to authorization, segregation of duties, safeguarding of assets, and asset accountability.

Observations and Suggestions

Determining which transactions are significant at your client is a matter of professional judgment. Factors you might consider in determining whether a class of transactions is significant for financial statement purposes include

- the volume of transactions and
- the relative importance of the transactions to the company's day-to-day operations and to the financial statements.

Examples of significant classes of transactions on many audits include revenue or sales transactions, purchases, payroll, cash receipts, and cash disbursements.

3.98 *Antifraud controls.* You should treat assessed risks of material misstatement due to fraud as significant risks and obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (ISA 240 par. 27)

IT Application Controls

3.99 Under paragraph 21 of ISA 315, you should obtain an understanding of how the client has responded to risks arising from IT. As such, you may obtain an understanding of IT application controls. Such controls are manual or automated and typically operate at a business process level and apply to the processing of transactions by individual transactions. Application controls can be preventive or detective and are designed to ensure the integrity of the accounting records. They relate to procedures used to initiate, record, process, and report transactions or other financial data. For example, application controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Another example is edit checks of input data, numerical sequence checks, and manual follow-up of exception reports.

Observations and Suggestions

IT application controls may include those relating to

- data input controls over transactions (including those rejected) to determine that they are authorized and that transactions accepted are processed correctly and completely.
- output controls that assess whether input errors are reported and corrections are made or data is resubmitted, preventing the possibility of incomplete or inaccurate data.
- testing packaged software updates before they are put into production. For example, testing that key reports from both the old and new software reflect the same information is one way to test the completeness and accuracy of information transfer between the software packages.
- using a more formal process for selecting new applications, for example, consideration of application controls, security requirements, or data conversion requirements.
- storing critical applications or data in secure locations or on secured file servers.

However, without good IT general controls where they are relevant, the auditor will have little basis to rely on application controls.

Revenue Recognition

3.100 Revenue recognition demands special audit consideration on many audits. ISA 240 states that the auditor should evaluate the types of revenue, revenue transactions, or assertions that give rise to the risk of material misstatement due to fraud, based on the presumption that there are risks of fraud in revenue recognition.

Table 3-10

Controls Over Revenue Recognition

Revenue recognition issues pose significant risk to auditors. The following revenue recognition controls are considered relevant to the audit:

1. Policies and procedures for the following:
    - *a*. Receiving and accepting orders
    - *b*. Extending credit
    - *c*. Shipping goods
    - *d*. Relieving inventory
    - *e*. Billing and recording sales transactions
    - *f*. Receiving and recording sales returns
    - *g*. Authorizing and issuing credit memos
2. Procedures for determining the proper cutoff of sales at the end of the accounting period
3. The computer applications and key documents used during the processing of revenue transactions
4. The methods used by management to monitor its sales contracts, including the following:
    - *a*. The company's policy about management or other personnel who are authorized to approve nonstandard contract clauses
    - *b*. Whether those personnel understand the accounting implications of changes to contractual clauses
    - *c*. Whether the entity enforces its policies regarding negotiation and approval of sales contracts and investigates exceptions
5. The application of accounting principles
6. The entity's financial reporting process to prepare the financial statements, including disclosures

Controls Related to Significant Activity-Level Risks

3.101 Significant risks are risks of material misstatement that require special audit attention. You should obtain an understanding of the controls, including control activities, related to these risks. Paragraph 5.37 of this publication provides additional guidance on identifying significant risks at the assertion level. (ISA 315 par. 29)

Identify Other Controls That Are Relevant to the Audit

Circumstances When Substantive Procedures Alone Will Not Provide Sufficient Appropriate Audit Evidence

3.102 In some circumstances, substantive procedures alone will not provide sufficient appropriate audit evidence about an assertion. In those circumstances, you should evaluate the design and implementation of controls related to that assertion. Further, as described in chapter 6, "Performing Further Audit Procedures," of this publication, you should test these controls to obtain evidence of their operating effectiveness. (ISA 315 par. 30 and ISA 330 par. 8)

Observations and Suggestions

Circumstances where "substantive procedures alone will not provide sufficient appropriate audit evidence" typically arise when significant transactions (for example, revenues, purchases, cash receipts, or cash disbursements) are initiated electronically or when data is stored or processed electronically without manual intervention or a paper "audit trail."

It is your understanding of the client's information system that enables you to identify these circumstances.

The Identification and Examples of Circumstances When Substantive Procedures Alone Will Not Provide Sufficient Appropriate Audit Evidence

3.103 In some cases, your client may initiate, record, process, or report a significant amount of information electronically. In those circumstances, it may not be possible to design effective substantive procedures that, by themselves, are capable of providing sufficient, appropriate audit evidence.

3.104 Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as sales. When determining whether substantive procedures alone are sufficient to gather the appropriate audit evidence you may consider the following:

a. *Characteristics of available audit evidence*. When the processing of a significant amount of client's information is highly automated with little or no manual intervention, audit evidence may be available only in electronic form. When audit evidence exists only electronically, a paper audit trail may not exist. Absent this paper trail, your ability to determine whether the electronic information provides appropriate and sufficient audit evidence usually depends on the effectiveness of controls over its accuracy and completeness.

b. *Greater risks of material misstatement*. The risks of material misstatement may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively. For example, inappropriate transactions may be initiated or electronically stored information may be altered when there is little or no manual intervention on the initiation or processing of transactions. Because of this increased risk, you may determine that it is not possible to reduce audit risk to an acceptable level solely by performing substantive procedures.

3.105 *For certain finished goods of its JY Sport line, Young Fashions initiates purchase orders based on predetermined rules of what to order and in what quantities. These rules are programmed into its IT system and transactions are entered into automatically, without further approval or any other type of manual intervention. No other documentation of orders placed for these goods is produced or maintained, other than through the IT system. Any differences between the amounts received and ordered should be identified and reconciled at the time the shipment is received (and the purchase order is matched to the receipt of goods).*

In this example, audit evidence for purchase orders is available only in electronic format. However, evidence of the receipt of goods is available. The auditor may be able to perform substantive audit procedures to address some assertions but not others. For example, obtaining confirmations of purchases from suppliers may provide evidence concerning the occurrence of the transaction and its amount. The inventory count process also provides evidence of existence of inventory quantities. However, to reach a conclusion concerning whether all valid purchase orders were captured by the system (a completeness assertion) the auditor may have no better choice than to rely on the controls relating to the IT system in conjunction with controls related to the receiving process. Because an unfilled purchase order does not give rise to a liability, the auditor assessed the risk of a misstatement associated with such a situation to be low.

3.106 *Ownco makes retail sales online. The company's IT system authorizes the transaction, invoices the customer, and collects the amount due by charging the customer's credit card.*

As with the previous example, the auditor may not be able to obtain evidence relating to the completeness assertion for revenue without testing the controls related to the IT system.

Controls Over Processes Not Directly Related to Financial Reporting

3.107 Ordinarily, controls that are relevant to an audit pertain to the preparation of the client's financial statements and may include controls over safeguarding of assets against unauthorized acquisition, use, or disposition. Similarly, compliance with regulatory requirements or laws may have financial implications, so the effectiveness of a company's programs over compliance may be relevant.

3.108 Controls relating to the client's operations and compliance with laws and regulations may be relevant to your audit as serious noncompliance may misstate information or data that is reported to shareholders. An example is the risk of unmeasured costs that may arise due to fines. On the other hand, the auditor generally examines the programs the client places into effect to achieve these objectives and the results of regulatory actions to assess their effectiveness rather than the auditor testing compliance directly.

3.109 *For example, controls pertaining to nonfinancial data that management uses in monitoring its financial reporting results or that you use in analytical procedures (for example, production statistics) or controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements (for example, controls over compliance with income tax laws and regulations used to determine the income tax provision) may be relevant to your audit.*

Perform Risk Assessment and Other Procedures

Performing Risk Assessment Procedures to Gather Information About Internal Control

3.110 To obtain the necessary understanding of internal control, you should perform risk assessment procedures, which include

a. inquiries of management and others within the client who, in your professional judgment, may have information that is likely to assist in identifying risks of material misstatement;

b. analytical procedures; and

c. observation and inspection.

Note: See paragraphs 3.77–.84 for guidance on when the entity uses a service organization to process transactions.

(ISA 315 par. 6)

3.111 In addition to these risk assessment procedures, when you perform other procedures they may help you identify risks of material misstatement. For example, you read analysts' reports or make inquiries of the client's legal counsel.

Observations and Suggestions

The auditing standards describe the procedures listed in paragraph 3.22 as risk assessment procedures. In fact, these procedures are designed to gather the information that then allows you to understand internal control. The procedures described are information-gathering procedures. The performance of these procedures does not provide you with the requisite understanding of internal control, only the information necessary to form your understanding. An understanding of internal control is a function of information gathering and its subsequent analysis and synthesis.

Inquiries and Their Limitations

3.112 Inquiry may allow you to gather information about internal control design, but inquiry alone is not sufficient to determine whether the control has been implemented. Thus, when inquiry is used to obtain information about the design of internal control, you may corroborate the responses to your inquiries by performing at least one other risk assessment procedure in order to determine that client personnel are using the control. That additional

procedure may be further observations of the control operating, inspecting documents and reports, or tracing transactions through the information system relevant to financial reporting. When no other procedure is more effective, corroborating inquiries, combined with observations, consideration of past actions, or other evidence supporting the inquiries, may together provide sufficient evidence.

3.113 When audit evidence is not available from any other sources, corroborative inquiries made of multiple sources may still have significant value when determining whether a control has been implemented. For example, making inquiries of the owner-manager about the implementation of the company's code of conduct will not, by itself, allow the auditor to obtain a sufficient understanding of that aspect of the control environment. However, corroborating the owner manager's response with additional inquiries of company personnel or a survey in conjunction with observations or other evidence the auditor may gather through other audit procedures that support the veracity of the inquiries, may provide the auditor with the requisite level of understanding. For example, ISA 500, *Audit Evidence*, notes that corroboration of evidence obtained through inquiry is often of particular importance. In the case of inquiries about the control environment and "tone-at-the-top," the information available to support management's responses to inquires may be limited. In these cases, further inquiries or surveys of company personnel are often designed to provide further evidence regarding the implementation or the effectiveness of such controls. Observing behaviors, understanding management's past history of carrying out its stated intentions with respect to control environment issues such as ethical policies and fraud intolerance, and management's ability to pursue a specific course of intended action may provide relevant information supporting the results of the inquiries.

Even in the case of very small businesses where there are, for example, only two or three employees, inquiries may be supplemented with auditor observations or other evidence supporting the results of inquiries.

3.114 Much of the information you obtain by inquiry can be obtained from management and those responsible for financial reporting. However, inquiries of others within the entity, such as production and internal audit personnel, and other employees with different levels of authority, also may be useful. Paragraph 3.24 and table 3-4 provide additional guidance on making inquiries of others within the entity.

Analytical Procedures

3.115 Paragraphs 3.26 and 3.28 provide guidance on how analytical procedures may help you gather information and gain an understanding of the client, its environment, and its internal control. The application of analytical procedures may lead you to identify unusual transactions or events, which may indicate the presence of significant risks (as discussed in chapter 5 of this publication). Paragraph 3.92 addresses controls related to significant risks.

Observation and Inspection

3.116 Observation and inspection may support inquiries of management and others and also provide information about internal control. Such audit procedures ordinarily include

- observing entity activities and operations;
- inspecting documents (business plans and strategies), records, and internal control manuals;
- reading reports prepared by management, internal auditors, and those charged with governance (such as minutes of board of directors' meetings); and
- visiting the client's premises and plant facilities.

3.117 The observation of the performance of a control procedure may not be possible when the control is performed on an as-needed basis, and you are not present to observe it. For example, the way in which management responds to a violation of the company's code of conduct is an element of the control environment that you cannot plan to observe.

3.118 When inspecting the documentation of a control, it is helpful to distinguish between the documentation of the design of the control and evidence of its performance, which addresses the implementation of the control. For example,

- a written code of conduct describes the design of an element of the control environment. However, by itself, it does not provide evidence about how the control has been implemented.
- the sign-off by the accounting staff that a reconciliation was performed will help you determine whether the control was implemented. However, the sign-off does not allow you to understand the design of the control and how the procedure should have been performed. It also does not establish what the signer did to review the transaction, other than to sign.

Other Procedures

Procedures Performed to Assess Misstatements Caused by Fraud

3.119 ISA 240 directs you to perform certain audit procedures to assess the risks of material misstatement due to fraud. Some of these procedures will complement your understanding of the implementation of internal control. These audit procedures include the following:

a. Inquiries of management and others within the entity about the risk of fraud, knowledge of any fraud or suspected fraud, programs and controls to mitigate fraud risks (ISA 240 par. 17–19)

b. Inquiries of management about whether and how they communicate to employees its views on business practices and ethical behavior (ISA 240 par. 17*d*)

c. Communications from management to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity (ISA 240 par. 17*c*)

d. Audit procedures relating to revenue recognition performed in response to the presumption that revenue recognition is a fraud risk (ISA 240 par. 26)

e. Audit procedures performed to obtain an understanding of the entity's financial reporting process and the controls over journal entries and other adjustments (ISA 240 par. 32*a*)

f. Audit procedures performed to evaluate the business rationale for significant unusual transactions (ISA 240 par. 32*c*)

Walkthroughs

Observations and Suggestions

Evaluating the design of a control involves considering whether the control is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and the client is using it. Risk assessment procedures to obtain audit evidence about the design and implementation of a control may include inquiring, observing, inspecting documentation, and tracing transactions through the information system. This activity is commonly referred to as a *walkthrough*. The following commentary on walkthroughs describes a process as rigorous and thorough as any other audit procedure you perform to gather audit evidence. Walkthroughs need to be well-planned and performed with due care and an appropriate level of professional skepticism. To perform a thorough walkthrough, you would plan to

- make inquiries of people who actually perform the procedure, not just someone at a supervisory level.
- corroborate the responses to inquiries by performing additional procedures such as the inspection of relevant documents or accounting records, or corroborating inquiries made of others.

Merely tracing information through the client's accounting system is not considered a walkthrough. A properly performed walkthrough will allow you to confirm the design of controls over the processing of the information and to gain some evidence that the controls exist and that client personnel are using them.

It is relatively easy to document a set of controls that should be in place, but the walkthrough provides evidence that the design reflects the way the control works. Anecdotal evidence indicates that differences between documented and implemented controls may be more common than expected.

3.120 The purpose of a walkthrough is to help

- confirm your understanding of key elements of the client's information processing system and related controls.
- evaluate the effectiveness of the design of internal control.
- determine whether certain controls have been implemented.

3.121 A walkthrough generally is designed to provide evidence regarding the design and implementation of controls. However, a walkthrough may be designed to include procedures that are also tests of the operating effectiveness of relevant controls (for instance, inquiry combined with observation, inspection of documents, or reperformance). See paragraphs 6.64–.67 of this publication for additional guidance on the use of walkthroughs to gather evidence about the operating effectiveness of controls.

3.122 There are several ways to perform a walkthrough to achieve your audit objectives. For example, you could

- select a single transaction and trace its processing through the company's information processing system and all the way through to its reporting in the financial statements.
- identify the key steps in the client's processing of a class of transactions, from initiation through to financial reporting. For each of these steps, you then perform risk assessment procedures to gain an understanding of the design of the process and the related controls and to determine that the controls have been implemented. At each step in the process you would perform the procedures for a given transaction, but not necessarily the same transaction at each step.

3.123 Although inquiries of management and those involved in the financial reporting process ordinarily are a significant component of a walkthrough, they are not the only component. Walkthroughs provide more reliable and relevant audit evidence when you corroborate responses of a single individual with inquiries of others, observations of the performance of control procedures, and inspection of accounting records and other documentation.

3.124 Inquiries related to the following may be helpful in gaining the necessary understanding of internal control:

- The individual's understanding of the client's stated procedures and controls
- Whether the processing and control procedures are performed as required and on a timely basis
- Specific situations in which the individual or others do not perform the company's prescribed control procedures
- The individual's understanding of the information processing and control procedures performed on information (*a*) before he or she receives it and (*b*) after he or she has transferred the information to the next processing step

3.125 You may corroborate the response to your inquiries through observation and inspection, or by, for example,

- observing the individual perform their assigned information processing or control procedure.
- reperforming the information processing or control procedure using the same documents and information technology that company personnel use to perform the procedures.

Using Service Auditors' Reports to Gather Information About Controls at a Service Organization

3.126 As described in paragraph 3.77, in some situations, you may need to gain an understanding of the design and implementation of controls at a service organization. To gain this understanding you may wish to obtain at least a type 2 report from the client's service organization. Table 3-11 summarizes the objectives of the two types of service auditor reports and how you might use these on your audit. When the audit strategy is to rely on the controls at a service organization, a type 2 report under ISA 402 (design and implementation and effectiveness) is necessary.

Table 3-11

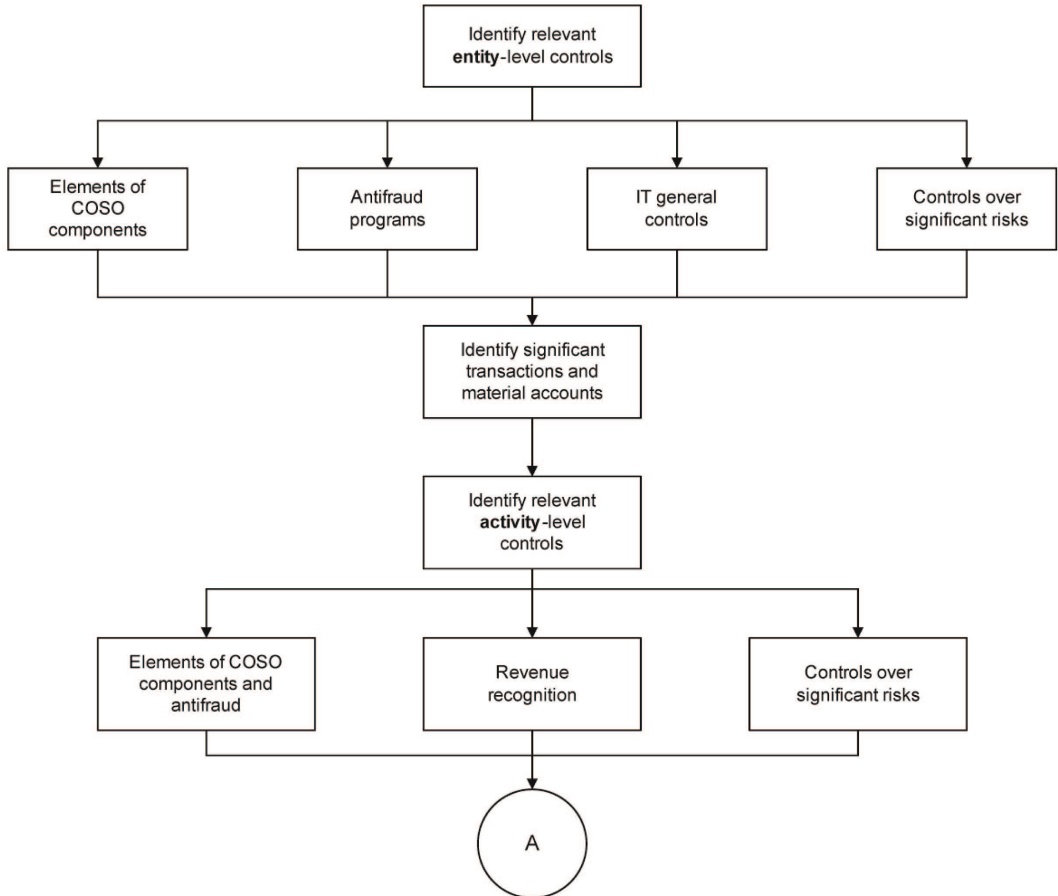
Summary of Service Organization Control Reports

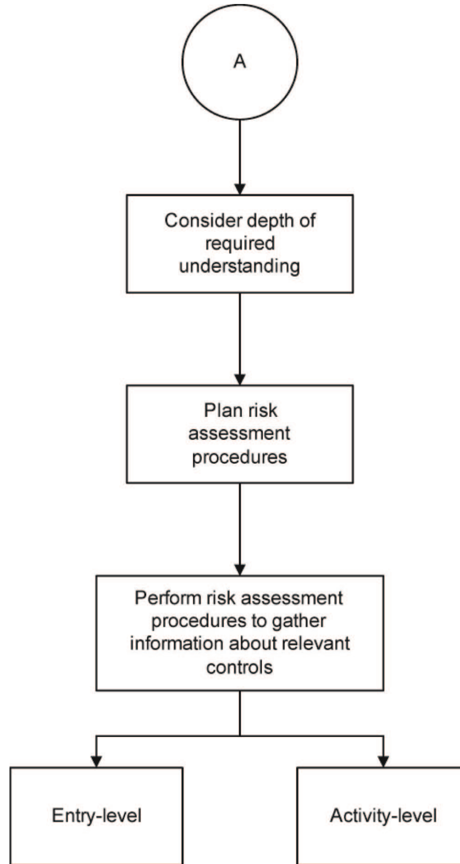
Title	*Contents*	*Relevance to User Auditors*
Reports on management's description of a service organization's system and the suitability of the design of controls (type 1 service organization report)	• Includes management's description of the service organization's system and a report by the service auditor that includes an opinion on whether such description is fairly presented and related controls are suitably designed to achieve specified control objectives • Is as of a specified date	• Assists the auditor in obtaining a sufficient understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit
Report on management's description of a service organization's system and the suitability of the design and operating effectiveness of controls (type 2 report)	• Includes all elements of a type 1 report and also includes the service auditor's opinion on whether the controls included in the description were operating effectively • Is for a specified period	• Has the same utility as a type 1 report and also provides evidence of the operating effectiveness of the relevant controls to support the user auditor's risk assessment

3.127 Illustration 3-2 summarizes the process for gathering information about internal control.

Illustration 3-2

Process for Understanding Internal Control





Information Obtained in Prior Audits

3.128 For continuing engagements, your previous experience with the entity contributes to your understanding of its internal control. For example, audit procedures performed in previous audits typically provide

- audit evidence about the client's organizational structure, business, and internal control.
- information about past misstatements.
- whether past misstatements were corrected on a timely basis.

All of this information can help you assess risks of material misstatement.

3.129 However, if you intend to use the information obtained in prior audits to support your risk assessments in the current period audit, you should determine whether the information from prior audits remains relevant. Changes may have occurred that affect the relevance of such information in the current audit. To determine whether changes have occurred that may affect relevance, you may make inquiries and perform other appropriate audit procedures, such as walkthroughs of systems to confirm the results of inquiries. (ISA 315 par. 9)

3.130 The nature, timing, and extent of the procedures you perform to update your understanding of the client obtained in prior periods may depend on matters such as

- the significance of the changes to the entity or its environment that have occurred since the prior period. (Note that a change in personnel at the company could be a significant change even if the client's processes or its internal control procedures did not change. For example, a change in the person responsible for a significant control activity or for monitoring the database could be significant.)

- the relative significance of the risks of material misstatement that could be affected by changes to the entity or its environment.
- the reliability of evidence available to support your conclusions about changes or lack of changes from the prior period. (Documented controls may be more reliable evidence when supported by observations and inquiry than if only inquiry is available to assess controls changes.)

3.131 For example, XYZ company manufactures technology used in wireless telephones. During the period between audits, three of the changes to the entity and its environment were

- the company leased additional office space;
- a competitor introduced new technology that was vastly superior to XYZ's; and
- the company revised its accounts payable procedures.

The auditor initially learned of these developments through an inquiry of company management. However, to determine what changes have occurred and assess how these changes affect the relevance of audit evidence from prior periods, the auditor may make inquiries and perform other appropriate procedures.

For example, given the nature of the changes at XYZ, the other procedures the auditor might perform include the following:

- *Observing company employees at work in the new office space.* The auditor determined that entering into a routine lease agreement of this nature did not pose significant risks of material misstatement and that the observation of operations and controls in the new space was sufficient to corroborate that the company occupied the new space. Accounting for the lease and other related costs might require information concerning the dates of occupation.
- *Reading an article in a trade journal about the competitor's release of its new product.* This release could significantly change the auditor's assessment of the risks of material misstatement, perhaps due to product obsolescence risks. The auditor believed the public information was sufficient to corroborate the representation that the release occurred.
- *Making inquiries of employees in accounting and in purchasing, examining revised documentation to reflect the revised controls, and performing a full walkthrough of the new accounts payable system.* Because of the magnitude of the change and its potential effect on the assessment of the risks of material misstatement, the auditor determined that these procedures were necessary to evaluate the design and implementation of internal control.

Identifying and Evaluating Change

3.132 In some situations, changes in the client or its environment require changes to the client's internal control. For example, if the company expands its operations to other locations, internal control should be expanded to those new locations. Control deficiencies may arise when changes in the entity or its environment are not matched by corresponding changes to controls. Thus, when determining whether changes have occurred that may affect the relevance of information about internal control obtained in a previous audit, you may consider *both* of the following:

a. Whether the company has changed its controls

b. Whether there have been changes to the entity or its environment that should have resulted in changes to control

3.133 Your client's ability to appropriately modify internal control depends on the effectiveness of its risk assessment process. A failure to appropriately modify internal control in response to changes in the entity or its environment may indicate a deficiency in the client's risk assessment process.

Table 3-12 provides examples of changes to the entity or its environment that may create new risks and therefore the need for changes to existing controls.

Table 3-12

Changes in the Client or Its Environment
That May Require Changes in Internal Control

Changes in the client or its environment may create new financial reporting risks, which in turn require modifications to internal control. In determining whether information about internal control that was obtained in a prior audit continue to be relevant in the current audit, it is helpful to consider whether the client made changes to internal control in response to circumstances such as the following:

- Changes in operating environment
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New business models, products, or activities
- Corporate restructurings
- Expanded foreign operations
- New accounting pronouncements
- Changes in economic conditions

Management's failure to appropriately modify internal control for changes such as the ones listed here may indicate a deficiency in their risk assessment process as well as result in deficiencies in their control activities.

Observations and Suggestions

When you have audited an entity in the prior period, you are not required to "reinvent the wheel" when it comes to understanding internal control for the current period audit. You do not have to start from scratch and ignore all you have learned in the prior period. Once you have established an appropriate basis for assessing the controls, the update of that assessment in following periods may not be as costly in time and effort.

However, you cannot simply carry forward your understanding from the prior period under an unsupported assumption that everything is the same as last year.

To determine whether your understanding of internal control remains relevant you may consider *both* of the following:

- Changes to internal control that have been made since the last audit
- Changes to internal control that *should have been made* but were not (for example, changes in the business or its operations that resulted in new risks and therefore should require new controls)

The procedures you perform to determine whether your previous understanding of internal control remains relevant may be less time-consuming than those procedures you performed in the initial audit. However, these subsequent procedures should be performed with the same level of professional skepticism and due care as they were when first performed.

A Process for Identifying and Evaluating Change

3.134 Illustration 3-3 describes a process you may use to identify and evaluate change as a means for determining the nature, timing, and extent of the risk assessment procedures you will perform to update your understanding of internal control obtained in a previous audit:

- Beginning at the top of the diagram, the risk assessment procedures you perform to obtain an understanding of the entity and its environment should allow you to gather information about matters that have changed since your previous audit.

- Information about change can be used to identify changes in inherent risk. For example, an economic downturn may create inherent risk for your client that was not present before the downturn.
- If inherent risk remains unchanged or new risks are appropriately addressed by controls that were in place in prior years, then you may want to perform risk assessment procedures to verify that controls have not changed.

3.135 As shown in illustration 3-3, there are three different approaches you might take to determine the nature, timing, and extent of risk assessment procedures to perform to update your understanding of the client obtained in previous audits. The approach you select depends, in part, on your assessment of risk in the current year. For example

- if the controls in place during the prior year would have been effective in addressing the current year's risks, then a good deal of the audit evidence obtained in prior audits will be relevant to the current audit. Once you determine that there have been no changes to those controls, then your understanding of internal control may be sufficient for you to assess risks of material misstatement.
- if prior year's controls would have been effective in addressing current year's risks but you discover that the design or implementation of those controls has changed, then you will want to assess the changes to those controls that have occurred since your previous audit. Assessing these changes and determining whether the revised controls adequately address the inherent risk present in the current year will enable you to support your assessment of the risks of material misstatement.
- in some instances, you may identify new or significantly changed inherent risk that could not be effectively addressed by prior year's controls. If this is the case, the information you obtained in prior audits will have very little relevance in the current audit, and you will most likely perform more extensive risk assessment procedures to gain an understanding of the design and implementation of control.

Observations and Suggestions

Decisions about the nature, timing, and extent of the risk assessment procedures you perform to update your understanding of the client are made on a process-by-process basis and not globally for the entire audit.

For example, assume that in previous audits you performed walkthroughs for all significant classes of transactions. In the current period the conditions at your client may lead you to determine that making inquiries of selected client personnel may be sufficient for accounts receivable, but a walkthrough and other procedures are necessary for inventory.

Determining Whether to Perform a Walkthrough Each Year

3.136 You are required to obtain an understanding of internal control to evaluate the design of controls and to determine whether they have been implemented. To do that, performing a walkthrough would be a good practice. Accordingly, auditors might perform a walkthrough of significant accounting cycles every year.

3.137 In some situations, you may rely on audit evidence obtained in prior periods to help satisfy some of the requirements for understanding the design and implementation of internal control in the current period. In those situations, you are required to perform audit procedures to establish the continued relevance of the audit evidence obtained in prior periods. That is, it would be inappropriate to rely completely on audit procedures performed in prior audits as audit evidence supporting your understanding of internal control design and implementation in the current period.

3.138 A walkthrough may be helpful in determining whether and how internal control design and implementation have changed since the prior period. However, you may determine that a walkthrough is not required. Rather, it is important that you first understand the audit objective (establish the continued relevance of the audit evidence obtained in prior periods) and then determine the audit procedure(s) that can meet that objective.

3.139 When determining the nature, timing, and extent of procedures to perform to update your understanding of internal control from the prior year, you may wish to consider the following:

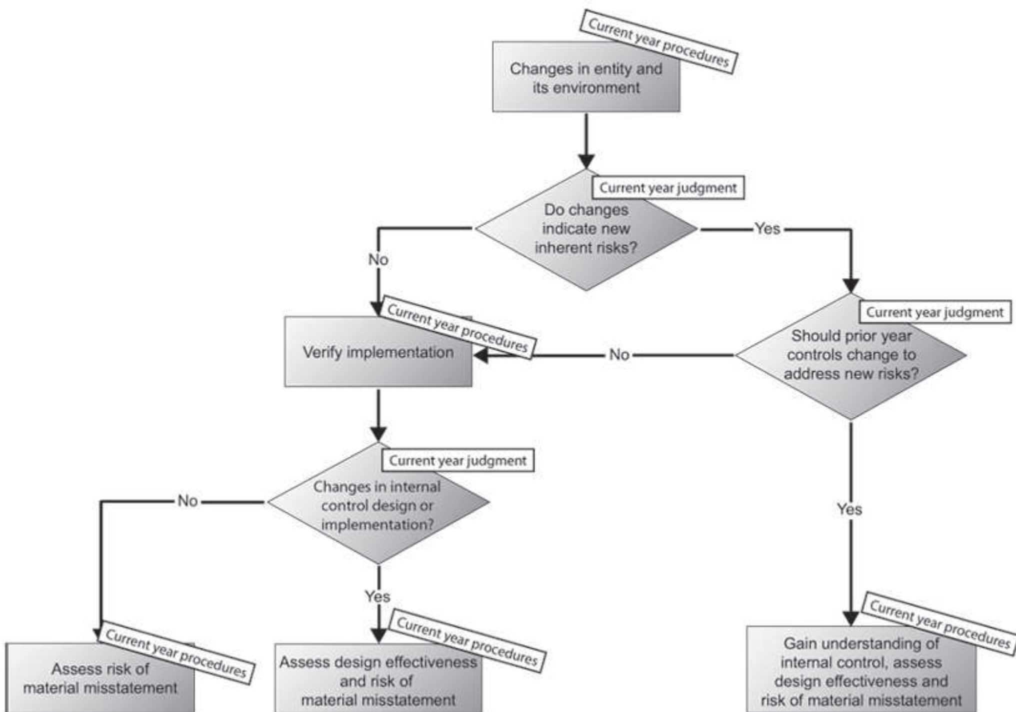
- *Effectiveness of the client's control environment, management's risk assessment, monitoring, and general controls.* The more effective these controls, the more appropriate it would be for you to use prior year's audit evidence to support your current understanding of internal control.
- *Reliance on automation.* The more automated the performance of the control the more appropriate it would be for you to use prior year's audit evidence to support your current understanding of internal control (assuming effective general controls).
- *Changes in client circumstances.* The fewer the changes in client circumstances (for example, personnel andchanges in business practices) the more appropriate it would be for you to use prior year's audit evidence to support your current understanding of internal control.
- *Risks of material misstatement.* The lower the risks of material misstatement for the relevant assertion, the more appropriate it would be for you to use prior year's audit evidence to support your current understanding of internal control.
- *Length of time since performing extensive risk assessment procedures*. The shorter the period of time since your initial evaluation on internal control design and implementation the more appropriate it would be for you to use prior year's audit evidence to support your current understanding of internal control.

Continuous Reevaluation

3.140 As your audit progresses, additional audit evidence you obtain from the performance of risk assessment or further audit procedures may either confirm or disconfirm your understanding of the changes that have occurred since the prior period. Disconfirming audit evidence may lead you to revise your audit strategy or audit plan.

Illustration 3-3

Process for Assessing Changes in an Entity's Internal Control



Audit Documentation

3.141 This chapter provides guidance on certain matters relating to the planning of the audit, including the determination of performance materiality. It also describes how you perform risk assessment procedures to gather an understanding of the client and how you should plan for the performance of those procedures. With regards to these matters, you should document

a. the preliminary overall audit strategy and any significant revisions to it. (ISA 300 par. 12)

b. the audit plan, including the audit procedures to be used that, when performed, are expected to reduce audit risk to an acceptably low level. The documentation should include a description of the nature, timing, and extent of planned

   i. risk assessment procedures.

   ii. further audit procedures.

   iii. other audit procedures necessary to comply with ISAs.

   (ISA 300 par. 9)

c. the level of materiality for the financial statements as a whole, which you used to plan your risk assessment procedures including

   i. the basis on which those levels were determined, and

   ii. any changes to those levels.

   (ISA 320 par. 14)

d. the levels of performance materiality, including the basis of those levels and any changes made over the course of the audit. (ISA 320 par. 14)

e. the discussion among the audit team regarding the client's financial statements to material misstatement due to error or fraud. This documentation should include

   i. the subject matter discussed.

   ii. significant decisions reached about the teams planned responses, both at the financial statement and the assertion level.

   (ISA 315 par. 33)

f. the risk assessment procedures you performed to gather information about the client. (ISA 315 par. 33)

g. the sources you used to gather information of the client. (ISA 315 par. 33)

h. the key elements of your understanding of the client's risks, including each of the aspects of the client and its environment. With regard to internal control, your documentation should include each of the five elements of internal control. (ISA 315 par. 33)

Paragraphs 1.39–.41 provide additional, more general guidance on the preparation of audit documentation.

Observations and Suggestions

Paragraph 3.44 describes the requirement to document your understanding of each of the five elements of internal control. As described in paragraph 4.26, understanding internal control means evaluating internal control design and determining whether the controls have been implemented. Accordingly, your documentation of internal control should include this evaluation and a determination that the controls are implemented.

Summary

3.142 This chapter provides guidance on the procedures—risk assessment procedures—that you perform to gain the understanding of your client, including the identification of inherent risks, that is necessary for you to first assess and then to respond to risks of material misstatement.

3.143 As a prelude to performing these risk assessment procedures, you will need to plan for them. Among other things, your planning will involve

- developing an audit strategy and a more detailed plan for gathering information, which will help you allocate resources to the engagement and make a preliminary determination of the risk assessment procedures you will perform;
- determining a materiality level for the financial statements as a whole, which will be used for audit planning purposes; and
- determining performance materiality, which is necessary to adjust materiality for the financial statements as a whole to a level that is appropriate for performing your audit at the assertion level.

3.144 Once you have planned for your risk assessment procedures, you will perform them, which constitutes the first step in your gathering of audit evidence to support your opinion on the financial statements. Chapter 4 of this publication describes how you use the information gathered through your risk assessment procedures to form an understanding of the client and its environment, including its internal control.

Observations and Suggestions

Risk assessment procedures are essentially information gathering procedures. As you obtain information, you begin to form an understanding of the entity and its internal control. This process of information gathering and gaining an understanding is iterative in nature. Throughout the audit, you are continuously gathering and evaluating information and adding depth to your understanding of the client.

As you incorporate the guidance in this chapter into your audits, you may wish to consider the following:

- Your initial understanding of the client and its environment will be reinforced or possibly challenged by the subsequent gathering of additional information. Some of this information will come from the results of your substantive procedures. For example, the discovery of audit differences in a particular account should lead you to question whether your initial understanding of controls related to that account was accurate. Audit differences do not just result in proposed adjustments to the general ledger. They also should prompt you to consider the controls that failed to prevent or detect and correct the error you discovered.
- Audit team members need to share information with each other to ensure that the understanding of internal control is made with full knowledge of all available information. ISA 315 requires a brainstorming session to facilitate this exchange of information, but you do not have to limit the sharing of information to the one brainstorming session early in the audit. Consider structuring your audit to include the regular sharing of information among audit team members.
- Your client is a primary source of the information you need to form an understanding internal control. Your ability to obtain timely, high quality information from your client will affect greatly the efficiency and effectiveness of your audit.

3.145

Appendix — Answers to Frequently Asked Questions About Audit Planning and Risk Assessment Procedures

Question	*See Paragraphs*
What is an audit strategy and what is an audit plan? How are they different?	3.02–.05
What should I include in my audit strategy?	3.02 and appendix A
What should I include in my audit plan?	3.05
How do I determine performance materiality?	3.07–.12
What is my overall objective in obtaining an understanding of the client?	3.16
How much of an understanding of my client and its environment should I obtain?	3.18–.21
What are *risk assessment procedures*?	3.22
Can I use other procedures, in addition to risk assessment procedures, to obtain information about my client and its environment?	3.33
Can I use information gathered in previous audits as a basis for my understanding of the client in the current year? How should I update that understanding from year-to-year?	3.134–.140
What is the purpose of the audit team discussion? What topics should be included in this discussion?	3.36–.38
How does the client's internal control documentation or lack of documentation affect my audit?	3.40–.47
What IT controls most typically affect my audits?	3.54–.69
When should I consider using an IT audit professional on my audits?	3.70–.76
My client uses a third party service organization to process some of its transactions. How does this arrangement affect my audit?	3.77–.84
What is a service auditor's report and what sort of information will it provide me about my client's internal control?	3.126–.127
Which entity-level controls are most likely to fall within the scope of my audit?	3.87–.93
What general types of activity-level controls would I most likely want to include within the scope of my audit?	3.95–.109
How can I best use inquiries to gather information about my client and its environment, including its internal control?	3.112–.114
What is a walkthrough? How can I use walkthroughs on my audit?	3.120–.125 and 3.138
What audit planning matters should I document?	3.141

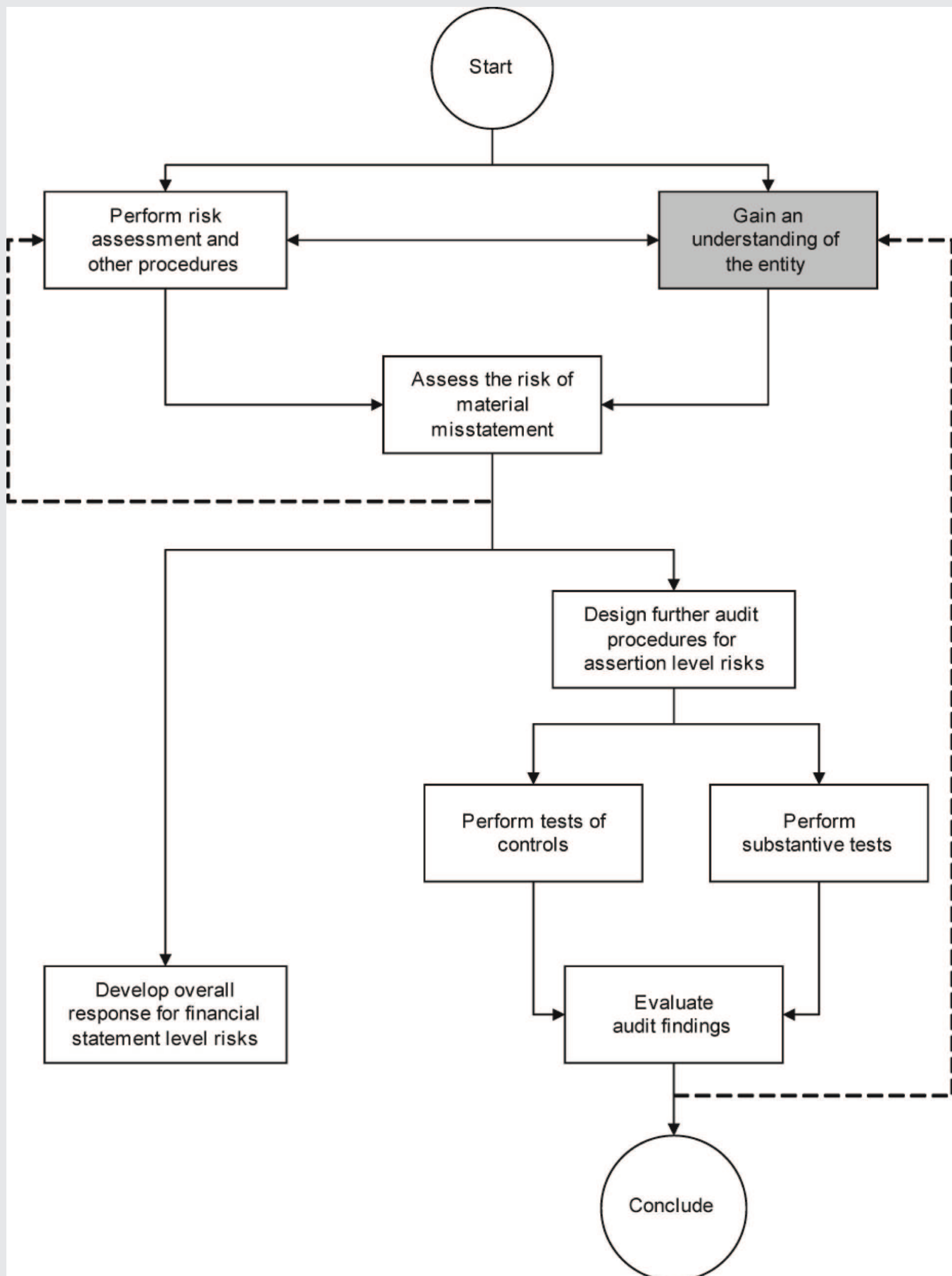
Chapter 4

Understanding the Client, Its Environment, and Its Internal Control

Observations and Suggestions

Illustration 4-1

Understanding the Client, Its Environment, and Its Internal Control



(continued)

After you develop a preliminary audit strategy, you will perform risk assessment procedures to gather information to gain an understanding of your client. Some of the information you need to understand your client may be carried forward from your previous experience or from other procedures, such as the process you follow to decide on client acceptance or continuance.

Information About the Entity and Its Environment

You will gather information about a wide range of matters relating to your client. Some of these matters relate directly to the financial reporting process, but many of them relate to the broader business issues, such as the current status of the client's industry and its business objectives and strategies.

Information About Internal Control

Your client's internal control is an integral part of its business. On every audit, you will gain an understanding of internal control that allows you to evaluate its design and determine whether controls are being used at the entity.

Using Your Understanding of the Client, Its Environment, and Its Internal Control

As you gather information, you will begin to form an understanding of the client and how the specific conditions and circumstances pertaining to their business may affect the preparation of the client's financial statements.

Ultimately, the information you gather and the understanding you gain about the client at this phase of the process provides audit evidence to support your assessment of the risks of material misstatement and, ultimately, your opinion on the financial statements. As you become knowledgeable about your client, you typically will discover you need additional information to gain an understanding that is sufficient enough to enable you to assess the risks of material misstatement. Thus, the gathering of information and creation of knowledge about your client is a continuous nonlinear process.

To assess risk and design appropriate substantive procedures and other procedures, you need to have a good understanding of your client and its environment, including internal control. To form a meaningful understanding of your client, you will perform risk assessment and other procedures to gather the information you need.

This chapter provides guidance on how to gather information about your client and how to use that information to understand the client in a way that allows you to appropriately assess the risks of material misstatements. This understanding of your client provides information that is necessary to support your risk assessments.

Introduction

Observations and Suggestions

The mere documentation of information that you gather about the client and its environment is not sufficient to support an assessment of the risks of material misstatement. You then evaluate that information and use it to form an understanding of your client that will allow you to assess risk and design appropriate other audit procedures.

This section has been organized to help you bridge the gap between gathering information and forming an understanding. The auditing standard directs you to gain an understanding of five different aspects of the client and its environment. For each of these aspects, this section of the publication lists the information that should be gathered and then explains how this information should be used to form a more in-depth understanding of the company that will allow you to assess the risks of material misstatement.

4.01 Risk assessment procedures help you gather information about your client and its environment. As you gather this information, you will need to synthesize and evaluate it to form a meaningful understanding of the client, one that will allow you to assess the risks of material misstatement. This understanding of the client and its environment provides the information necessary to support your risk assessments.

4.02 As described in chapter 3, "Planning and Performing Risk Assessment Procedures," of this publication, your understanding of the client and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors

b. Nature of the entity

c. Selection and application of accounting policies

d. Objectives and strategies and the related business risk that may result in a material misstatement of the financial statements

e. Measurement and review of the entity's financial performance

f. Internal control

Paragraphs 4.04–.24 provide guidance on items *a–d*.

4.03 Obtaining an understanding of internal control involves evaluating the design of controls and determining whether they have been implemented (that is, placed in operation). Paragraphs 4.25–.37 provide guidance on understanding internal control.

Forming an Understanding of the Entity and Its Environment

Understanding the Industry, Regulatory, and Other External Factors

Breadth of Understanding

4.04 You should obtain an understanding of

- the client's relevant industry, regulatory, and other external factors, including the applicable financial reporting framework.
- the nature of the client.
- the client's selection and application of accounting policies, including the reasons for changes thereto.
- the client's objectives and strategies and those related business risks that may result in risks of material misstatement.
- the measurement and review of the client's financial performance.

(ISA 315 par. 11)

How Your Understanding Helps You Assess the Risks of Material Misstatement

4.05 The information you gather about the industry, regulatory, and other external factors should help you form an understanding of the client that will help you identify and assess risks of material misstatements.

Industry factors include industry conditions such as the competitive environment, supplier and customer relations, and technology developments. Examples you may consider include

- the market and competition.
- cyclical or seasonal activity.
- product technology.
- energy supply and cost.

Relevant regulatory factors include the regulatory environment, which encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples you may consider follow:

- Accounting principles and industry-specific practices
- Regulatory framework for a regulated industry
- Laws and regulations that significantly affect the client's operations
- Taxation

- Government policies affecting the conduct of the client's business
- Environmental requirements affecting the client's industry and business

Industry conditions, the degree of regulation or other external factors may subject your client to specific risks of material misstatement. Also, industry regulations may specify certain financial reporting requirements, which, if not complied with, would result in a material misstatement of the financial statements.

For example, many years ago the *government* standards were changed for configuration of civil band *mobile* radios. Manufacturers of parts for these radios had inventories of these parts they were producing under the old standard. Some of these parts became obsolete the day the new regulation was unexpectedly announced.

Understanding the Nature of the Entity

Breadth of Understanding

4.06 The nature of an entity includes

a. its operations;

b. its ownership and governance structure;

c. the types of investments it is making and plans to make; and

d. the way it is structured and how it is financed.

Understanding the nature of the client enables you to understand the classes of transactions, account balances, and disclosures to be expected in its financial statements. This may include an entity formed by your client to accomplish a narrow purpose (for example, a variable interest entity).

How Your Understanding Helps You Assess the Risks of Material Misstatement

4.07 The information you gather with respect to the items listed in paragraph 4.06 will help you understand the matters about the client that may affect the risks of material misstatement. For example,

- the account balances, classes of transactions, and disclosures expected to be in the financial statements.
- complex organizational structures that increase the risks of material misstatements; for example, the allocation of goodwill to subsidiaries or the accounting for variable interest entities.
- transactions with related parties.

4.08 With regard to the client's selection and application of accounting policies, your understanding of the client includes understanding

- the methods the client 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 client's accounting policies.

For each of these matters you should evaluate whether the client's selection and application of accounting policies are appropriate and consistent with the applicable financial reporting framework and accounting policies used in the client's industry. When the client changes its accounting policies, you also should obtain an understanding of the reason for the change.

(ISA 315 par. 11*c*)

Understanding of Sales Transactions

4.09 Sales are often a significant class of transactions for many of your clients and, for that reason, it may often be important for you to obtain an understanding of matters relating to sales that may affect your client's revenue recognition. With regard to assertions about revenue, you might consider obtaining information relating to the following matters:

- The kinds of products and services sold
- Whether seasonal or cyclical variations in revenue may be expected
- The marketing and sales policies customary for the client and the industry
- Policies regarding pricing, sales returns, discounts, extension of credit, and normal delivery and payment terms
- Who, particularly in the marketing and sales functions, is involved with processes affecting revenues including order entry, extension of credit, and shipping
- Whether compensation arrangements depend on the company's recording of revenue; for example, whether the sales force is paid commissions based on sales invoiced or sales collected and the frequency with which sales commissions are paid might have an effect on the recording of sales at the end of a period

4.10 *Your client's customers.* Obtaining an understanding of the classes and categories of your client's customers is important. For example, if sales to distributors are material, it is important to understand whether concessions have been made in the form of return product rights or other arrangements in the distribution agreements the client has entered into. For example, distribution agreements in the high-tech industry might include such terms as price protection, rights of return for specified periods, rights of return for obsolete product, and cancellation clauses, such that the real substance of the agreement is that it results in consignment inventory.

4.11 *Assistance provided to distributors.* Other factors that may be relevant to your understanding include whether the client assists distributors in placing product with end users and how the company manages, tracks, and controls its inventory that is held by distributors. For example, the client may take physical inventories of product held by distributors or receive periodic inventory reports from distributors that are reconciled to the client's records.

4.12 *Selection and application of accounting principles.* You may consider the need to understand the accounting principles that are appropriate for the client's sales transactions, including special industry practices. In considering the appropriateness of recognizing revenue on sales to distributors, for example, you should bear in mind that a sale is not final until the distributor accepts the product and the risks and rewards of ownership have been transferred. In some cases, the distributor does not take ownership but only transfers ownership to its customers when the product is sold.

Understanding of IT Systems

4.13 Although many engagements will require the use of an IT specialist to gather information and assess risk related to the client's IT system, non-IT auditors may be able to gather information and obtain a basic understanding of IT-related risks. Table 4-1 provides an example of information that may be gathered and how it may help assess risk.

Table 4-1

Information That May Be Gathered About IT Systems

Information About IT	*How This Information Helps Assess Risk*
List of applications (including operating system), the vendor, and version number	• Provides a general understanding of the complexity of the client's system and the scope of your work. • Identifies applications that were provided by different vendors. (See paragraph 2.74 of this publication for a discussion of the risks related to the use of applications from different vendors.) • Comparison of information between audit periods can identify installation of new applications or upgrades to existing applications that were performed during the year.

(continued)

Information About IT	*How This Information Helps Assess Risk*
Network policies such as password protocols	• Provide an overall understanding of the parameters the entity has established for its network and whether these fall within a typical range. • Identify weaknesses that might lead to risks of fraud or error.
List of key hardware components	• Provides a general understanding of the overall complexity of the system.
Systems configuration diagram	• Provides a visual summary of the hardware and software configuration of the system. • Forms a basis for the auditor's understanding of the financial reporting process. • Information about data storage can help design data extraction applications using software.
Documentation of IT general or application controls	• Provides information about the design of general controls such as access controls. • Information about application controls can be used to design risk assessment or further audit procedures. • Provides a basis for assessing changes over time that could affect performance. • Provides a basis for the walkthrough of the process that may be performed to confirm implementation of the control.

Understanding Your Client's Objectives, Strategies, and Related Business Risks

4.14 You should obtain an understanding of the business risk your client faces because most business risk will eventually have financial consequences and therefore an effect on the financial statements. An understanding of business risk increases your likelihood of identifying risks of material misstatement. (ISA 315 par. 15)

4.15 The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of following 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
- 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 nonroutine or nonsystematic 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 result in significant measurement uncertainty, including accounting estimates
- Pending litigation and contingent liabilities (for example, sales warranties, financial guarantees, and environmental remediation)

Note that this list was reprinted from appendix 2 of ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

4.16 You should obtain an understanding of your client's objectives and strategies because it will help you gain a more meaningful understanding of the client's business risks:

- *Objectives* are the overall plans for the client. Management and those charged with governance set these plans in response to internal and external factors affecting the business.
- *Strategies* are the operational approaches that the client uses to reach its objectives.

(ISA 315 par. 11*d*)

Observations and Suggestions

It is helpful to compare management's stated objectives with its actions. A "disconnect" between the two may indicate a risk of material misstatement either due to error or fraud. For example, a business that seems only marginally profitable and inconsistent with the owner's stated objectives may be a "front" for a disreputable business.

Breadth of Understanding

4.17 Business risk is broader than and inclusive of the risks of material misstatement of the financial statements. You do not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

4.18 Your responsibility is to identify and assess the risks of material misstatement of the financial statements. Within that context, your current understanding of the client's key business objectives and strategies is your basis for understanding the most significant business risks facing the client. Once you identify these significant business risks and the client's strategy for dealing with them, it is important that you determine which of them, in light of the client's unique and specific circumstances, may result in a material misstatement.

How Your Understanding Helps You Assess the Risks of Material Misstatement

4.19 When identifying business risks, be alert for

a. changes in the client's business strategies, for example, introducing a new product or expanding into a new market, frequently creates business risks. Additionally, changes in external or internal conditions that the client does *not* respond to also can create risk. For example, if the client's product is aimed solely at a particular market, and the characteristics of that market shift, the client may face certain business risks if it fails to respond to this market shift.

b. operational complexities also may create business risk. For example, the nature of a long term construction project creates risk in the areas of percentage of completion, pricing, costing, design, and performance control.

4.20 Business risk may affect the financial statements in a variety of ways. They may have an immediate effect or one that is long term. They may affect the financial statements as a whole, or individual assertions. For example

- the business risk arising from a contracting customer base caused by industry consolidation may increase the risk of misstatement associated with the valuation of accounts receivable or obsolescence in the valuation of inventories (an immediate consequence for a specific assertion).
- the business risk of significant transactions with related parties may increase the risk of misstatement of a range of significant account balances and assertions (an immediate consequence for multiple assertions).
- the business risk of a decline in your client's industry may affect the client's ability to continue as a going concern (a long term consequence that affects the financial statements as a whole).

Management's Responsibilities for Assessing Business Risks

4.21 Usually, management identifies business risks and develops approaches to address them. This process for managing risk is an element of the client's internal control and should be understood as part of your procedures to gain an understanding of internal control. (ISA 315 par. 11*d*)

4.22 In a smaller entity, management may not have a formal risk assessment process and may lack documentation of these matters. That your client lacks documentation or a formal process does not relieve you of your responsibilities to gain an understanding of how the client manages business risk. If it is not possible to inspect documentation related to the client's business risk management, you may obtain your understanding through inquiries of management and observation of how the client responds to business risks.

Understanding Your Client's Measurement and Review of the Client's Financial Performance

Breadth of Understanding

4.23 You should obtain an understanding of how management measures and reviews the entity's performance to determine whether performance is meeting their objectives. Table 4-2 lists examples of internal and external performance measures that may provide information that is useful to your understanding of the client and its environment. (ISA 315 par. 11*e*)

Table 4-2

Examples of Internal and External Performance Measures

You should obtain an understanding of the measurement and review of your client's financial performance. This information will help you gain a more in-depth understanding of the client and its environment, and you may obtain this information from both internal and external sources.

Internally generated measures that you may find helpful include

- financial and nonfinancial performance indicators.
- budgets and variance analyses.
- segment information and divisional, departmental, or other level performance reports.
- comparisons of your client's performance with that of its competitors.

Externally generated measures that you may find helpful include

- analysts' reports.
- credit rating agency reports.

Observations and Suggestions

The way in which management monitors internal control is one of the components of internal control. You should be careful to distinguish between measurement and review of financial performance from the monitoring of internal control.

For example, management may review key ratios related to inventory levels. This review may tell management a great deal about the financial performance of the entity but little, if anything, about the effectiveness of controls over inventory. Your understanding of the client's methods for reviewing financial performance may not meet the requirement you have to understand the design and implementation of the monitoring component of internal control.

How Your Understanding Helps You Assess the Risks of Material Misstatement

4.24 Your understanding of how management measures and reviews the client's financial performance can further your understanding of the client and its environment in a number of ways, including the following:

- Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance. Also, as described in paragraph A1 of ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, pressure or incentive provides a reason to commit fraud. Your understanding of your client's performance measures will help you consider whether such pressures could result in management or employee actions that may have increased the risks of material misstatement, whether due to error or fraud. Performance measures may indicate a risk of misstatement of related financial statement information. For example, performance measures may indicate that the client has unusually rapid growth or profitability when compared to other entities in the same industry. This information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the presence of fraud risk factors relating to fraudulent financial reporting.
- Internal measures may highlight unexpected results or trends, which may indicate the existence of a misstatement in the financial statements.

4.25 Once you gain an understanding of the measurements your client uses to measure and review financial performance, you may decide to use some of these measures in your audit, for example, as part of your analytical procedures. When you use management's performance measurements in your audit, you should evaluate the reliability of the data. (ISA 520 par. 5*b*)

Observations and Suggestions

Your responsibility for obtaining an understanding of internal control may have been clarified and may have increased significantly with the issuance of ISA 315. As described in the following sections, a sufficient understanding of internal control is one that allows you to evaluate the design of controls and to determine whether controls have been implemented (placed in operation). This threshold suggests a substantial understanding of internal control.

(continued)

Does this definition mean that your understanding of internal control should enable you to identify all significant deficiencies in internal control? No. That high threshold is reserved for an attestation of internal control effectiveness.

When performing a financial statement audit, your understanding of internal control will not allow you to provide reasonable assurance that all significant deficiencies have been identified. However, the evaluation of control design and determination that controls have been implemented is a significant threshold (less than reasonable assurance), that you may identify significant deficiencies in the design of internal control as a result of your obtaining an understanding of internal control in a financial statement audit. This depth of understanding of internal control is necessary to make a fully informed assessment of the risks of material misstatement.

Evaluating the Design and Implementation of Internal Control

4.26 On every audit, you should obtain an understanding of internal control that is sufficient to enable you to

a. evaluate the design of controls that are relevant to the audit and determine whether the control—either individually or in combination—is capable of effectively preventing or detecting and correcting material misstatements.

b. determine that the control has been implemented, that is, that the control exists and that the entity is using it.

(ISA 315 par. 12–13)

Observations and Suggestions

Your evaluation of internal control design and the determination of whether controls have been implemented are critical to your assessment of the risks of material misstatement and the design of further audit procedures. It is not possible to develop a reliable assessment of the risks of material misstatement absent a sufficient understanding of internal control. For this reason, you will perform risk assessment procedures to gather information and form an understanding of internal control on every audit. Even if your initial audit strategy contemplates performing only substantive procedures for all transactions, account balances, and disclosures, you still should evaluate the design of internal controls and determine whether they have been implemented in order to plan your audit procedures to appropriately address the risks.

Evaluating Control Design

4.27 The process for evaluating control design includes your consideration of

- the risk of what can go wrong at the assertion level.
- the likelihood and significance of the risks, irrespective of internal control considerations.
- the relevant control objectives.
- the controls, either individually or in combination, that satisfy each control objective.

4.28 To evaluate whether controls have been designed to satisfy each control objective, it is helpful to consider

- whether the control or combination of controls would—if operated as designed—likely meet the control objective.
- whether the controls necessary to meet the control objective are in place.

4.29 *Financial statement assertions can help you evaluate the effectiveness of control design. Control objectives are based on assertions. For example, one of Ownco's control objectives is to ensure that payables and purchases are complete and valid (occurrence). The company uses a purchase order (PO) system to manage the purchase of raw materials used in the manufacture of its fishing lures. Before ordering any materials, the operations manager enters the order into the system and receives a PO number. Suppliers are instructed to include this number in the invoices they send to Ownco.*

In this example, one of the things that can go wrong in recognizing and reporting purchases is that the company could process the same purchase transaction more than once, thus overstating inventory (prior to the physical count) and ultimately cost of goods sold (after the physical count). To mitigate this risk, the IT system matches the PO number on the vendor's invoice to the file of outstanding POs. Any invoice that contains a PO that is not considered outstanding is not paid and is put into a suspense file for further follow up.

This control procedure is effective at addressing a risk related to the occurrence assertion. However, there are other "things that can go wrong" related to purchases. For example, the system may fail to capture all authorized purchases (completeness assertion). To evaluate whether the client has effectively designed controls over purchases, the auditor also will have to consider the controls related to completeness and all other assertions.

Determining If the Control Has Been Implemented

4.30 Determining whether a control has been implemented is important because it confirms your understanding of control design and helps ensure that your risk assessment is based on accurate information. However, it is not unusual for client personnel to use a control differently from the way the control is described in a policy manual or in response to inquiries you make of someone else. For example, your client's accounting policy manual may state that physical inventory accounts are performed annually. However, because of increases in the volume of transactions, the client deviates from this stated policy and counts some inventory items twice a year. This practice is not reflected in the policy manual and is not known by all individuals in the company.

4.31 The determination of whether a control has been put in place and is implemented involves obtaining evidence about whether those individuals responsible for performing the prescribed procedures have

- an awareness of the existence of the procedure and their responsibility for its performance and
- a working knowledge of how the procedure should be performed.

Determining whether the control has been implemented does not require you to determine whether the control was performed properly throughout the audit period.

4.32 *For example, Smith, CPA, makes inquiries of client employees regarding the reconciliation of general ledger control totals to the underlying subsidiary ledgers. During the course of one of his interviews, Smith learns that the employee responsible for reconciling the accounts receivable subsidiary ledger to the general ledger was on a three-month extended leave of absence, during which time the duty was performed by someone with incompatible functions.*

For the purpose of obtaining an understanding of internal control, Smith is not obligated to design his procedures to identify these circumstances. However, once the information is obtained, Smith should assess it and use it to design further audit procedures.

Distinguishing Between the Evaluation of Design (and Implementation) and the Assessment of Operating Effectiveness

Observations and Suggestions

In practice, misunderstandings sometimes arise over the procedures auditors should perform on all audits, regardless of their audit strategy, and those they should perform only when they intend to rely on controls to modify the nature, timing, and extent of substantive audit procedures.

On all audits, you should evaluate internal control design and determine whether controls have been implemented.

If you intend to rely on controls, you should test them to assess their operating effectiveness.

Paragraphs 4.33–.35 are intended to clarify the differences between evaluating control design and implementation (discussed in this chapter) and testing controls to assess their operating effectiveness (discussed in chapter 6, "Performing Further Audit Procedures," of this publication).

4.33 Obtaining an understanding of the design and implementation of internal control is different from assessing its operating effectiveness:

- *Understanding design and implementation* should be performed on every audit as a prerequisite for assessing the risks of material misstatement. (ISA 315 par. 13)
- *Assessing operating effectiveness* builds on your understanding of internal control design and implementation and is necessary only when the design of your substantive procedures relies on the effective operation of controls or when substantive procedures alone will not provide you with the audit evidence needed to form a conclusion about the financial statements.

Table 4-3 summarizes the differences between design and operating effectiveness.

4.34 Generally, the procedures necessary to understand the design and implementation of manual controls are not sufficient to serve as tests of the operating effectiveness of those controls. For example, obtaining audit evidence about the implementation of a manually operated control at a point in time does not provide audit evidence about the operating effectiveness of that control at other times during the period under audit.

4.35 Examples of situations where the procedures you perform to understand the design and implementation of controls may be sufficient to support a conclusion about their operating effectiveness include

- controls that are automated to the degree that they can be performed consistently, provided that the auditor is satisfied that IT general controls operated effectively during the period.
- controls that operate only at a point in time rather than continuously throughout the period. For example, if the client performs an annual physical inventory count, your observation of that count and other procedures to evaluate its design and implementation provide you with evidence that you consider in the design of your substantive procedures.

Table 4-3

Design Versus Operating Effectiveness

Audit Evidence Should Support Your	*Design and Implementation*	*Operating Effectiveness*
Understanding of how the control is designed	X	X
Evaluation of whether the design is effective	X	X
Determination that the control procedure has been implemented	X	X
Understanding of how the control procedure was applied throughout the period		X
Determination that the control was applied consistently throughout the period		X
Understanding of who or by what means the control was applied throughout the audit period		X

Evaluating Design and Implementation in the Absence of Control Documentation

4.36 For smaller companies, the company's evidence supporting the design and implementation of some elements of internal control may not be available in documentary form. For example, the entity may lack

- a written code of conduct that describes management's commitment to ethical values.
- a formal risk assessment process.

4.37 Without adequate documentation of controls, the risk assessment procedures available to you to understand control design are limited to inquiry and observation. As risk assessment procedures, both inquiry and observation have limitations, as described in paragraphs 3.112–.113.

Accordingly, absent adequate documentation, you might consider whether the information you have gathered about internal control is sufficient to evaluate its design.

4.38 Inadequate documentation of the components of internal control also may be a control deficiency. For example, the lack of appropriate documentation may impair management's ability to communicate control procedures to those responsible for their performance or to monitor control performance effectively. If the client does not document a control, you may document the control as part of your risk assessment procedures to identify and assess the risks of material misstatements. Paragraphs 3.44–.46 of this publication provide additional guidance on evaluating internal control in the absence of control documentation.

Observations and Suggestions

The client's lack of adequate documentation does not necessarily mean that controls do not exist, nor does the lack of documentation relieve you of your responsibility to gain an understanding of the controls being used by client personnel and evaluating their design. Without adequate documentation, you will gain this understanding through inquiry and observation.

To evaluate whether inadequate documentation is a control deficiency and, if so, the severity of that deficiency, it is helpful to consider how the client can meet its control objectives without adequate documentation. In some circumstances the company may achieve its control objectives without formal documentation, for example, at a small entity where most communication—even critical information—is done orally. In other circumstances, the company's ability to meet its control objectives may be hindered significantly in the absence of the documentation of control policies and procedures. As summarized in table 3-9, an important element of the communication element of your client's internal control is whether it can communicate effectively financial reporting roles and responsibilities and significant matters relating to financial reporting.

It is acceptable for the auditor to assist the audited entity in gathering internal control documentation. Once developed, such documentation is usually maintained and updated by the entity. If the entity is unable to understand or maintain such documentation, the auditor needs to assess the severity of this deficiency in internal control, and the deficiency may result in a requirement to communicate to those charged with governance. If the auditor assists the entity in preparing internal control documentation and shares information obtained in the audit process, care should be taken not to share auditor assessment techniques and methodology such that the client has insight to how the auditor did or will evaluate controls. Sharing such information could result in a risk of undetectable fraud.

Management is responsible for maintaining and documenting its system of controls, but the auditor is responsible for understanding and assessing the controls. From an efficiency standpoint, this may mean that client documentation may need to be more extensive than auditor documentation. Vice-versa, auditor documentation may not be adequate to fully describe the internal controls of an entity.

Evaluating Entity-Level Controls

The Control Environment

4.39 You should obtain sufficient knowledge of the control environment to understand the attitudes, awareness, and actions of management and those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting. Table 4-4 summarizes those elements of the control environment that you may consider when gaining an understanding of the control environment. (ISA 315 par. 14)

Table 4-4

Elements of the Control Environment

In evaluating the design of your client's control environment, you may consider the following elements and how they have been incorporated into the entity's processes:

a. *Communication and enforcement of integrity and ethical values*. Essential elements that influence the effectiveness of the design, administration, and monitoring of controls.

b. *Commitment to competence*. Management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

c. *Participation of those charged with governance*. Independence from management, the experience and stature of its members, the extent of its involvement and scrutiny of activities, the information it receives, the degree to which difficult questions are raised and pursued with management, and its interaction with internal and external auditors.

d. *Management's philosophy and operating style*. Management's approach to taking and managing business risks, and management's attitudes and actions toward financial reporting, 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*. How authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.

g. *Human resource policies and practices*. Recruitment, orientation, training, evaluating, counseling, promoting, compensating, and remedial actions.

Observations and Suggestions

It is preferable to evaluate the control environment early on in the audit process using the "top-down" approach. This is because the results of your evaluation affect your overall risk assessment at the financial statement level which in turn could affect the nature, timing, and extent of other planned audit procedures.

For example, weaknesses in the control environment may undermine the effectiveness of other control components and, therefore, be negative factors in your assessment of the risks of material misstatement, in particular in relation to the risk of fraud. It may also cause you to perform more extensive procedures as of year-end rather than as of an interim date.

Evaluating Design and Implementation

4.40 When obtaining an understanding of the control environment, you may consider the collective effect of all control environment elements rather than a single element in isolation. Strengths in one element may compensate for weaknesses in others. Conversely, weaknesses in one element may diminish strengths in another. For example, the client's use of another CPA as an accounting resource may compensate for a lack of internal resources that would otherwise exist to interpret complex accounting matters.

4.41 Management's strengths and weaknesses may have a pervasive effect on internal control. For example,

- owner-manager controls may mitigate a lack of segregation of duties, or an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities.
- management's failure to commit sufficient resources to address security risk presented by IT may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or by allowing unauthorized transactions to be processed.

- human resources policies and practices directed toward hiring competent financial, accounting, and IT personnel may not mitigate a strong bias by top management to overstate earnings.

4.42 The existence of a satisfactory control environment can be a positive factor when you assess the risks of material misstatement. Although an effective control environment will not guarantee the absence of misstatements, it may help reduce the risks of material misstatements of the financial statements. For example, the effective oversight of those charged with governance combined with an effective internal audit function may constrain improper conduct by management.

4.43 Conversely, weaknesses in the control environment may undermine the effectiveness of other control components and therefore be negative factors in your assessment of the risks of material misstatement, in particular in relation to the risk of fraud. For example, when the nature of management incentives increases the risks of material misstatement of financial statements, the effectiveness of control activities may be reduced.

Observations and Suggestions

In smaller entities, the control environment might be less formal than larger entities. Irrespective of the relative formality of the control environment and the documentation of related policies and procedures, you still should gain an understanding of all five components of internal control, including the control environment. Even in audits of smaller entities, you may rely on the control environment to determine the nature, timing, and extent of further audit procedures assuming you have tested the control environment and found it to be effective.

When entity documentation is lacking, you may need to produce more robust documentation of your understanding of internal control to serve as a basis for the determination of the nature, timing, and extent of further audit procedures.

The Client's Risk Assessment Process

4.44 You should obtain sufficient knowledge of your client's risk assessment process to understand how management considers risk relevant to financial reporting objectives and decides about actions to address that risk. (ISA 315 par. 15)

Evaluating Design and Implementation

4.45 In evaluating the design and implementation of your client's risk assessment process, you should obtain an understanding of whether client management has a process to

a. identify business risk relevant to financial reporting.

b. estimate the significance of the risks.

c. assess the likelihood of their occurrence.

d. decide upon actions to manage them.

(ISA 315 par. 15)

4.46 Your client may not have established a risk assessment process or you may have identified risks of material misstatement in the financial statements that management failed to identify. In such cases, you should consider why the client's risk assessment process failed to identify those risks and whether their process is appropriate to the client's circumstances. Paragraphs 7.49–.58 provide additional guidance on evaluating control deficiencies related to the client's risk assessment process. (ISA 315 par. 17)

4.47 *For example, Ownco does not have an effective risk assessment component to internal control. Consequently, the auditor's overall approach to the engagement involves significant procedures to identify and assess the financial reporting risk relating to changes in*

- *the company's operating environment.*
- *new personnel or IT system.*
- *new technology.*
- *new accounting pronouncements.*

To properly consider these items, the auditors conduct extensive inquiries of management, company employees, the company's lawyers, and external parties whose interactions with the company may affect financial reporting. These third parties include suppliers, creditors, and customers. To the extent that market factors might influence the business, these would be considered. If Ownco had a more robust risk assessment process, the auditors would be able to reduce the extent of the procedures performed to understand internal control.

Inquiries of Management About Identified Business Risks

4.48 You should obtain an understanding of whether the client has a process for identifying business risks relevant to financial reporting objectives. If the client has such a process you should obtain an understanding of it and the results thereof. If your client has an effective risk assessment process, it can help you identify risks of material misstatement. For example, client management already may have identified business risk prior to the start of your audit. For this reason, you may ask them about business risk that they have identified, and you should consider whether this business risk may result in material misstatement of the financial statements. (ISA 315 par. 15–16)

Information and Communication

4.49 Under ISA 315 paragraph 18, you should obtain a sufficient knowledge to assess the risks of material misstatement of the client's information and communication system, including the related business processes relevant to financial reporting, including

a. the classes of transactions which are significant to the financial statements.

b. the procedures within both IT and manual systems by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.

c. the related accounting records used in *b*.

d. how the information system captures events and conditions, other than transactions, that are significant to the financial statements.

e. the process used to prepare the client's financial statements, including significant accounting estimates and disclosures.

f. controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.

Under ISA 315 paragraph 19, you should obtain an understanding of how the client communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including

a. communications between management and those charged with governance and

b. external communications, such as those with regulatory authorities.

Evaluating Design and Implementation

4.50 Examples of events and conditions significant to your client's financial statements that the financial information system captures may relate to

- an asset impairment;
- a contingent liability;
- the classification of an asset or liability;
- the client's ability to continue as a going concern; and
- subsequent events required to be disclosed to keep the financial statements from being misleading.

4.51 The information system relevant to financial reporting objectives consists of the procedures and records designed and established to

- initiate, record, process, and report entity transactions;
- resolve incorrect processing of transactions (for example, automated suspense files accompanied by procedures to investigate and resolve them on a timely basis. Also,

when planning the audit you should be aware that when IT is used to transfer information automatically, there may be little or no visible evidence of inappropriate intervention.);

- process and account for system overrides or bypasses of controls;
- transfer information from transaction processing systems to the general ledger;
- capture information relevant to financial reporting for events and conditions other than transactions (for example, depreciation); and
- ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.

Journal entries are generally part of the client's information system and its financial reporting process. Such entries includes standard and nonstandard journal entries. Standard journal entries might be used to record sales and purchases or to record accounting estimates such as asset valuation allowances. Nonstandard entries might be used to record nonrecurring or unusual transactions or adjustments such as a business combination or disposal, or a nonrecurring estimate such as asset impairment.

4.52 The information system relevant to financial reporting includes the client's communication of financial reporting roles and responsibilities.

4.53 Your understanding of the communication component of the client's information system also includes assessing the extent to which personnel understand

a. how their activities in the financial reporting system relate to the work of others.

b. the means of reporting exceptions to an appropriate higher level within the entity so that they may be acted on.

Monitoring of Controls

4.54 You should obtain an understanding of

a. the major types of activities that the entity uses to monitor internal control over financial reporting, including the sources of the information related to those activities.

b. how those activities are used to initiate corrective actions to the entity's controls.

(ISA 315 par. 22)

Observations and Suggestions

The COSO publication *Guidance on Monitoring Internal Control Systems* provides enhanced guidance on the monitoring component of internal control. This guidance goes beyond the requirements of the auditing standards but may be useful to auditors charged with evaluating the design and implementation of controls in conjunction with a financial statement audit.

The COSO monitoring guidance describes a model for monitoring that includes the following control objectives:

- *Establish a foundation for monitoring.* The entity has developed a tone at the top and organizational structure that supports effective monitoring. Management has established a baseline understanding of the entity's internal control design and implementation.
- *Design and execute monitoring procedures.* Management has identified and prioritized risks and has identified the key controls that address meaningful risks. Sources of information about control design and implementation have been identified, and the monitoring program, whether ongoing or separate, is implemented.
- *Assess and report results.* Results of the monitoring efforts are prioritized and results reported to the appropriate level of management. Management takes corrective action as necessary.

To evaluate the design and implementation component of internal control and, if applicable, to test the effectiveness of the client's monitoring, you may find the COSO monitoring guidance helpful.

Evaluating Design and Implementation

4.55 Monitoring is a process to assess the effectiveness of internal control performance over time. It involves assessing both (*a*) the design and operating effectiveness of controls on a timely basis and (*b*) taking necessary corrective actions. Monitoring may ensure that controls continue to operate effectively. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them. Management accomplishes monitoring of controls through ongoing activities, separate evaluations of the entire internal control system, or a combination of the two.

4.56 Changes in the entity or its environment may require changes in internal control. Thus management's monitoring of controls also includes a consideration of whether controls are modified as appropriate for changes in the entity or its environment.

4.57 In many entities, 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, misstatements may exist in the information, potentially leading management to incorrect conclusions from its monitoring activities. For this reason, when evaluating the design and implementation of the monitoring component of internal control, you may

a. identify the sources of the information management uses to monitor control effectiveness.

b. determine whether management has a sufficient basis for concluding that these sources are reliable for that purpose.

4.58 *For example, the comparison of budget to actual is a significant part of the monitoring activities performed by management and the board of directors of Young Fashions. If either the budgeted amounts or the actual amounts are inaccurate, the control procedure will be ineffective. Thus, to evaluate the effectiveness of the design of the control, the auditor may consider whether management and the board have a sufficient basis for relying on the budgeted and actual amounts by obtaining evidence about the accuracy and completeness of the information.*

4.59 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. The extent to which management uses this information to make corrections or improvements to internal control may be an indication of their attitude and awareness of internal control matters, which have a bearing on the effectiveness of the control environment. For example, if management receives information from an external party about a significant deficiency in internal control and fails to evaluate or act on that information, that failure may be a control deficiency.

4.60 If the entity has an internal audit function, you should obtain an understanding of (*a*) the nature of the internal audit function's responsibilities and how the internal audit function fits in the client's organizational structure and (*b*) the activities performed or to be performed by the internal audit function, to determine whether the internal audit function is likely to be relevant to the audit. (ISA 315 par. 23) In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. When obtaining an understanding of the internal audit function, you should follow the guidance in ISA 610, *Using the Work of Internal Auditors*.

4.61 Your understanding of management's monitoring of controls may help you identify more detailed controls or other activities that you may consider in making risk assessments.

Other Entity-Level Controls

Antifraud Programs and Controls

4.62 The primary responsibility for the prevention and detection of fraud and error rests with those charged with governance and your client's management. In obtaining an understanding of the control environment, you may consider the design and implementation of entity programs and controls to address the risk of fraud. These programs and controls may include

a. identifying and measuring fraud risks.

b. taking steps to mitigate identified risks.

c. implementing and monitoring appropriate preventive and detective internal controls and other deterrent measures.

Table 4-5 summarizes items management may consider in the design of the company's antifraud programs.

Table 4-5

Elements of an Antifraud Program

Element of the Antifraud Program	*Design and Implementation of the Entity's Program Should Consider*
Identification and measurement of fraud risks	• Vulnerability of the entity to fraudulent activity. • Whether any exposures to fraud could result in a material misstatement of the financial statements or material loss to the organization. • Characteristics that influence the risk of fraud that is specific to the entity, its industry, and country.
Steps to mitigate identified risks	• Changes to the entity's activities and processes, for example — to cease doing business in certain locations. — to reorganize business process. — to monitor or supervise high risk areas more closely.
Implementation and monitoring of appropriate preventive and detective internal controls	• Well-developed control environment, including a strong value system and culture of ethical financial reporting. • Effective and secure information system. • Appropriate monitoring activities. • Control activities over areas identified as high risk. • Controls over interim financial reporting. • Communication procedures to report any requests to commit wrongdoing. • Appropriate oversight by those charged with governance.

IT General Controls

4.63 You should consider whether the entity has responded adequately to the risk arising from IT by establishing effective controls, including effective general controls upon which application controls depend. 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. (ISA 315 par. 21)

As with all other controls, on all audits you should evaluate the design of IT general controls and determine whether they have been implemented in order to assess the risks of material misstatement. You should test IT general controls when you plan to rely on IT application controls to modify the nature, timing, and extent of your substantive procedures.

Observations and Suggestions

The way in which smaller entities implement IT general controls usually are different from the way in which larger entities achieve the same control objectives. However, even smaller entities will want to implement IT general controls such as the following:

- Secure logical access to critical applications, databases, operating systems, and networks.
- Develop controls related to significant upgrades to the IT operating system or to significant packaged applications. For example, significant upgrades should be tested before they are put into production.
- Back up critical data and programs.
- Restrict physical access to critical hardware items such as the server, telephone lines, and power supply equipment.

Controls Over Nonroutine Transactions, Judgmental Matters, and the Selection and Application of Significant Accounting Policies

4.64 As described in paragraph 3.92, controls related to significant risks are relevant to your audit. Frequently, at the financial statement level, significant risks often relate to nonroutine transactions and judgmental matters. As such, you will need to evaluate the design of the controls related to nonroutine transactions and judgmental matters and determine whether they have been implemented:

4.65 *Controls related to nonroutine transactions*. Paragraph 32*c* of ISA 240 direct the auditor to gain an understanding of the business rationale for significant unusual transactions. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include the following:

- Whether the form of such transactions is overly complex
- Whether management has discussed the nature of and accounting for such transactions with those charged with governance
- Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction
- Whether transactions that involve unconsolidated related parties, including variable interest entities, have been properly reviewed and approved by those charged with governance
- Whether transactions involve previously unidentified related parties, or parties unable to support the transaction without assistance from the entity being audited

4.66 *Controls related to accounting estimates*. ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, describes the following as matters the auditor may consider in obtaining an understanding of relevant controls related to accounting estimates:

- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
- The review and approval of accounting estimates, including the assumptions or inputs used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services (for example, in the case of a large financial institution, relevant segregation of duties may include an independent function responsible for estimation and validation of fair value pricing of the entity's proprietary financial products staffed by individuals whose remuneration is not tied to such products).

ISA 540 addresses the procedures that are appropriate when auditing these estimates.

4.67 ISA 240 directs auditors to perform certain procedures to address the risks of material misstatement due to fraud for each of the following items:

- *Nonroutine transactions*. You should gain an understanding of the business rationale for significant transactions that are outside the normal course of business. (ISA 240 par. 32*c*)
- *Judgmental matters*. You should perform a retrospective review of significant accounting estimates. (ISA 240 par. 32*b*[ii])
- *Selection and application of accounting policies*. You evaluate management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions. (ISA 240 par. 29*b*)

These procedures you perform to assess the risks of material misstatement due to fraud also may help you assess the risks of material misstatement due to error.

Observations and Suggestions

Smaller entities may not have established formal controls over nonroutine transactions, judgmental matters, or the selection and application of accounting policies. This lack of formality may be appropriate given the nature of the entity and the relative infrequency with which management addresses these matters. Nevertheless, many smaller entities do have procedures that either serve as a control or as a monitoring control that partially mitigates the severity of any deficiency in internal control, such as a periodic management review of these transactions.

However, a lack of formality does not relieve you of your responsibility to understand controls in these areas. In fact, the lack of formal controls over nonroutine transactions, judgmental matters, and accounting policies is quite relevant to your assessment of the risks of material misstatement. The lack of a control is not excused due to an entity's size or lack of attention to control issues.

The overreliance by management on the company's external auditors to identify nonroutine transactions or situations that require an accounting estimate may be a control deficiency. Under COSO, the independent auditor is not considered a part of the internal control of an entity.

Controls Over the Selection and Application of Significant Accounting Policies

4.68 Management is responsible for adopting appropriate accounting policies. Risks of material misstatement of the financial statement arise if management's selection or application of its accounting policies is inappropriate.

4.69 You should obtain an understanding of your client's selection and application of accounting policies and you should evaluate whether they are appropriate for the client's business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. Your understanding encompasses

a. the methods the entity uses to account for significant and unusual transactions.

b. the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

c. changes in the entity's accounting policies.

d. financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.

(ISA 315 par. 11*c* and A28)

4.70 ISA 260, *Communication with Those Charged with Governance*, addresses the oversight role of those charged with governance relating to the entity's selection and application of its accounting policies. Table 4-6 summarizes that guidance.

Table 4-6

Controls Over the Selection and Application of Accounting Policies

Management has the primary role for the selection and application of accounting policies. However, the oversight of those charged with governance is important for the client to achieve its financial reporting objectives. Controls that ordinarily are relevant to the audit together with examples of circumstances where those charged with governance should exercise their oversight are presented in the following table. In the following examples, if a company does not have an audit committee, those charged with governance should be substituted.

Control Procedure	*Examples*
Informing the audit committee about the initial selection of and subsequent changes to significant accounting policies or their application	The audit committee should be informed of *a.* the initial selection and application of significant accounting policies. *b.* subsequent changes to significant accounting policies. *c.* subsequent changes to the application of significant accounting policies.
Informing the audit committee about the methods used to account for significant unusual transactions	Example transactions include • bill-and-hold transactions. • self-insurance. • multielement arrangements contemporaneously negotiated. • sales of assets or licensing arrangements with continuing involvement of the enterprise.
Informing the audit committee about the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative accounting guidance or consensus	Examples of controversial or emerging areas of accounting include • revenue recognition. • off-balance-sheet financing. • accounting for equity investments. • research and development activities. • special purpose financing structures that affect ownership rights (such as leveraged recapitalizations, joint ventures, and preferred stock subsidiaries).

Observations and Suggestions

With regard to your client's selection and application of accounting policies, you have two responsibilities: (*a*) to assess the client's controls over the selection and application process and (*b*) to evaluate whether the selection and application of the policies are appropriate. That your client has chosen and applied its accounting policies in an appropriate manner does not provide evidence that the controls over that process are designed and operating effectively. That is, your client may apply its accounting policies properly and still have a control deficiency.

A best practice that has developed is for companies with less experienced accounting personnel to engage a consultant on accounting matters with whom they can periodically discuss issues, before having these issues aired solely with the independent auditor. Reliance on the independent auditor to be the sole source of guidance on accounting issues indicates a deficiency in internal control as defined by COSO. Of course, the independent auditor can, and should be, a party to the discussions on accounting matters, but reliance solely on the independent auditor for such matters is a deficiency or a significant deficiency, as determined in the circumstances.

The Responsibilities of Those Charged With Governance

4.71 The responsibilities of those charged with governance are of considerable importance. Their participation in the financial reporting process affects your client's overall control consciousness. In evaluating the quality of that participation, you may consider matters such as

- the independence of the directors.
- their ability to evaluate the actions of management.
- their ability to understand the client's business transactions.
- their understanding of the financial reporting process.
- their ability to evaluate whether the financial statements are fairly presented.

4.72 *Like many companies its size, Young Fashions has difficulty in finding and retaining high-quality independent directors. Company officers constitute four of the seven current members of the board. In spite of the challenges it faces, the co-CEOs of the company have taken steps to upgrade its board of directors, including the following:*

- *The company has contacted the Financial Executives Institute, local universities, and local CPA firms to identify candidates from business, academia, and public accounting who may be available to serve as board members.*
- *The board has formally added to its agenda several items related to the oversight of the financial reporting process, including emerging risks to financial reporting, identified control deficiencies, accounting estimates, and other judgmental matters (including key assumptions), and the review of the financial statements prior to their release.*
- *The board also allocates a portion of every meeting for discussions of issues with the auditors without management present.*

Observations and Suggestions

Not-for-profit organizations may face unique challenges in involving their board of directors in the financial reporting process and serving in an oversight capacity. For example, board members at a not-for-profit organization typically are most interested in helping the organization fulfill its mission. These members may lack a strong business background and therefore the ability to evaluate the financial reporting process or whether the financial statements are presented fairly.

In other not-for-profit organizations, board members may be chosen by the executive director or chief executive of the organization, which may impair the board's ability to act independently from management and evaluate their actions. Some boards may not meet outside of the presence of the executive director.

In circumstances such as these, you will need to consider whether the board is capable of fulfilling its oversight responsibilities and whether the circumstances indicate a potential control deficiency.

Evaluating Activity-Level Controls

Information Systems

4.73 As described in chapter 3 of this publication, you should obtain an understanding of the client's information system for significant transactions and transaction streams. This information system consists of the procedures and records established to initiate, record, process, and report these transactions, as well as the related accounting records, supporting information, and specific accounts. (ISA 315 par. 18)

Understanding Business Processes

4.74 Your client's business processes are inextricably united with the entity's information system. For example, when goods are purchased or sold, information about that transaction is recorded. To the extent that the information is relevant to the financial statements, an understanding of the underlying business process is relevant to the audit. Thus, as part of obtaining an understanding of the design and implementation of your client's information system, you should obtain a sufficient understanding of the underlying business processes. (ISA 315 par. 18)

Controls Related to the Use of Spreadsheets

4.75 As described in paragraph 2.78, your client's information system includes the use of spreadsheets and other ad hoc processing of information used in the financial reporting process. Thus, your understanding of the information system is not restricted to the formal accounting

processing system but encompasses an understanding of how the company uses spreadsheets in its financial reporting process.

4.76 When gaining an understanding of how your client's use of spreadsheets may affect the audit, the following factors may be helpful:

- *Significance of the spreadsheet to the financial information processing stream.* Spreadsheets that are used to process or prepare amounts or disclosures that are material and reported directly in the financial statements are more significant to the financial information system than spreadsheets that process immaterial amounts or disclosures or that affect the financial statements only indirectly. The more significant the spreadsheet is to the financial information system, the greater the risks of material misstatement of the financial statements.
- *Complexity of the spreadsheet.* Spreadsheets that use macros or that link to other spreadsheets are more complex than those that use simple calculations or formulas. As the complexity of the spreadsheet increases, so does the risk of misstatement.
- *Number of spreadsheet users.* Spreadsheets frequently are developed without the controls normally found in more formal, purchased software. For example, the spreadsheet may not have edit checks related to the input of data or access to the cells containing formulas may not be restricted appropriately. For these reasons, the more people who use the spreadsheet, the greater the risk that it will be used or modified inappropriately, leading to misstatement.
- *Experience and expertise of the individual who developed the spreadsheet.* When spreadsheets are developed by less qualified individuals, the risk of misstatement increases.

Control Activities

4.77 Control activities relevant to the audit are those for which you consider it necessary to obtain an understanding to assess risks of material misstatement and to design and perform further audit procedures. In addition to those control activities described in chapter 3 of this publication that ordinarily are relevant to your audit, which include those related to significant risks, you may determine that an understanding of other control activities is necessary. This determination is a matter of judgment. Chapter 5, "Risk Assessment and the Design of Further Audit Procedures," of this publication provides additional guidance on identifying significant risks.

Evaluating Design and Implementation

4.78 Effectively designed control activities are those that are capable—either individually or in combination with other control activities—of satisfying control objectives. Control objectives should be related to the specific risks of "what can go wrong." Thus, the effectiveness of the design of control activities ultimately depends on the degree to which they mitigate the financial reporting risk at the assertion level.

4.79 Assertions are helpful in identifying what can go wrong in the preparation of the financial statements. For example, if you were to consider what could go wrong in the processing of sales transactions, you would consider the completeness assertion and the risk that not all valid sales transactions were captured by the client's information system. You might then identify ways in which the system might not capture all transactions and see whether that risk is being controlled.

4.80 In describing "what can go wrong," it is helpful to describe the risk in a way that is specific to your client's business processes. By necessity, assertions are described in broad terms; however, to be most useful in your audit, the description of risk should reflect the unique circumstances of your client. For example, a description of "what can go wrong" related to the completeness assertion for revenue at a cash business such as a convenience store will be different from a specific description of risk related to the same completeness assertion for a computer software company.

The Identification of Control Deficiencies

4.81 The primary objective of your evaluation of the design and implementation of internal control is to provide evidence to support your assessment of the risks of material misstatement. However, during the course of obtaining this understanding of internal control, you may become aware of deficiencies in the design of controls at either the entity or activity level.

Entity-Level Control Deficiencies

4.82 During the course of evaluating the design and implementation of entity-level controls, you may become aware of control deficiencies, such as the following:

- Inadequate design of internal control over the preparation of the financial statements being audited.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization.
- Flaws in the design of IT general controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs. See appendix F, "Assessing the Severity of Identified Deficiencies in Internal Control," of this publication (for example, deficiencies 3–4) for examples of evaluating IT general control deficiencies.
- Employees or management who lack the qualifications and training to fulfill their assigned functions; for example, the corporate controller is unable to apply the applicable financial reporting framework in recording the entity's financial transactions or preparing its financial statements.
- Inadequate design of monitoring controls that assess effectiveness of the entity's internal control over time.

Chapter 7, "Evaluating Audit Findings, Audit Evidence, and Deficiencies in Internal Control," of this publication discusses the identification, evaluation, and reporting of control deficiencies in more detail.

Activity-Level Control Deficiencies

4.83 During the course of evaluating the design and implementation of activity-level controls, you may become aware of control deficiencies, such as the following:

- Inadequate design of internal control over a significant account or process
- Inadequate documentation of the activity-level components of internal control
- Absent or inadequate segregation of duties within a significant account or process
- Absent or inadequate controls over the safeguarding of assets needed for internal control over financial reporting
- Flaws in the design of IT application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs

Chapter 7 of this publication discusses the identification, evaluation, and reporting of control deficiencies in more detail.

Audit Documentation

4.84 This chapter provides guidance on certain matters relating to the planning of the audit, including the determination of performance materiality. It also describes how you perform risk assessment procedures to gather an understanding of the client and how you should plan for the performance of those procedures. With regard to these matters, you should document

a. the key elements of your understanding of the client, including each of the aspects of the client and its environment identified in paragraph 4.02.

b. with regard to internal control, your documentation should include each of the five elements of internal control.

c. the risk assessment procedures you performed to gather information about the client.

d. the sources you used to gather information about the client.

Paragraphs 1.39–.41 provide additional, more general guidance on the preparation of audit documentation.

(ISA 315 par. 32*b*)

Summary

4.85 This chapter described the breadth and depth of the understanding of your client that is necessary for you to assess the risks of material misstatement, beginning with your understanding of the client and its environment. This understanding will help you identify the broad business risks facing the company, which is important to your audit because many business risks give rise to risk affecting the preparation of the financial statements.

4.86 Your client's internal control is an integral part of its operations and obtaining an understanding of internal control is critical if you are to assess properly the risks of material misstatement. Your understanding of internal control involves

- evaluating the design of internal control to determine whether this design has the ability to prevent or to detect and correct material misstatements.
- determining whether the client has implemented the controls; that is, that client personnel are using them.

4.87 You will evaluate internal control and determine their implementation at both the entity level and activity level. By understanding these two levels of control, you will be better able to assess risk at both the financial-statement and the assertion level.

4.88 The next chapter of this publication discusses how you use your understanding of the client, which includes its internal control, as a basis for assessing the risks of material misstatement.

4.89

Appendix — Answers to Frequently Asked Questions About Understanding the Client, Its Environment, and Its Internal Control

Question	*See Paragraphs*
What should I understand about my client's industry and other external factors? How will this knowledge help me in my audit?	4.04–.05
What should I understand about my client's business, including sales transactions and IT systems? How will this knowledge help me in my audit?	4.06–.13
Why do I need to understand my client's business risk? How will this understanding help me in my audit?	4.14–.20
Why do I need to understand how my client measures and reviews the company's financial performance? How will this understanding help me in my audit?	4.23–.25
What does it mean to "evaluate the design" of internal control? How do I do this?	4.27–.29
How do I determine if a control has been implemented?	4.30–.32
What is the difference between evaluating control design and testing controls?	4.33–.35
How can I evaluate the design and implementation of internal control if my client does not have extensive documentation?	4.36–.38
How do you evaluate the design and implementation of • the control environment? • the client's risk assessment process? • information and communication? • monitoring? • other entity-level controls?	4.39–.72
How do I evaluate the design and implementation of activity-level controls?	4.78–.80
What information about my understanding of the client should I document?	4.84

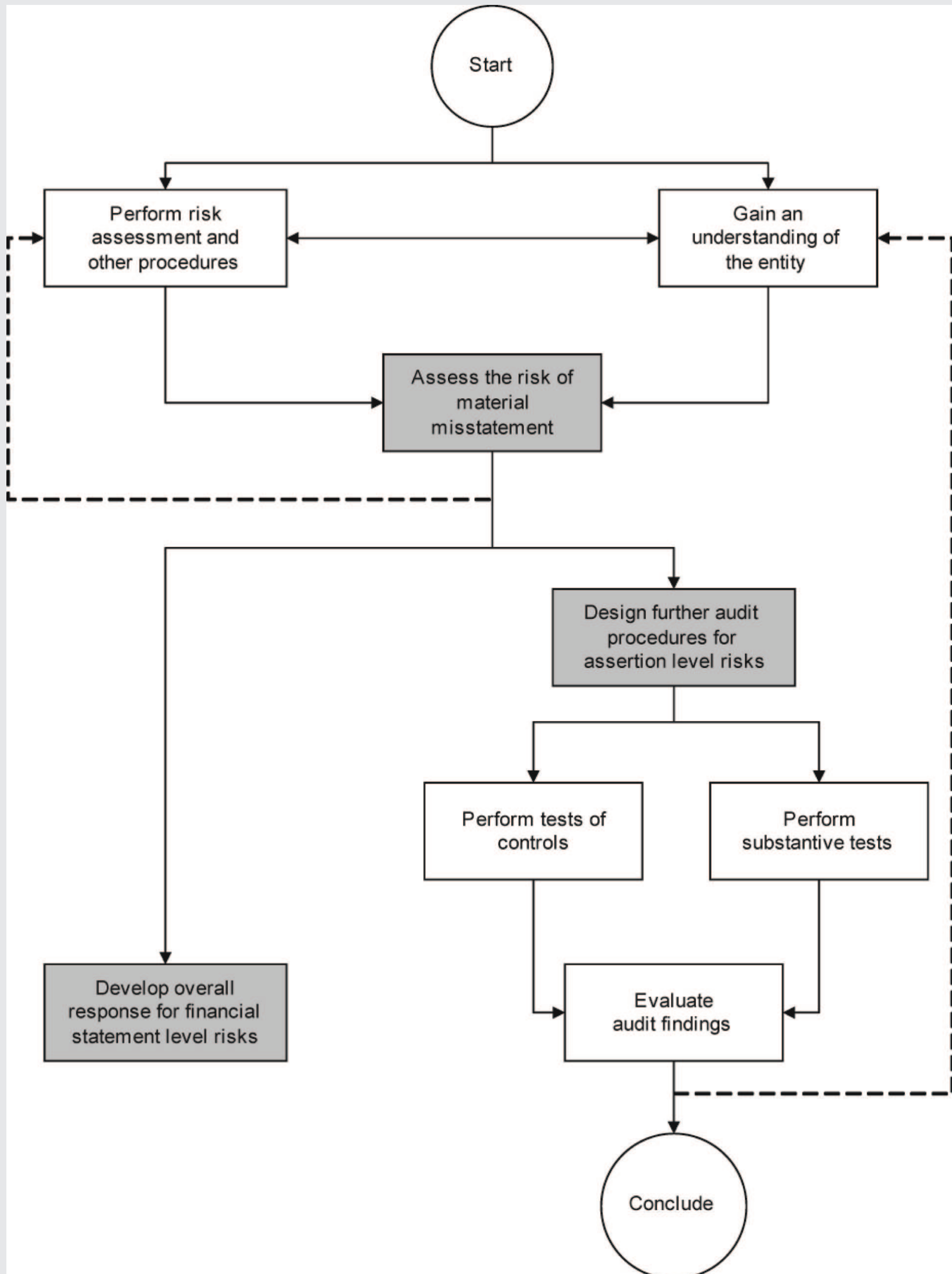
Chapter 5

Risk Assessment and the Design of Further Audit Procedures

Observations and Suggestions

Illustration 5-1

Risk Assessment and the Design of Further Audit Procedures



(continued)

This chapter provides guidance on incorporating your understanding of the entity, its environment, and its internal control into your assessment of the risks of material misstatement and the design of further audit procedures.

Broad Business Risks and Financial Reporting Risks

Your knowledge of the client and the results of your risk assessment procedures should allow you to identify the broad business risks facing the client. This is an important first step in your assessment of the risks of material misstatement of the financial statements because financial reporting risks are derived from these broad business risks. With a working knowledge of your client's business risks, you will be better able to identify financial reporting risks.

Financial Statement Versus Assertion Level Risk

You should assess risk at both the financial statement and the assertion level. Typically, you will assess financial statement level risk and relate it to what can go wrong at the assertion level. Some financial statement level risks are so pervasive that they cannot be related to a finite set of assertions, and for these risks you will develop an overall audit response.

Design Further Audit Procedures.

Further audit procedures should be responsive to our assessment of the risks of material misstatement. To design these procedures you will choose their nature, timing, and extent.

Your risk assessment procedures allow you to gather the information necessary to obtain an understanding of your client. This knowledge provides a basis for assessing risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive procedures, or both.

This chapter describes the process for assessing risk at both the financial statement and assertion level and how to design further audit procedures that effectively address this risk.

Introduction

5.01 You should obtain an understanding of the client and its environment. This understanding about your client encompasses a broad range of information, including

- industry, regulatory, and other external factors affecting the client, including the applicable financial reporting framework.
- the nature of the entity, including its operations, its ownership and governance structure, the types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives, and the way that the entity is structured and how it is financed.
- the entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should 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.
- the entity's objectives and strategies and those related business risks that may result in risks of material misstatement.
- the measurement and review of the entity's financial performance.

(ISA 315 par. 11)

This knowledge gained of your client from your understanding forms the basis for identifying risks and evaluating how these risks could give rise to financial material statement misstatements.

5.02 The term *risk assessment procedures* describes a *process* in which you identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. Based on risk identified and your assessment you

a. develop an overall response to financial statement level risks, and

b. design further audit procedures in response to assertion level risks.

Observations and Suggestions

Risk assessment in an audit is not a single activity or circumstance but a series of actions. As part of your audit, you may assign a value (for example, "high" or "low") to the risk of material misstatement for a given assertion, but that assignment of value is only a step of the risk assessment process—it is not the entire process.

To assign a value, you often will first identify the risks that could affect the financial statements at the assertion level. You will then analyze these risks as well as the design of the client's controls that address the risks. Only after performing these steps will you be able to make an appropriate assessment of risks at the assertion level and therefore design appropriate audit procedures.

Key steps in the risk assessment process should be documented. This documentation is necessary to support your conclusions about risk at the assertion level. Under the auditing standards you would not "default" to concluding that risk is "high" without providing some basis for your conclusion. A risk assessment will guide you to setting the appropriate nature, timing, and extent of audit procedures to address the risks that exist.

Finally, your assessment of risk at the assertion level provides support for the decisions you make about the nature, timing, and extent of your substantive procedures and, in some cases, your tests of controls. Because of this direct link between risk assessment and the design and performance of further audit procedures, your risk assessment procedures ultimately support your opinion on the financial statements.

5.03 To provide a proper basis for the design of further audit procedures, your assessment of risk should be expressed for the assertions related to significant classes of transactions, account balances, and disclosures. You relate identified risks to what could go wrong at the assertion level in the preparation of the financial statements. For example, consider a situation whereby sales personnel are able to make changes to standard sales contracts but this information is not always communicated to accounting. As a result, there is a high risk that changes with accounting implications that will not be considered properly and revenue could be recorded in the wrong accounting period (cut-off). By expressing your risk assessment at this level of detail, you will be able to design further audit procedures that are directly related to the risk. (ISA 315 par. 25*b*)

5.04 You should design further audit procedures whose nature, timing, and extent are based on, and are responsive to, your assessed risks of material misstatement at the assertion level. The risk assessment reflects your judgment about inherent risk and control risk. The higher you assess the risk, the more persuasive audit evidence you should obtain to provide a high level of assurance about whether the financial statements are stated fairly. (ISA 330 par. 7)

5.05 To gauge the relative significance of identified risks, you should consider the following:

a. *Magnitude*, that is, whether the risks are of a magnitude (size) that could result in a material misstatement of the financial statements

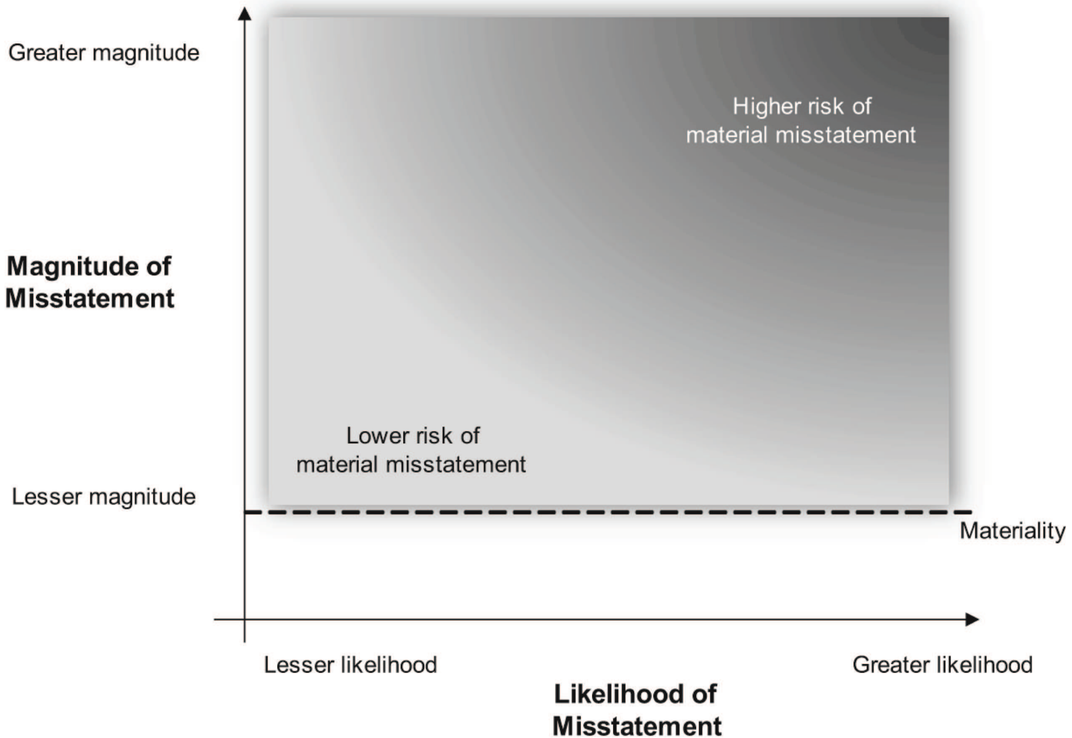
b. *Likelihood*, that is, the chance of the material misstatement happening.

(ISA 315 par. 26*d*)

5.06 By definition, a high likelihood of a misstatement that is material to the financial statements results in a high risk of material misstatement. Conversely, if you determine that an identified risk would have a lower chance to result in a misstatement and any misstatement that would result would be immaterial, you would assess the risks of material misstatement to be relatively low for that assertion. Illustration 5-2 describes this relationship between magnitude and likelihood when assessing risks of material misstatement.

Illustration 5-2

Relationship Between Magnitude and Likelihood When Assessing Risks of Material Misstatement



The Risks of Material Misstatement

5.07 The risks of material misstatement are the risks that an account or disclosure item contains a material misstatement. Chapter 2, "Key Concepts Underlying the Auditor's Risk Assessment Process," of this publication provides a more detailed discussion of this definition and its implications, including the following:

- The risks of material misstatement are a combination of inherent and control risk. (ISA 200 par. A37)
- The risks of material misstatement are the client's risks, which exist independently of your audit. (ISA 200 par. A37)
- You should assess the risks of material misstatement at both the financial statement level and the assertion level. (ISA 315 par. 26)

Risk Identification

5.08 In a financial statement audit, ultimately you are concerned with the risks related to financial reporting. However, many financial reporting risks are driven by broader business risks, which in turn, stem from the company's business objectives and strategies.

5.09 *For example:*

- *In an effort to increase profitability (the company's business objective), Young Fashions decides to extend credit to customers it historically has not extended credit to (strategy).*
- *As a result of this new strategy, the company is vulnerable to an increase in bad debts and in the time and effort it expends on collections, which could impede its ability to realize its overall objective of increased profitability (business risk).*

- *In regards to financial reporting, there is a risk that those responsible for estimating (or reviewing, as a control) bad debts may not be aware of or properly consider the effects of the new credit policy. Consequently the estimate for the bad debt allowance may be materially misstated (financial reporting risks).*
- *If increased bad debts already have been observed without management consideration of this in the estimation of bad debts, the likelihood issue is moot, and you should go on to assess the magnitude of the possible misstatement.*

5.10 Because financial statement reporting risks are derived from underlying business risks, your identification of the risks of material misstatement begins with an understanding of your client's overall business objectives, their strategies for achieving those objectives, and the risks to their achievement. Chapter 4, "Understanding the Client, Its Environment, and Its Internal Control," of this publication provides additional guidance and examples of the identification of client objectives, strategies, and risks.

5.11 As part of your understanding of internal control, you will gather information about management's risk assessment process. As part of your risk assessment procedures, you also may make inquiries about the risks that management has identified as part of their own risk assessment. The risks that management identifies as part of its risk assessment process should not supplant your own procedures, the results of those procedures, and your professional judgment. However, understanding the risks that management already has identified can facilitate a more efficient and effective audit. (ISA 315 par. 16)

5.12 It may be helpful to consider a generic set of financial reporting risks. Table 5-1 provides such a list. However to be relevant to your audit, the financial reporting risks you identify and document should be specific to the unique facts and circumstances that exist at your client.

Table 5-1

Types of Misstatement

In general, risks of material misstatement may relate to one or more of the following:

a. An inaccuracy in gathering or processing data from which financial statements are prepared

b. A difference between the amount, classification, or presentation of a reported financial statement element, account, or item and the amount, classification, or presentation that would have been reported under generally accepted accounting principles (GAAP)

c. The omission of a financial statement element, account, or item

d. A financial statement disclosure that is not presented in conformity with GAAP

e. The omission of information required to be disclosed in conformity with GAAP

f. An incorrect accounting estimate arising, for example, from an oversight or misinterpretation of facts

g. Differences between management and the auditor's judgments concerning accounting estimates, or the selection and application of accounting policies that the auditor considers inappropriate (for example, a departure from GAAP)

Observations and Suggestions

Performing risk assessment procedures and gaining an understanding of your client's business (as described in chapter 3, "Planning and Performing Risk Assessment Procedures," of this publication) will enable you to identify broad business risks fairly easily. Your challenge will be to analyze these broad business risks—separately and in combination—and to determine the effect, if any, these could have on the financial statements.

Further, your understanding of the client usually will focus on business processes such as sales, purchasing, or cash receipts and disbursements. The risks of material misstatement are focused on accounts and assertions. To properly link your understanding of the client's broad business risks to the risks of material misstatement, an additional challenge will be to map your understanding of client business processes to specific account balances and their assertions.

Assess Risks at the Financial Statement Level

5.13 Risks of material misstatement at the financial statement level are those risks that relate pervasively to the financial statements and potentially affect many individual assertions. Examples of risks at the financial statement level may relate to the following:

- The process used to prepare the period-end financial statements, including
  - the development of significant accounting estimates
  - the preparation of the notes to the financial statements
- The selection and application of significant accounting policies
- IT general controls
- The control environment
- Entity level controls

Chapter 2 of this publication discusses each of these example financial statement level risks in greater detail.

5.14 *For example, Ownco is a small family-owned business. The company employs a full-time bookkeeper, but this individual performs several incompatible functions. The business owner is actively involved in the business, but this involvement generally is limited to business development and operational issues and does not include oversight of the financial reporting process and supervision of the bookkeeper.*

Both the owner-manager and the bookkeeper are qualified and experienced to process or provide oversight to the processing of routine transactions. However, neither is adept at recognizing and applying emerging accounting matters or accounting for other nonroutine transactions. This lack of expertise creates a risk that potentially could affect many assertions.

5.15 Your evaluation of the design of the client's control environment will affect your assessment of the risks of material misstatement at the financial statement level. All things being equal, a client with an effectively designed control environment will allow you to have more confidence in the reliability of the evidence you have obtained than a client with an ineffectively designed control environment. Weaknesses may require you to obtain greater quantity and more persuasive evidence or evidence closer to the period end.

Whenever your audit strategy goes beyond the *design* of internal control to include an expectation that controls have *operated* effectively throughout the period (that is, you intend to design substantive procedures based on the effective operation of those controls), you should test these controls. (ISA 330 par. 8*a*)

5.16 *For example, Lee, CPA, audits PQR Corp, which operates in a technology-dependent industry that evolves rapidly. Significant judgment is required to properly apply GAAP, particularly in the areas of revenue recognition and asset valuation. Because of the rapidly evolving nature of the industry, the accounting principles applicable to revenue recognition and asset valuation that are relevant to the company continue to be subject to multiple interpretations and*

clarifications by the accounting standard setting bodies. These industry conditions create significant financial statement level risks, which affect the valuation assertion for certain assets and assertions related to revenue recognition.

PQR is headquartered near a town that has experienced a steady decline in population, and for this and other reasons, the company has difficulty in hiring experienced, qualified accounting personnel. The ability of management to hire qualified personnel (its "commitment to competence") is an element of an entity's control environment, and the lack of qualified personnel could be a deficiency in the control environment. However, Garcia, CPA, is the CFO and controller of PQR. She has been with the company since its inception and has worked in the industry her entire 20-year professional career. She keeps herself well-apprised of the evolving business practices and accounting standards that affect the company. Thus, Garcia's strengths mitigate any weaknesses that may exist at the lower levels in the accounting department.

Based on his client acceptance and continuance procedures as well as on information gathered in previous audits, Lee is aware of Garcia's experience, knowledge, and expertise. Intuitively, he feels comfortable relying on her, but intuition alone is not enough to justify this reliance for the audit.

To support his reliance on Garcia, during the current period audit, Lee performs certain risk assessment procedures, which as indicated in chapter 3 of this publication, include more than inquiry. As part of his risk assessment procedures to evaluate control design and confirm their implementation, Lee performs walkthroughs of Garcia's process for monitoring revenue recognition and the valuation of assets, and he observes Garcia's oversight, supervision, and training of accounting personnel.

Based on the design of the financial statement level controls performed by Garcia, the CFO and controller, Lee makes two decisions about the overall approach to the audit.

- *Hanashiro, a well-respected staff auditor with three years' experience, will be responsible for the day-to-day supervision of the audit. Hanashiro has worked on previous audits of PQR in a nonsupervisory capacity, but the other auditors assigned to the engagement have no experience with the client.*
- *The revenue cycle will be tested at an interim date, two months in advance of the period end.*

Based on his professional judgment, Lee concludes that the information gathered about the design of Garcia's procedures, which was obtained while performing risk assessment procedures, is sufficient and adequate to support his overall approach to staffing the engagement.

5.17 *Assume the same situation as described in paragraph 5.16 except that during the year, Garcia takes a six-week personal leave to care for an aging parent. During her absence, the company does not assign anyone to perform her assigned duties. At the end of her leave, Garcia decides to leave the company and relocate closer to her parents. After a two-week search, the company decides not to hire anyone from the outside to replace Garcia, but instead to promote the most senior person from her staff. This person was quite capable in her former position, but does not have nearly the qualifications, expertise, or experience of Garcia.*

Thus, during the year, the position of CFO and controller was unfilled for two months. At the end of that time, a person who was much less qualified than Garcia filled the position. Under this scenario, the financial statement level risks related to the entity and its business environment remain the same. However, the financial statement level control described in the previous scenario (the oversight and supervision of Garcia) was not operational at the same level of reliability for a good portion of the year. Consequently, the risks of material misstatement at the financial statement level is greater than it was under the previous scenario.

Under this set of facts, Lee, CPA, makes different decisions about the overall approach to the audit:

- *Johnson, a five-year staff auditor with a strong reputation for detail, will supervise the audit. The budget for the job will be increased to include more involvement of Karl, a manager with extensive experience auditing technology companies. Karl will become involved immediately in planning the audit.*
- *Receivables will not be tested at an interim date but will be tested at year end. An additional test will be performed for the two months when there was an unfilled position; adjustments during this period will be carefully reviewed.*

These differences in the overall approach to the audit reflect the different risk assessments caused by Garcia's absence.

Overall Responses to Risks at the Financial Statement Level

Observations and Suggestions

Your audit response to financial statement level risks should be responsive to the assessed risk.

The same is true for responses to risk at the account/assertion level. It is critical that your further audit procedures are linked clearly and responsively to your assessment. For example, if you determine that the risks related to the valuation of inventory are significant, the type of substantive procedures you design should provide strong evidence about valuation.

Similarly, your risk assessment at the financial statement level should be clearly aligned to your overall audit strategy, and your overall strategy should be responsive to your risk assessment.

Both your risk assessment and response should be documented.

The following paragraph describes some important characteristics of financial statement level risks. The purpose of these descriptions is to help you "bridge" between your assessment of financial statement level risks and your subsequent response.

5.18 Characteristics of financial statement level risks that are relevant for audit purposes include the following:

- *Financial statement level risks can affect many assertions*. By definition, financial statement level risks may result in material misstatements of several accounts or assertions. For example, a lack of controls over journal entries increases the risk that an inappropriate journal entry could be posted to the general ledger as part of the period-end financial reporting process. The posting of an inappropriate journal entry may not be isolated to one general ledger account but potentially could affect any account. In general, overall audit risk increases when the magnitude or scope of an identified risk of misstatement is not known.
- *Assessing financial statement level risks requires significant judgment*. Ultimately, you should relate identified risks of misstatement to what can go wrong. For example, suppose that while performing risk assessment procedures to gather information about the control environment, you discovered weaknesses relating to the hiring, training, and supervision of entity personnel. These weaknesses result in an increased risk of a misstatement of the financial statements, but it will be a matter of your professional judgment to determine
  - — the accounts and assertions that could be affected.
  - — the likelihood that a financial statement misstatement will result from the increased risk.
  - — the significance of any misstatement.
- *Risks at the financial statement level may not be identifiable with specific assertions*. Control weaknesses at the financial statement level can render well-designed activity-level controls ineffective. For example, a significant risk of management override can potentially negate existing controls and procedures at the activity level in many accounts and for many assertions. Linking such a risk to specific accounts and assertions may be very difficult, and may not even be possible. As another example, your client may have excellent data input controls at the application level. But if poorly designed IT general controls allow many unauthorized personnel the opportunity to access and inappropriately change the data, the well-designed input controls have been rendered ineffective. Also, strengths in financial statement level controls, such as an overall culture of ethical behavior, may increase the reliability of controls that operate at the activity level. Determining the extent to which financial statement level controls affect the reliability of specific activity level controls (and therefore the assessment of the risks of material misstatement) is subjective and may vary from client to client.

5.19 *For example, Young Fashions does not have a complete, well-designed set of controls relating to accounting estimates. More specifically, accounting personnel do a good job making recurring estimates, such as the allowance for doubtful accounts and sales returns. However, they are much less adept at making estimates related to asset valuation issues, including the impairment of long-lived assets and goodwill. Risks related to accounting estimates may be considered a financial statement level risk because they have the ability to affect many different*

assertions. But given the circumstances that exist at Young Fashions, these financial statement level risks can be correlated with or mapped to misstatements that can occur in specific assertions (for example, valuation of long-lived assets and goodwill).

5.20 However, because of the unique characteristics of financial statement level risks, it may not be possible to correlate all of these risks to a finite set of assertions. For example, a weakness in control environment may affect all or mostly all of the accounts, classes of transactions, or disclosures and the assertions. To respond appropriately to these types of financial statement level risks, you may need to reconsider your overall approach to the engagement. Table 5-2 provides examples of overall responses to risks at the financial statement level that have a pervasive effect on the financial statements and cannot necessarily be mapped to individual assertions.

Table 5-2

Examples of Overall Responses to Risks at the Financial Statement Level

Your overall response to risks at the financial statement level may include

- emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence.
- assigning more experienced staff or those with specialized skills or using specialists.
- providing more supervision.
- incorporating additional elements of unpredictability in the selection of further audit procedures to be performed and in selecting individual items for testing.
- making general changes to the nature, timing, or extent of audit procedures as an overall response; for example, performing substantive procedures at period end instead of at an interim date. One could also focus more time and attention on audit areas more closely associated with the risk.

Observations and Suggestions

Paragraphs 28–29 of ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, describe the overall responses you may take in response to your assessment of the risks of material misstatement due to fraud. When determining your overall audit response, you can consider your assessment of fraud risk concurrently with your assessment of the risks of material misstatement due to error. You can develop one overall response that is appropriate for both kinds of risks.

Assess Risks at the Assertion Level

5.21 Some risks of misstatement relate to a single assertion or a set of assertions for the same business process or class of transactions. For example, the risks associated with the inaccurate counting of inventory at year end may affect the existence and valuation of inventory and the completeness and accuracy of cost of goods sold. Risks associated with the completeness of accounts payable affect payables, purchases, and expenses.

Consideration of the Two Components of the Risks of Material Misstatement

5.22 As described in chapter 2 of this publication, the risks of material misstatement are a combination of inherent and control risk, and you can decide whether to assess these two components separately or in combination. Either way, you should assess both components. For example, even if you assess inherent risk as low for a particular assertion, you still should assess control risk.

5.23 *For example, assume you are auditing a balance sheet account that you expect to have only one adjustment per month posted to it. You believe that the monthly adjustment is relatively easy to calculate. You assess inherent risk as low, partially because of the ease of the calculation, and partially because you have not identified misstatements in this account in prior year audits, and you believe that the bookkeeper is capable of recording the correct monthly amount.*

In this example, your professional judgment concerning the assessment of inherent risk was influenced by your belief that the bookkeeper is competent and has never made an error in prior years in posting the monthly adjustment. As a result, your assessment of inherent risk did not assume that there are no controls because there are some controls in place that the bookkeeper applies in making the monthly adjustment.

Therefore, you have to be careful when assessing inherent risk as low because you may be assuming that certain basic controls are in place and operating effectively. In such cases, you may actually be making a combined assessment of the risks of material misstatement rather than assessing only inherent risk.

Consideration of Internal Control in Assessing Risks

5.24 When assessing risks at the assertion level, you may identify the controls that have been implemented (placed in operation) and whose design indicates that the control is capable of effectively preventing or detecting and correcting material misstatements. Determining whether a control is *capable* of effectively preventing or detecting and correcting material misstatements does not require the auditor to obtain evidence about the actual operating effectiveness of the control.

Your assessment of a control may also bring to your attention risks that result from an ineffective or improperly designed control. These additional risks may need to be considered in your audit plan.

5.25 *For example, Young Fashions purchases finished goods from providers located in Asia or Europe. If these goods are not up to specifications provided by Young Fashions, the company has the contractual right to either return finished goods and request a full credit be made to its account or sell the items as "factory seconds" through discount retailers. If they elect to sell the items, the manufacturer will credit Young Fashions for the difference between the profit that would have been made had the company been able to sell the item at full price, and the actual profit made selling the items as factory seconds. In addition, the amount of the credit is denominated in foreign currencies, which may fluctuate from the time the goods are initially billed and Young Fashions receives proper credit for unsatisfactory merchandise.*

Because of these complications in determining the proper balance in the payables account, the inherent risk associated with purchases is relatively high. However, the auditor has determined that the company has a highly effective design of the controls related to its return of merchandise. In assessing the risks of material misstatement related to the assertions for purchases, the auditor should consider both the inherent risk of misstatement and the design of the controls being used by the company that can mitigate that risk.

Observations and Suggestions

Evaluating the design of a control and determining whether it has been implemented are vital to properly designing further audit procedures, even if those procedures are expected to consist solely of substantive procedures. For example, consider the design of further audit procedures related to cash balances under three different scenarios.

Scenario 1: No interim controls implemented. In gaining an understanding of control design and implementation, you determine that your client only reconciles the bank accounts once a year when preparing for the audit. That is, controls over cash receipts and disbursements do not exist throughout the year.

Scenario 2: Controls exist but are not designed effectively. In this scenario the client prepares monthly bank reconciliations; however, there is inadequate segregation of duties. The person performing the reconciliations also has the ability to post cash receipts and disbursement activity to the general ledger.

Scenario 3: Adequately designed controls have been implemented. Your client performs monthly bank reconciliations and the procedures have been designed effectively, including adequate segregation of duties.

Design of Substantive Procedures

The design of your substantive procedures will vary for each of the previously mentioned scenarios. In scenario 1, the client has not implemented what typically is an important control

over cash receipts and disbursements. Accordingly, you might change the nature of your substantive procedures to include procedures to detect material misstatements caused by fraudulent cash disbursements or activity (such as lapping) related to cash receipts during the year. You note that if the year-end reconciliation is done properly, the financial statements will be correct regarding this item. You may choose to obtain a bank cut-off statement and use it to check the reconciliation or to even reperform the year-end reconciliation yourself. You may confirm payment information with client customers as part of your receivables confirmation procedures or you might examine underlying documentation supporting a selection of cash disbursements. You also may extend your planned substantive procedures to examine more cancelled checks or deposits in transit than you otherwise would have. Also, you might check for unusual journal entries, write-offs, or other interim activities that could indicate risks from unreconciled cash.

In scenario 3, the client has designed and implemented an effective control procedure. All other circumstances being equal to those of scenario 1, under this scenario, you may determine that sufficient relevant audit evidence related to period-end cash balances may be obtained by testing the year-end bank reconciliation. That is, you might not obtain bank cut-off statements, confirm cash, confirm payments received from customers or made to vendors, or perform many of the other procedures that were appropriate for scenario 1.

Scenario 2 is different from scenarios 1 and 3 and could be more troublesome because there exists a segregation of duties issue that could negate the effectiveness of the reconciliation. You might not perform all the procedures that were appropriate for a situation where virtually no controls have been implemented, but you would have to respond to the fact that the control is not designed effectively (due to a lack of segregation of duties). For example, you may decide to examine reconciliations that were performed by someone else, during the time when the person who typically performed them was on vacation. Or you may perform more detailed tests of certain accounts as a way to detect unauthorized disbursements and scan the nonstandard journal entries for cash account related items. You might also look toward any monitoring procedure that is performed over the reconciliation and its effectiveness. An effective monitoring control can mitigate the severity of this control deficiency to some extent.

Conclusion

Note that each scenario had an effect on the *nature* of the substantive procedures performed. Different procedures were designed to the varying risks presented by the different scenarios.

Absent an evaluation of control design and a determination of whether the controls are being used by the client, the design of your audit procedures may not be an appropriate response to the risks that are present at the client. Without appropriately designed audit procedures, you may fail to gather the sufficient, appropriate audit evidence that is necessary to provide a high level of assurance about whether the financial statements are free of material misstatement.

5.26 Individual control policies and procedures often do not address a risk completely in themselves. Often, only multiple control activities, together with other components of internal control (for example, the control environment, risk assessment, information and communication, or monitoring) will be sufficient to address a risk. For this reason, when determining whether identified controls are capable of effectively preventing or detecting and correcting material misstatements, the auditor may consider his or her understanding of control policies and procedures within the context of the processes and systems in which they exist.

5.27 *For example, when processing accounts payable, there may be a risk that the entity processes payments or other debits to the account at the incorrect amount. This error may be introduced at several points within the information processing system. For example, at initiation, if the company writes a manual check to the vendor, the amount of the check may be entered incorrectly into the accounting system. At other points in the processing stream, journal entries to adjust payables for billing corrections may be posted inappropriately or at their incorrect amounts. For the audit to gain a complete understanding of the risks related to the valuation of accounts payable, you may consider both the controls over the initiation of payments and those over the posting of billing adjustments.*

5.28 Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective the 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. For this reason, when determining whether identified controls are capable of effectively preventing or detecting and correcting material misstatements, it will be helpful to consider whether the identified controls are directly or more indirectly related to an assertion.

5.29 Your audit strategy may include testing controls for the purpose of relying on their operating effectiveness in the design of your substantive procedures. In those circumstances, your initial assessment of the risks of material misstatement will be based on an assumption that controls operated effectively throughout the audit period. However, after performing your tests of controls, you may need to reassess your initial assessment of the risks of material misstatement; for example, if your tests identify deviations in the way the control operated during the period.

Identification of Significant Risks

5.30 As part of your risk assessment, you should identify significant risks, one or more of which arise on most audits. Significant risks are those that require special audit consideration. This special consideration means that you should

a. obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Paragraphs 4.64–.67 of this publication provide guidance on controls relating to nonroutine transactions and judgmental matters, which often are the source of significant risks.) (ISA 315 par. 29)

b. perform substantive procedures that are linked clearly and responsively to the risk. Moreover, when your approach to significant risks consists only of substantive procedures, you should perform either

   i. tests of details only, or

   ii. a combination of tests of details and substantive analytical procedures.

   That is, the substantive procedures related to significant risks should not be limited solely to substantive analytical procedures (when you are not testing the operating effectiveness of controls related to the significant risks).

   (ISA 330 par. 21)

c. if relying on the operating effectiveness of controls intended to mitigate the significant risk, you should test controls in the current period and not rely on tests of controls performed in prior years. (ISA 330 par. 15)

d. document those risks you have identified as significant.

5.31 One or more significant risks normally arise on most audits. In exercising professional judgment to determine whether a risk is a significant risk, you should consider

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

(ISA 315 par. 28)

When considering whether an identified risk is a significant risk, you should exclude the effect of controls related to the risk. In other words, your determination of whether a risk is a significant risk is based solely on inherent risk. Chapter 2 of this publication provides guidance on the factors that you may consider when assessing inherent risk.

Observations and Suggestions

As stated in paragraph 5.31, the determination of significant risk is based solely on inherent risk. It is common for auditors to assess inherent risk as "high," "moderate," or "low." In defining significant risk you may think of significant risk as one where the inherent risk is higher than the usual "high" and therefore it requires special audit consideration.

For example, in considering the valuation of receivables, you may assess inherent risk to be high because it is based on a subjective estimate. However, suppose that at your specific client

- management has extensive experience in estimating the allowance for doubtful accounts and there has been little change in the company's products or major customers over the past few years.
- the information used by management to make the estimate is relevant and highly reliable
- the retrospective review of accounting estimates performed on previous audits has not indicated a bias on the part of management. (See paragraph A46 of ISA 240 for a discussion of the retrospective review of accounting estimates.)

Further, suppose that during the current audit period this client

- entered into a transaction with a related party that may be a variable interest entity requiring its consolidation in the financial statements of the client.
- applied for the first time, a relative complex accounting standard relating to leases.

Under these circumstances, the valuation of receivables, the possible consolidation of a variable interest entity, and the new application of an accounting principle may all be judged to be, at a minimum, high inherent risks. But of the three, only the consolidation and lease accounting issues would require special, out-of-the-ordinary audit consideration. These two matters might be considered significant risks; the valuation of receivables in this case is probably not a significant risk.

In some companies the valuation of inventories presents an annual challenge that requires careful consideration of the specific facts and circumstances surrounding the valuation assertion. Perhaps the products are highly sensitive to issues relating to a volatile technology, and thus for such a businesses, the valuation of inventory may be a significant risk that recurs annually.

In determining whether a risk is a significant risk, it is helpful to consider inherent risks not in isolation, but rather, in the context of *all* high inherent risks at the client. As indicated in paragraph 5.30, one or more significant risks generally arise on most audits. Thus, significant risks are likely to exist even in those situations where there are no new or unusual circumstances at the client.

Sometimes, comparing all high inherent risks to each other may help you identify which ones are the significant risks in those situations.

The unnecessary designation of too many risks as significant risks can impair the efficiency of the audit process by requiring special handling of these risks and precluding reliance on controls tested in previous audit periods.

Questions such as the following may help to determine which risks truly require special audit consideration:

- Which of the risks would be most likely to require the immediate, focused attention of the auditor with the final responsibility for the audit? If your firm requires a concurring review of all audits, which of the risks would command the initial attention of the concurring reviewer?
- For which risks would you be reluctant to rely on substantive analytical procedures as your only source of audit evidence?
- Which of the risks are atypical for the client?
- Were any of the risks unexpected, given your previous experience with this client?
- If, hypothetically, you had a constraint on the time available to perform the audit, which risk(s) would you be absolutely certain to address through substantive procedures of details?

Nonroutine Transactions and Judgmental Matters

5.32 Nonroutine transactions and judgmental matters often create a significant risk. For this reason, you will want to design your risk assessment procedures to identify nonroutine transactions and judgmental matters such as estimates.

5.33 Nonroutine transactions are transactions that are unusual, either due to size or nature, and that therefore occur infrequently. Risks relating to significant nonroutine transactions may arise 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 nonroutine transactions, which may make it difficult for the entity to implement effective controls over the risks
- Significant related-party transactions

5.34 Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Risks relating to judgmental matters may arise from matters such as the following:

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

5.35 Significant risks also may arise from management judgments about matters that may affect the recognition, classification, or disclosure of financial statement items. These judgments may include

- the determination of when the company's earnings process is complete, which, in turn, will drive its revenue recognition policies.
- assumptions about intended future actions by management or likely future events. These assumptions may affect the recognition, measurement, or classification of assets and liabilities. For example
  - management's intent with regard to investment securities will determine how those securities are presented and classified in the financial statements.
  - management's projection of expected future cash flows may determine whether the carrying value of an asset has been impaired.
  - management's judgments about the likelihood of a future event occurring (for example, "probable" or "remote") may determine whether a contingent liability should be recognized.
- decisions about the matters to be disclosed in the notes to the financial statements and about the content and language used to describe those matters. These decisions affect the completeness, understandability, and fairness of the company's financial statement disclosures.

Significant Financial Statement Level Risks

5.36 At the financial statement level, significant risks may arise from the following:

- *External circumstances*. External circumstances giving rise to business risks influence your determination of whether the risk requires special audit attention. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Recent significant economic, accounting, or other developments also may require special attention.
- *Factors in the client and its environment*. Factors in the client and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may influence the relative significance of the risk. For example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large

number of business failures may have a pervasive effect on risk for several account balances, classes of transactions, or disclosures.

- *Recent developments*. Recent significant economic, accounting, or other developments can affect the relative significance of a risk.

Significant Assertion Level Risks

5.37 At the assertion level, when determining whether an identified risk requires special audit consideration, you may consider a number of matters, including the following:

- *Complex transactions or calculations*. Complex calculations are more likely to be misstated than simple calculations.
- *Risk of fraud or theft*. Revenue recognition is presumed to be a financial reporting fraud risk; cash is more susceptible to misappropriation than inventory of coal.
- *Estimates*. Accounts consisting of amounts derived from accounting estimates that are subject to significant measurement uncertainty pose greater risks than do accounts consisting of relatively routine, factual data.
- *Related party transactions*. Related party transactions may create business risks that can result in a material misstatement of the financial statements.

Observations and Suggestions

To the extent possible, you will want to relate significant risks to the assertion level, not simply the account level.

Significant risks may vary between clients in the same industry. At the same client, they may change over time. For example, suppose that your client entered into a hedging transaction. The first time they entered into the transaction you may determine that, due to the complexity of the accounting, there was a significant risk that the transaction was accounted for improperly. However, because the transaction was unique and important to the entity, the decision to enter into the transaction was appropriately authorized, the client obtained proper guidance on how to account for the transaction, and the client set up appropriate controls.

Suppose that over time, the company entered into the same type of hedging transactions on a regular basis, as a normal part of its operations. As a routine transaction (with proper controls), determining the proper accounting is no longer considered complex (for this particular client). However, you may discover that the controls over these transactions are not effectively designed—the treasurer has the ability to both enter into and approve the transactions. Thus, after a few years you might decide that this is no longer a significant risk.

At a similar client, you may discover that the controls over these transactions are not effectively designed—the treasurer has the ability to both enter into and approve the transactions.

Under these circumstances, you may determine that a significant risk related to hedging transactions still exists, but that risk no longer relates to determining the proper accounting but rather to the authorization of the transaction and whether the company has adequately accounted for and disclosed all obligations and risks that may arise from the transactions. Furthermore, you may assess that the exposure to the company from such transactions is such that hedges should remain a significant risk requiring periodic, careful assessment of the fair value of the hedge.

Linking the Assessed Risks to the Design of Further Audit Procedures

Observations and Suggestions

The auditing standards require you to establish a "clear linkage" between your assessment of the risks of material misstatement and further audit procedures.

Linkage describes the relationship between the assessed risk and your further tests. *Clear linkage* means that the further tests are responsive to the assessed risks and that there is a close correlation between the assertions of the assessed risk and the assertions addressed by the substantive procedure. The test should provide strong evidence about the assertion that is at risk of material misstatement. A vague correlation between your assessed risks and your further audit procedures may indicate that yet additional audit procedures may need to be performed to address the identified risks.

Although generic audit programs for standard audit areas may be helpful in providing a starting point for determining the nature of the substantive procedures you will perform, it is important to modify generic audit programs as necessary to ensure that your choice of substantive procedures is clearly linked to your assessed risks.

5.38 Your risk assessment process culminates with the articulation of the account balances, classes of transactions, or disclosures where material misstatements are most likely to occur and—even more specifically—how the misstatements may occur and the assertions that are likely to be misstated. This assessment of the risks of misstatement, which relates identified financial reporting risks to what can go wrong at the assertion level, provides a basis for the design of further audit procedures.

Design of Further Audit Procedures

5.39 Further audit procedures provide important audit evidence to support your audit opinion. These procedures consist of tests of controls and substantive procedures. Often, you will determine that a combined approach using both tests of the operating effectiveness of controls and substantive procedures is an effective approach.

5.40 You should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level. Effectively designed procedures provide a clear linkage between the risk assessments and the nature, timing, and extent of the further audit procedures. (ISA 330 par. 6)

5.41 In designing further audit procedures, you should consider matters such as

- the significance of the risk and the likelihood that a material misstatement will occur. In general, the more significant (in terms of likelihood and magnitude) the risk, the more reliable and relevant your audit evidence should be.
- the characteristics of the class of transactions, account balance, or disclosure involved, which will help determine the nature, timing, and extent of procedures available to you. For example, the gross accounts receivable balance comprises transactions with third parties, which means you can contact these external parties to confirm the transactions or individual account balances. On the other hand, the allowance for doubtful accounts is an estimate prepared internally, which does not lend itself to confirmation but to other substantive procedures.
- the nature of the specific controls used by the client, in particular, whether they are manual or automated.
- whether you plan to test controls in order to modify the nature, timing, and extent of substantive procedures.

(ISA 330 par. 7)

Nature of Further Audit Procedures

5.42 The nature of further audit procedures refers to

a. their purpose, that is, tests of controls or substantive procedures (or dual-purpose tests) and whether they are designed to test for overstatement, understatement, or both.

b. their type, that is

i. inspection,

ii. observation,

iii. inquiry,

iv. confirmation,

v. recalculation,

vi. reperformance, or

vii. analytical procedures (including scanning).

Table 5-3 and paragraphs 5.43–.54 provide additional guidance on each of these procedures.

Observations and Suggestions

Of the three variables that you consider when you design further audit procedures (nature, timing, and extent), it is your choice of the type of procedures (their nature) that will be most important in determining whether the further audit procedures are responsive to assessed risks.

Table 5-3

Types of Audit Procedures

Type of Procedure	*Definition*	*Additional Guidance*
Inspection of Documents	Inspection of documents involves examining records or documents, whether internal or external, in paper form, electronic form, or other media.	• This procedure provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal documents, on the effectiveness of the controls over their production. • Some documents represent direct audit evidence of the existence of an asset but not necessarily about ownership or value. • Inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting principles, such as revenue recognition. • Some forms of documents are less persuasive than others. For example, faxes and copies may be less reliable than original documents.

(continued)

Type of Procedure	*Definition*	*Additional Guidance*
Inspection of Tangible Assets	Inspection of tangible assets consists of physical examination of the assets.	• This procedure may provide audit evidence relating to existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. • Inspection of individual inventory items ordinarily accompanies the observation of inventory counting.
Observation	Observation consists of looking at a process or procedure being performed by others.	This procedure provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed.
Confirmation	Confirmation is the process of obtaining a representation of information or of an existing condition directly from a knowledgeable third party.	This procedure • frequently is used in relation to account balances and their components but need not be restricted to these items. • can be designed to ask if any modifications have been made to an agreement, and if so, what the relevant details are. • also is used to obtain audit evidence about the absence of certain conditions, for example, the absence of an undisclosed agreement that may influence revenue recognition. See ISA 505, *External Confirmations*, for further guidance on confirmations.
Recalculation	Recalculation consists of checking the mathematical accuracy of documents or records.	This procedure can be performed through the use of IT; for example, by applying a data extraction application or other computer assisted audit techniques (CAATs).
Reperformance	Reperformance is the auditors independent execution of procedures or controls that were originally performed as part of the entity's internal control.	This procedure may be performed either manually or through the use of CAATs; for example, reperforming the aging of accounts receivable.

Inquiry

5.43 Inquiry consists of seeking information of knowledgeable individuals. These individuals may be involved in the financial reporting process or outside of that process; they may be internal or external to the company. Inquiry is used extensively throughout the audit and often is complementary to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Asking questions of knowledgeable individuals is only part of the inquiry process. Evaluating the responses to your inquiries is an equally integral part of the process.

5.44 Inquiry normally involves

- considering the knowledge, objectivity, experience, responsibility, and qualifications of the individual to be questioned.
- asking clear, concise, and relevant questions.
- using open or closed questions appropriately.
- listening actively and effectively.
- considering the reactions and responses and asking follow-up questions.
- evaluating the response.

5.45 Responses to inquiries may provide you with information you did not previously possess or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information you have obtained. In those situations, you should resolve any significant inconsistencies in the information obtained. In some cases, responses to inquiries provide a basis for you to modify or perform additional audit procedures. (ISA 500 par. 11)

5.46 Although inquiry may provide important audit evidence and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient appropriate audit evidence to detect a material misstatement. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls.

5.47 In some instances, you may need to obtain evidence about management's intended actions; for example, when obtaining evidence to support management's classification of investments as either trading, available for sale, or held to maturity. To corroborate management's responses to questions regarding their intended future action, the following may provide relevant information:

- Management's past history of carrying out its stated intentions
- Their stated reasons for choosing a particular course of action
- Their ability to pursue a specific course of action

5.48 In some cases, you may consider it necessary to obtain replies to inquiries in the form of written representations from management. For example, when obtaining oral responses to inquiries, the nature of the response may be so significant that it warrants obtaining written representation from the source. See ISA 580, *Written Representations*, for further guidance on written representations.

Substantive Analytical Procedures

5.49 Substantive analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Substantive analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. See ISA 520, *Analytical Procedures*, for further guidance on analytical procedures.

5.50 *Scanning accounting data.* Scanning is an analytical procedure that includes

- the identification of anomalous individual items within account balances or other data. You may identify these items by reading or analyzing entries in any one of a number of accounting records, including transaction listings, subsidiary ledgers, general ledger

control accounts, adjusting entries, suspense accounts, reconciliations, or other detailed reports. Computer assisted audit techniques (CAATs) may help you identify anomalies.

- the search for large or unusual items in the accounting records (for example, nonstandard journal entries), as well as in transaction data (for example, suspense accounts, adjusting journal entries) for indications of misstatements that have occurred.

Your determination of which items in a population are anomalous, large, or unusual is a matter of your informed professional judgment.

5.51 Because you test the items selected by scanning, you obtain audit evidence about those items. Your scanning also may provide some audit evidence about the items not selected because you have used professional judgment to determine that the items not selected are less likely to be misstated.

The Selection of Audit Procedures

5.52 Your risk assessments will have a bearing on your selection of audit procedures. The higher your assessment of risk, the more reliable and relevant (that is, persuasive) the audit evidence you seek from substantive procedures. This determination of the requisite reliability and relevance of audit evidence may affect both the types of audit procedures to be performed and their combination. For example, you may confirm the completeness of the terms of a contract with a third party, in addition to inspecting the document and obtaining management's representation. This combination of several procedures would result in more reliable and relevant audit evidence than you would have obtained by performing only one procedure.

5.53 In determining the audit procedures to be performed, you should consider the underlying reasons for your assessment. These underlying reasons relate to both the inherent and control risks related to the assertion. For example, if you assessed risks of material misstatement to be low that a material misstatement might occur because of low inherent risk, you may determine that substantive analytical procedures alone may provide sufficient appropriate audit evidence. On the other hand, if you expect that there is a lower risk of material misstatement because the client has effective controls and you intend to design substantive procedures based on relying on the effective operation of those controls, you should perform tests of controls or dual-purpose tests in addition to analytical procedures or other substantive procedures. (ISA 330 par. 7)

Observations and Suggestions

It is common for auditors to use standardized audit programs as a starting point for determining the nature of their further audit procedures. To develop such a program requires certain assumptions to be made about the risks of material misstatement, your audit strategy, the effectiveness of the design or operation of internal control, and other matters. Accordingly, when starting to tailor your audit program from standardized audit programs, you will want to consider the assumptions underlying the type of procedures to be performed and whether those assumptions are consistent with your knowledge of the client and the audit evidence you have obtained.

For example, a standardized audit program for fixed assets may assume that the area has low inherent risk but high control risk and that the primary risk of material misstatement was incorrectly capitalizing expenditures for repairs and maintenance or other expenses. Because control risk was assumed to be high, the audit strategy underlying the program was one in which the auditor would not be testing controls over fixed asset additions. Based on these assumptions, the program calls for you to select fixed asset additions that exceed a certain amount and examine supporting documentation to determine that the item was properly capitalized at an appropriate amount. The program also calls on you to scan repairs and maintenance account for any items that should have been capitalized.

Your client may be different. Suppose that your client acquired a great deal of fixed assets during the year and that, due to the nature of the business, the primary risk of material misstatement was improperly classifying leasehold improvements as furniture and equipment. Further, suppose that the client's IT system shared a great deal of information between systems and that as a result of your audit approach in other areas, you already had planned to test IT general and

application controls that were relevant to fixed asset additions. Under this scenario, some of the procedures that appeared in the standard audit program may not be relevant or different procedures may need to be performed to address specific risks. For example, you will want to perform procedures specifically to address the misclassification of fixed assets. Additionally, because of the tests of controls you already will be performing, you may determine that tests of details generally would not be required and that analytical procedures (combined with your tests of controls) would be sufficient.

Further audit procedures should be linked clearly to the specific risk assessments that exist at your client. Those specific assessments—together with your audit plan, knowledge of the client, and other matters—may or may not be consistent with the assumptions underlying a particular standard audit program. The use of a standard audit program whose underlying assumptions vary from the conditions that exist on your engagement will result in you performing (or not performing) further audit procedures that are linked clearly to your risk assessments. Consequently, you may not be able to provide a high level of assurance about whether the financial statements are free of material misstatement.

Testing Information Produced by the Client's Information System

5.54 You should obtain audit evidence about the accuracy and completeness of information produced by the entity's information system whenever you use that information in performing further audit procedures. For example, the auditors of Young Fashions use nonfinancial production and sales information to perform substantive analytical procedures. To justify relying on this information, the auditor should obtain audit evidence about the accuracy and completeness of such information, which may be provided either by tests of controls or substantive procedures. (ISA 500 par. 9)

Timing of Further Audit Procedures

5.55 Timing refers to when you perform your audit procedures or to the period or date to which the audit evidence applies. You may perform further audit procedures

- at an interim date,
- at period end, or
- after period end, in those instances where the procedure cannot be performed prior to or at year end (for example, agreeing the financial statements to the accounting records).

5.56 The higher the risks of material misstatement, the more likely it is that you will

- perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or
- perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis).

Table 5-4 provides a summary of other matters you may consider when determining the timing of your tests.

Table 5-4

Matters to Consider When Determining Timing of Tests

In considering when to perform audit procedures, you may consider matters such as

- your assessed risk of misstatement. In general, the higher the risk, the more likely it is that you will perform procedures nearer to or at the period end.
- the control environment. In general, the more effective the control environment, the more likely it is that you will be able to perform tests as of an interim date.
- when the information necessary to perform your procedures is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).

(continued)

- 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, you may examine contracts available on the date of the period end).
- the period or date to which the audit evidence relates.

Observations and Suggestions

Procedures that you perform at or close to period end will provide more reliable audit evidence on ending balances. On the other hand, performing audit procedures before the period end may help you identify significant matters at an early stage of the audit, thus allowing you to either resolve the issue with the help of the client or develop an effective audit approach to address the issue.

Performing Procedures at an Interim Date

5.57 If you perform tests before period end, you should cover the remaining period by (*a*) performing 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, which provide a reasonable basis for extending the audit conclusions from the interim date to the period-end. Chapter 6, "Performing Further Audit Procedures," of this publication provides further guidance on updating tests of controls and substantive procedures performed at an interim date.

Extent of Further Audit Procedures

5.58 Extent refers to the quantity of a specific audit procedure to be performed; for example, a sample size or the number of observations of a control activity. You may determine the extent of your audit procedure after considering all of the following:

- Performance materiality
- Your assessed risks of material misstatement
- The degree of assurance you plan to obtain

5.59 As the risks of material misstatement increases, you may increase the extent of audit procedures. However, increasing the extent of an audit procedure is effective only if the procedure itself is both relevant to the specific risk and reliable; therefore, the nature of the audit procedure is the most important consideration.

Determining Whether to Test Controls

Observations and Suggestions

Your determination about whether to test controls is done at the assertion level on an assertion-by-assertion basis. That is, you do not make a decision about testing controls for the entire audit as a whole, but rather for certain specific accounts and assertions.

The results of your tests of controls may allow you to assess control risk for specific assertions below the maximum, which, in turn, would allow you to make appropriate modifications to the nature, timing, and extent of planned substantive procedures that address the same assertion.

You are not required to test controls if you choose an all substantive audit approach even in those situations where you believe that the design and implementation of the client's internal control are capable of preventing or detecting and correcting material misstatements.

5.60 You should perform tests of controls when either

a. your risk assessment at the assertion level includes an expectation of the operating effectiveness of controls, or

b. you determine that substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.

(ISA 330 par. 8)

It only makes sense to test controls when you have determined that the controls being used by client personnel have been designed effectively. An ineffectively designed control cannot be made effective by testing. Substantively testing the accuracy and existence of transactions (and not controls) also is not evidence of the effective operation of controls (and does not confirm that controls even exist).

Observations and Suggestions

The term *expectation of the operating effectiveness of control* means that your understanding of the client's internal control has enabled you to initially assess control risk at less than maximum because you believe that the design and implementation of controls suggests that they are capable of effectively preventing or detecting and correcting material misstatements. This initial assessment of control risk is subject to the satisfactory results of your tests of operating effectiveness of those controls to support that initial control risk assessment.

An Expectation of Control Operating Effectiveness

5.61 As described in paragraph 3.04 and table 3-2 of this publication, your audit strategy as reflected in your audit plan will include a decision about whether you will test the operating effectiveness of internal control. However, as described in paragraph 3.05 of this publication, audit planning is a continuous process—your audit plan will evolve throughout the course of the engagement, as you gather additional information and form a deeper understanding of your client. Thus, your decision about whether to test controls will be revisited periodically over the entire course of the audit, for example, as you evaluate the design of internal control and determine that controls are being used by client personnel.

5.62 Your decision about whether to rely on controls may be considered within a cost-benefit framework. If the benefits of testing control effectiveness—both in terms of audit efficiency and effectiveness—are greater than the cost of testing controls, you would be inclined to adopt an audit strategy (or modify a preliminary strategy) that includes testing controls.

5.63 *The incremental cost of testing controls.* As first described in paragraph 1.19 of this publication, on every audit, you should evaluate the design of internal control and determine whether controls have been implemented. Chapters 3–4 of this publication describe the process for obtaining this understanding of internal control and this process is fairly rigorous. When evaluating the costs of testing controls, you will only consider the incremental cost of testing controls, compared to the costs already incurred to evaluate their design and implementation.

5.64 *For example, suppose that you inspected several monthly reconciliations between the accounts payable subsidiary ledger and the general ledger account. As a risk assessment procedure, you inspected these reconciliations primarily to determine whether your client had implemented the control. It is unlikely that the mere inspection of these reconciliations would be sufficient to draw a low risk conclusion about their operating effectiveness.*

However, the reperformance of these reconciliations may provide sufficient, appropriate audit evidence of operating effectiveness.

The incremental cost of reperforming the reconciliations you already are inspecting may be fairly minimal, whereas the benefits of being able to rely on the controls to design your substantive procedures may be substantial.

5.65 *Consider costs over a three-year period.* If certain conditions are met, the audit evidence gathered from tests of controls may be relevant for a three-year period. Thus, when evaluating the incremental cost of testing controls, consider that these costs may benefit three engagements.

Reminder: this "three-year" guidance does not apply for significant risks.

5.66 *Consider costs of testing complementary controls.* As described in paragraphs 2.57–.61 of this publication, the operating effectiveness of controls you want to test may be affected by other, complementary controls. For example, the effective operation of IT application controls over time depends on the effective functioning of IT general controls. Accordingly, when evaluating the costs of testing controls, you will consider the incremental cost of testing *all* controls that are necessary to gather audit evidence about operating effectiveness. Paragraph 6.11 of this publication provides additional guidance on testing the related controls that affect the operating effectiveness of the control activity that is the primary subject of your tests of controls.

Observations and Suggestions

When evaluating the benefits of testing controls, it is common for auditors to consider whether relying on controls can reduce the extent of substantive procedures; for example, by reducing the number of accounts receivable confirmations to send.

However, when your client's internal controls operate effectively, the *nature* of your substantive procedures also will be affected. For example, you may be able to perform substantive analytical procedures rather than tests of details. For accounts such as receivables and inventories where certain substantive procedures (for example, confirmations and inventory count observations) may be expected or required, these procedures may be limited to a minimum. Often, modifying the nature of your substantive procedures will provide as much benefit as or more benefit than reducing the extent of your procedures.

5.67 *The nature of the client's information system may affect the benefit to be derived from testing controls.* As described in paragraph 2.67 of this publication, it is common for IT systems to store data in a database, which is then accessed by a variety of IT "modules," such as procurement, order processing, or inventory management. Testing this system and obtaining audit evidence that the modules operate properly and that the integrity of the data is maintained may allow you to perform different types of tests that improve both audit efficiency and effectiveness. These tests may include

- substantive analytical procedures. The level of assurance you obtain from substantive analytical procedures is influenced by the reliability of your client's information system. By testing controls, you may establish the reliability of the client's system, which will allow you to perform analytical procedures that provide you with a higher level of assurance. In some instances, this level of assurance may be sufficient, thereby eliminating the need for you to perform substantive tests of details.
- computer assisted auditing techniques. The effectiveness of a CAATs application (for example, data extraction) is improved when the client data that serves as the source of the application is accurate. With audit evidence supporting the operating effectiveness of the controls over the electronic processing of data, you will be in a position to more effectively deploy CAATs across a wider variety of transactions and accounts.

5.68 *The nature of the tests influences your decision about testing controls.* In some instances it may be more effective and efficient to test controls rather than perform substantive procedures. For example, if an entity uses an inventory costing method that creates "layers" of costs (for example, first in, first out [FIFO]), it may be easier and more efficient to test the operating effectiveness of controls over the entity's inventory costing system and performing analytical procedures instead of performing tests of details over the costing of the entire inventory balance.

Similarly, some financial services firms have excellent controls over the trades and transactions in and out of a customer's account, and it may be very costly and ineffective to rely on extensive confirmation procedures to validate the customer balances or individual transactions, so control reliance may significantly reduce the extent of confirmation procedures required.

5.69 *By relying on controls, you may reduce the sample sizes.* When the client has controls that operate effectively, you may reduce the level of your assessed risks of material misstatement. A reduction in risk levels generally results in a reduction in sample sizes for substantive testing. Put another way, with a lower level of risk, you may be willing to accept sample sizes based on lower confidence levels. Even a small reduction in confidence levels can result in a significant reduction in sample sizes.

Observations and Suggestions

For example, suppose you are designing a sample of accounts receivable and you will draw your sample from a population with total recorded amount of $150,000. You desire a substantial amount of audit assurance (that is, you have not tested controls and therefore have a higher assessed level of risks of material misstatement, and you have planned no other substantive procedures of receivables for existence). Assume further that tolerable misstatement is $10,000 and that the effect of expected misstatement in the population is $1,000. Using an assurance factor of 3 for example, and based on these assumptions, your sample size might be (150,000 ÷ 9,000) × 3 = 50 sampling units.

Now suppose that you perform some tests of controls, find them to be effective, and therefore require less assurance from your substantive procedures. All other factors being equal , and using an assurance factor of 3, your substantive sample size might be (150,000 ÷ 9,000) × 2.3 = 39 sampling units. That is, by testing controls, you have reduced the extent of your confirmation effort by 22 percent. More extensive testing of controls would lead to additional reductions is substantive detail test sample sizes.

Because you are now testing controls, you would need to weigh the cost and time savings of performing the one procedure to save effort in the other.

Audit Documentation

5.70 In regards to the assessment of risk and design of further audit procedures, you should document

a. the assessment of the risks of material misstatement at both the financial statement level and the assertion level. (ISA par. 32*c*)

b. the overall response to address the assessed risks of misstatement at the financial statement level. (ISA 330 par. 28)

c. the identified risks and related controls evaluated for

i. significant risks.

ii. those circumstances where substantive procedures alone will not provide sufficient appropriate audit evidence.

(ISA 315 par. 32)

d. the nature, timing, and extent of the further audit procedures. (ISA 330 par. 28)

e. the linkage of those procedures with the assessed risks at the assertion level. (ISA 330 par. 28)

Paragraphs 1.39–.41 of this publication provide additional, more general guidance on the preparation of audit documentation.

5.71 ISA 230, *Audit Documentation*, states that documentation should be sufficient such that an experienced auditor, with no prior experience with this client, can understand the procedures performed, evidence examined, and conclusions reached. Your strategy and how you addressed the risks you identified should be "transparent."

Observations and Suggestions

Suppose you are assessing inherent risk related to debt, and you assess inherent risk to be low. What is the basis for that assessment? Is it because the client has variable rate debt but interest rates are not expected to change? Or is it because the client has only fixed rate debt?

Paragraph 5.70 discusses the documentation of the basis for that inherent risk assessment.

Documenting the basis for your risk assessment also helps you in future audits. If documented well in year 1, it will be easier for you to update your risk assessment in subsequent years.

Summary

5.72 This chapter described a process for assessing the risks of material misstatement of the client's financial statements. The results of your risk assessment procedures and your knowledge of the client and its environment, which were described in chapter 4 of this publication, provide the primary inputs into this process.

5.73 Many of the risks of material misstatement of the financial statements are driven by broad business risks, so your assessment process begins by identifying these broad business risks facing the client. Once you identify these, you will analyze them to determine how they affect the financial reporting process, if at all.

5.74 After identifying financial reporting risk, you will assess the relative significance of the risk by considering the magnitude of the risk and the likelihood that it will occur. Risk should be assessed at both the financial statement and assertion level. If possible, financial statement risk should be related to what could go wrong at the assertion level. If the financial reporting risk is so pervasive that its effect cannot be isolated to a finite set of assertions, you will develop an overall response to this risk.

5.75 Your risk assessments will drive the design of further audit procedures, which consist of tests of controls and substantive procedures. These further audit procedures should be clearly linked and responsive to the assessed risk. The design of further audit procedures includes determining their nature, timing, and extent. Of these elements, it is the nature of the tests that is of most importance.

5.76 Chapter 6 of this publication discusses how you will perform the audit procedures that have been designed.

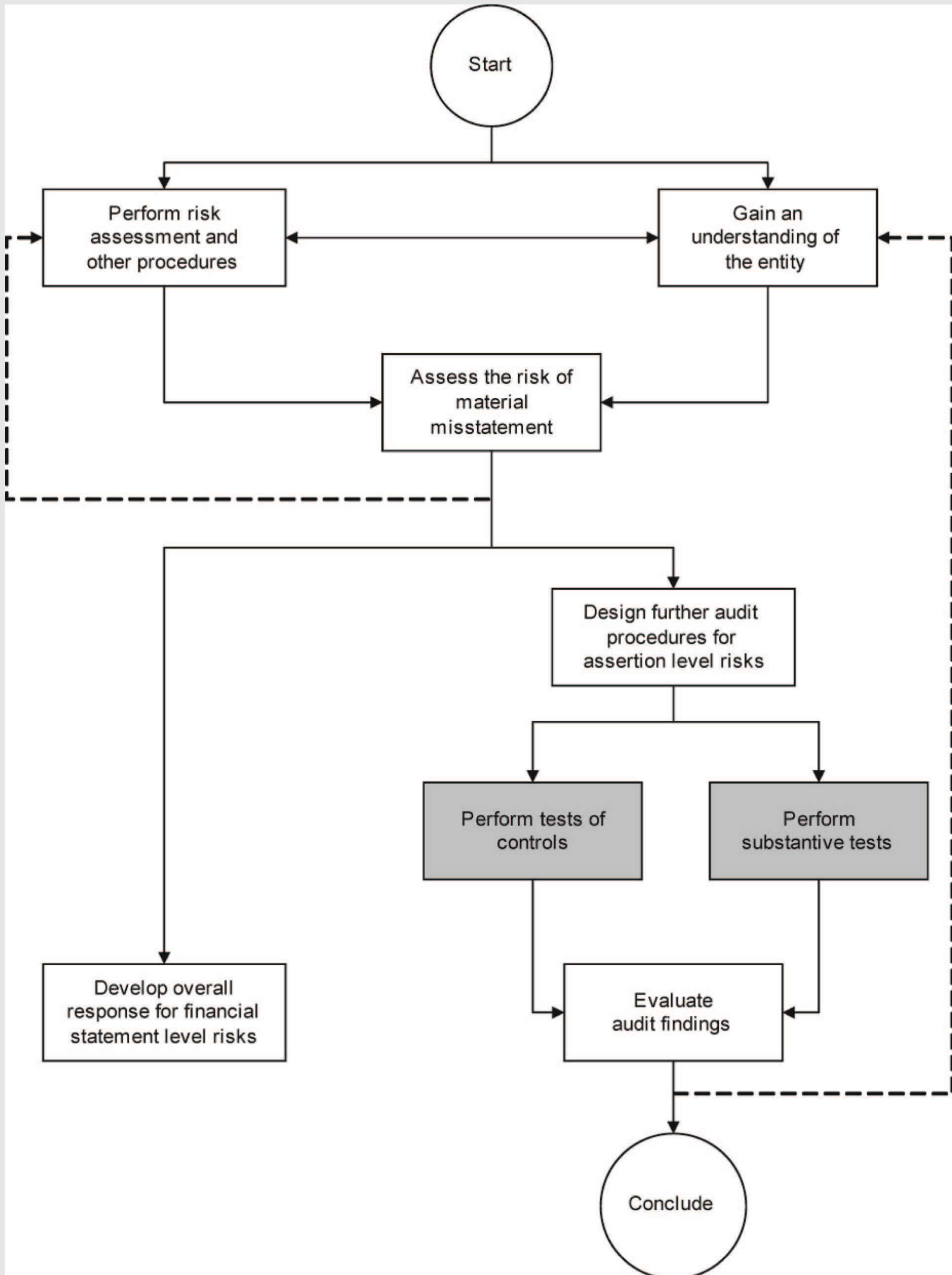
Chapter 6

Performing Further Audit Procedures

Observations and Suggestions

Illustration 6-1

Overview of Performing Further Audit Procedures



(continued)

Further audit procedures consist of tests of controls and substantive procedures. The previous chapter provided guidance on how to design the nature, timing, and extent of these audit procedures, with an emphasis on linking your response to your assessed risks. This chapter provides guidance on performing planned procedures.

Tests of the Operating Effectiveness of Controls

On all engagements, you are required to evaluate the design of the client's internal control and to determine that the controls have been implemented. In some situations, your audit strategy may involve relying on the operating effectiveness of the controls for some assertions in the design of your substantive procedures. In those instances, you will design and perform tests of the operating effectiveness of controls, in addition to the procedures you perform to evaluate design. This chapter provides guidance on how to evaluate the operating effectiveness of controls.

Substantive Procedures

Most likely, you will perform a variety of substantive procedures on a number of account balances, disclosures, and the overall presentation of the financial statements and should perform substantive procedures for significant risks as defined in chapter 5, "Risk Assessment and the Design of Further Audit Procedures," of this publication. In many cases, several procedures may be necessary to address an assessed risk. This chapter focuses on guidance related to the performance of these substantive procedures.

The previous chapter described how to design further audit procedures in a way that is responsive to and clearly linked with your assessment of the risks of material misstatement. This chapter provides guidance on how to perform the further audit procedures you have designed.

This chapter focuses only on those audit procedures you perform at the assertion level. Paragraphs 5.18–.20 of this publication describe how to develop an overall response to risk at the financial statement level.

Introduction

6.01 Further audit procedures consist of tests of the operating effectiveness of controls and substantive procedures.

Tests of Controls

6.02 Tests of controls provide evidence about the effectiveness of the operation of a control in preventing or detecting material misstatements in a financial statement assertion. In tests of controls, you generally are concerned about the rates of any deviation from a prescribed control procedure. Tests of controls are necessary when your audit strategy involves relying on the operating effectiveness of the controls for some assertions in the design of your substantive procedures.

6.03 When performing tests of controls, you should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about

a. how controls were applied at relevant times during the period under audit.

b. the consistency with which they were applied.

c. by whom they were applied, or in the case of IT controls, the means by which they are applied.

(ISA 330 par. 10)

6.04 When evaluating the operating effectiveness of controls, you should also evaluate the misstatements you detect when performing substantive procedures. For example, suppose that, through the confirmation of accounts receivable, you identify several billing errors where the client failed to bill its customers at the proper amount, and the error went undetected until the customer contacted the company. Your detection of these errors is relevant, reliable audit evidence about the relative ineffectiveness of the related controls. Your detection of a material misstatement that indicates that such misstatement would not have been detected by the entity's internal control is an indicator that controls are not operating effectively. (ISA 330 par. 16)

Observations and Suggestions

Beginning with illustration 1-1, this publication has described auditing as an iterative, nonlinear process. You form a preliminary audit strategy and plan and obtain an understanding of the client and its environment to assess the risks of material misstatement. That understanding or the resulting assessment may cause you to reexamine and possibly revise your initial audit strategy and plan, which in turn may cause you to obtain additional information about the client.

Paragraph 6.04 describes another example of this iterative process, in which you make an assessment of control risk and then discover misstatements that were not prevented or detected and corrected by the company's internal control. This discovery will cause you to reexamine your initial assessment of internal control, which may cause a revision to the audit strategy, and so on.

Many audits proceed in this dynamic, ever-changing fashion in which the results of audit procedures result in a revision of earlier judgments, which result in new or revised audit procedures. Because of this interconnectedness, it is helpful for auditors to consider the results of audit procedures not in isolation, but rather, in terms of how they affect the audit as a whole.

6.05 The absence of misstatements detected by a substantive procedure does not provide audit evidence about the operating effectiveness of related controls (or whether controls even exist). For example, if you found no differences or exceptions noted by customers during the confirmation of receivables, it would be inappropriate for you to draw any conclusion about the effectiveness of any related controls.

General Considerations When Testing Controls

Sources of Audit Evidence About Internal Control Effectiveness

6.06 The audit evidence used to provide support for your conclusion about the operating effectiveness of controls during the audit period may come from a variety of sources, including

- tests of controls performed during the current period.
- risk assessment procedures performed during the current period.
- evidence provided in a service organization control type 2 report under ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization.*
- evidence obtained from the performance of procedures in previous audits.
- the information gathered and conclusions reached as part of your quality control procedures for client acceptance and continuance. For example, client acceptance procedures may include inquiries of attorneys, bankers, or others in the business community about client management that provide insight into their
  - competence,
  - integrity,
  - operating philosophy, and
  - ethical values.

Risk Assessment Procedures Versus Tests of Controls

6.07 Risk assessment procedures allow you to evaluate the *design effectiveness* of internal control for the purpose of assessing risks of material misstatement. Tests of controls build on your evaluation of design effectiveness and allow you to assess the operating effectiveness of controls during the operating period. The results of your tests of controls are used to design substantive procedures.

6.08 In some instances, risk assessment procedures, although not specifically designed as tests of controls, may nevertheless provide evidence about their operating effectiveness. For example, a walkthrough or the observation of the performance of a control may provide evidence about the operating effectiveness of controls. The sufficiency of that audit evidence depends on those factors described in table 7-3, as well as on the nature of the control itself. For example, your observation of the client's physical inventory count, which is performed only once a year, may provide you with sufficient evidence about their operation. On the other hand, the observation of the performance of an edit check, performed on every transaction entered into the IT system,

is much less likely to provide sufficient evidence about the operating effectiveness of the control throughout the audit period.

Evidence of Operating Effectiveness of Controls at a Service Organization

6.09 As described in paragraph 3.126 of this publication, a type 2 service auditor's report may provide evidence about the operating effectiveness of controls at a service organization. However, controls over the information provided to the service organization may still need to be assessed.

Evaluating the Effectiveness of Indirect Controls

6.10 When designing tests of controls, you may focus first on testing control activities because the control activities component of internal control is the one most directly related to the assertion. For example, physically counting goods that have been received and comparing the quantity and description to the vendor's packing slip is directly related to both the existence and valuation of inventory.

6.11 In some circumstances, in addition to testing the controls that relate directly to assertions, it may be necessary for you to obtain audit evidence supporting the effective operation of indirect controls upon which the effectiveness of the direct control depends. (ISA 330 par. 10*b*) For example, assume you decide to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits. The user review combined with the related follow up is the control that is of direct relevance to you. The controls over the accuracy of the information in the reports are described as indirect controls.

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 IT controls, also may provide substantial audit evidence about its operating effectiveness.

When considering the need to test indirect controls, you may consider the following:

a. The significance of the indirect control to the effective functioning of the direct control. As the effectiveness of the direct control becomes more dependent on the indirect control, your need to test the indirect control generally increases.

b. The relative significance of the audit evidence of the indirect control to the auditor's conclusion on the effectiveness of the direct control. Your conclusion about the operating effectiveness of a control activity is supported by a combination of evidence about (i) the operating effectiveness of the direct control activity itself and (ii) the operating effectiveness of other, indirect controls upon which the effectiveness of the direct control depends. In some instances, you may be able to support a conclusion based primarily on tests of the direct control, with little evidence about the operating effectiveness of the related indirect controls. In other instances (for example, IT application controls), your conclusion may be based primarily on tests of the indirect controls and little on tests of the direct control. In those situations where you rely significantly on the operating effectiveness of the indirect control, you should obtain more sufficient and adequate audit evidence to support the conclusion on the operating effectiveness of the indirect control, for example, the monitoring of the performance of the reconciliation.

c. The degree of reliability required of the audit evidence obtained about internal control operating effectiveness. Testing the indirect control increases the reliability of the audit evidence obtained about the operating effectiveness of the direct control. For example, you may test 4 month-end reconciliations and draw a conclusion about the effectiveness of those reconciliations for an entire 12-month period. If you have tested the operating effectiveness of the indirect controls related to the reconciliation, the conclusion about the effectiveness of the reconciliation during the period you did not test will be more reliable than if you did not test the indirect controls.

d. Evidence of operating effectiveness that may have been obtained as part of obtaining an understanding of the design and implementation of the indirect controls. When performing risk assessment procedures to obtain an understanding of internal control, you may obtain some information about the operating effectiveness of the indirect controls as they relate to an assertion. For example, risk assessment procedures may provide

you with some evidence about the operating effectiveness of portions of the control environment. This information about operating effectiveness may be limited, but nevertheless, it may be sufficient for the purpose of drawing a conclusion about the operating effectiveness of the direct control.

Observations and Suggestions

You will need to exercise your judgment to determine whether to test indirect controls. Common examples of indirect controls upon which the effective operation of other controls often include

- IT general controls,
- segregation of duties, and
- the effective communication of control responsibilities when the employee responsible for performing the control changed during the period.

6.12 When testing indirect controls, you may choose not to test the operating effectiveness of the entire component to which the indirect control pertains, but may limit the tests to those elements of the component that have an immediate bearing on the effectiveness of the direct control.

For example, when testing controls over purchasing to place moderate reliance on them, you may consider the need to test the control environment or IT general controls relating to the entire entity beyond the required design and implementation assessment procedures you already have performed. If practical, you may limit your tests to those aspects of the control environment or IT general controls that have a direct bearing on the financial statement assertions related to purchasing. To place high reliance on the controls, you may often need to gather additional evidence concerning the IT general controls and overall control environment to support high reliance on the purchasing controls.

6.13 Consider the following situation:

Young Fashions receives all its goods from overseas suppliers. Some of its finished garments in the JY Sport line are similar in design to garments in the more expensive Couture line. The primary difference between the two is in the composition and quality of the fabric—a silk garment in the Couture line may be similar to a garment in the JY Sport line that is made from a blend of synthetic fibers.

To the untrained eye, these similar garments are indistinguishable from each other. The packaging containers label the garments, but for quality control purposes, the company examines each shipment of material received prior to stocking them. This operational control also serves as an important financial reporting control because the information about the materials (for example, the identification of the material, its weight, and quality) are compared to the shipping document and vendor invoice.

The company's review of its finished goods shipments has a direct effect on the existence and valuation of inventory. However, for this control procedure to be effective, the individuals performing the procedure must be properly trained, and they must operate in an environment where the proper performance of the procedure is emphasized appropriately. The auditor considers training and the "tone at the top" (both of which are elements of the control environment) to have an immediate bearing on the effectiveness of the inspection of finished goods, but only an indirect effect on preventing or detecting and correcting misstatements related to the valuation and existence of inventory.

After considering the factors listed in paragraph 6.11, the auditor determines that he or she wants to obtain audit evidence about the operating effectiveness of these indirect controls. In this example, the auditor may design tests of controls related to training and tone at the top for the personnel charged with performing the inspection. The auditor may not need to test control environment components that do not have an immediate bearing on the performance of the control (for example, compensation policies, the alignment of authority and responsibility, or the oversight of the board of directors).

The auditor may also decide not to determine whether the components of the control environment that have an immediate bearing on the performance of the raw materials test are operating effectively throughout the organization. When testing indirect controls, the auditor may limit those

tests to controls or elements of control components that have an immediate bearing on the effectiveness of the direct control.

Observations and Suggestions

Testing the control environment can be challenging because the control environment comprises primarily of subjective matters such as "tone at the top" or management's philosophy and operating style, for which empirical evidence about operating effectiveness may not exist. Nevertheless, it usually is possible to design procedures that, if performed properly, may provide you with persuasive evidence about the operating effectiveness of the control environment.

Procedures that may be useful for testing the control environment include

- inquiries of management and others within the entity about specific *actions* management has taken that illustrate the tone at the top, operating style, or other elements of the control environment.
- surveys of employees asking for their observations about management's actions and the control environment at the entity.
- reading and evaluating documentation related to control environment elements. For example, personnel policies, training materials, budgets, codes of conduct, job descriptions, and other documents that may provide some evidence about the design of control environment policies and procedures.
- observations made by the audit engagement team members related to the other procedures previously mentioned.

When evaluating "tone at the top" and other subjective matters such as management's attitude toward financial reporting and internal control, it usually is helpful to focus on management's actions and how they respond to issues you raise during your audit. For example, you may consider management's response to matter, such as

- internal control deficiencies.
- misstatements.
- their responsibility for preparing the financial statements.
- allegations of fraud or suspected fraud.
- the presence of fraud risk factors under their control, such as compensation policies, that may increase the company's vulnerability to fraud.
- violations of the company's code of conduct.

The Relationship Between Tests of Controls and Substantive Procedures

6.14 Generally, there is an inverse relationship between the persuasiveness of the audit evidence to be obtained from substantive procedures and that obtained from tests of controls. As the persuasiveness of the audit evidence obtained from tests of controls increases, the sufficiency and adequacy of the audit evidence required from substantive procedures likely decreases. For example, in circumstances when you adopt a strategy at the assertion level that consists primarily of tests of controls, you should perform tests of controls to obtain more persuasive audit evidence about their operating effectiveness. (ISA 330 par. 9)

6.15 On the other hand, the more audit evidence from substantive procedures, the less audit evidence from tests of controls would be necessary. In many instances, the nature and extent of substantive procedures alone may provide sufficient, appropriate evidence at the assertion level, which would make the testing of control effectiveness (beyond assessing their design and implementation) unnecessary.

A Financial Statement Audit Versus an Examination of Internal Control

6.16 Testing the operating effectiveness of internal control to support an opinion on the financial statements is different from testing controls to support an opinion on the effectiveness of the internal control system.

6.17 In an attestation engagement to examine the effectiveness of internal control, the audit evidence obtained from the tests of internal control is the *only* evidence you have to support your opinion. In contrast, when performing an audit of the financial statements, you ordinarily perform both tests of controls and substantive procedures. The objective of the tests of controls in a financial statement audit is to assess the operating effectiveness of controls and incorporate this assessment into the design of the nature, timing, and extent of substantive procedures. Thus, when testing controls in a financial statement audit, you have flexibility in determining not only whether to test controls, and if so which controls to test, but also the level of effectiveness of those controls that is necessary to provide the desired level of support for an opinion on the financial statements.

Determining the Nature of the Tests of Controls

Observations and Suggestions

Determining the nature of your tests of controls means deciding on what type of test you will perform. For example, to obtain audit evidence about the effectiveness of a control, what will you do? Will you make inquiries? Observe activities? Reperform procedures? Will you select a sample of transactions for detail testing? What population will you draw your sample from?

Your choice of the type of procedure you will perform is a critical element of performing an effective audit.

6.18 The nature of the procedures you perform to test controls has a direct bearing on the relevance and reliability of your audit evidence. When responding to assessed risks of material misstatement, the nature of the audit procedures is of most importance. Performing more tests or conducting the tests closer to the period end will not compensate for a poorly designed test that produces information that lacks relevance or reliability about the effectiveness of a control.

6.19 The types of audit procedures available for obtaining audit evidence about the effectiveness of controls can include

- inquiries of appropriate entity personnel.
- inspection of documents, reports, or electronic files indicating performance of the control.
- observation of the application of the control.
- reperformance of the application of the control by the auditor.

6.20 The nature of the particular control influences the type of audit procedure necessary to obtain audit evidence about operating effectiveness. Documentation may provide evidence about the performance of some controls, and in these situations, you may inspect this documentation to obtain evidence about the operating effectiveness of the control.

6.21 For other controls, documentation may not be available or relevant. For example, documentation of the 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 automatically by the client's IT system. In these circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation of the performance of the control or the use of computer assisted audit techniques (CAATs).

6.22 Paragraphs 3.112–.114 of this publication describe the limits of inquiry and observation when obtaining evidence about the design and implementation of internal control. When choosing the audit procedures you will perform to gather evidence about the operating effectiveness of controls, these same limitations may apply for tests of controls.

6.23 Because of the limits of inquiry and observation, inquiry combined with inspection or reperformance ordinarily provide more relevant and reliable audit evidence than a combination of only inquiry and observation. For example, you may inquire about and observe the entity's procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, you might find it necessary to supplement the observation with other

observations or inquiries of entity personnel, and you may also inspect documentation about the operation of such controls at other times during the audit period.

Tests of IT Controls

6.24 Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated control, combined with audit evidence about the operating effectiveness of IT general controls (and in particular, security and change controls) may provide you substantial audit evidence about the operating effectiveness of the control during the entire audit period. That is, once you have determined that an IT application control has been implemented (placed in operation), you may draw a conclusion about the operating effectiveness of the IT portion of the control activity, so long as you have determined that relevant IT general controls are operating effectively.

Observations and Suggestions

IT application controls often consist of an automated portion and a manual portion, both of which operate effectively together. For example, the IT system may create an exception report of transactions that do not meet certain criteria. By itself, the production of such a report is not sufficient to prevent or detect a material misstatement. To be effective, someone at the client reviews the exception report and then follows up and properly resolves the items listed.

Determining that the automated portion of an IT application control has been implemented and that relevant IT general controls have operated effectively provides you with evidence about the operating effectiveness only for the automated portion of the control. To properly evaluate the entire control, you also will have to gather evidence about the operation of the manual component of the control—in our example, the manual follow up of items included on the exception report.

6.25 *For example, the processing of sales on account at Ownco includes a control to ensure that credit sales to a wholesale customer do not exceed that customer's authorized credit limit. This control is programmed into the entity's IT system, which generates an exception report of credit sales over a customer's authorized credit limit. The system does not allow processing of the transaction to continue until the exception has been acted on and properly resolved.*

During the performance of the risk assessment procedures, the auditor identified this control and determined that it was suitably designed and implemented (placed in operation). To obtain audit evidence about the operating effectiveness of the control, the auditor is not required to test the application control directly, for example, through the offline processing of a sample of transactions to determine if the programmed control functions as designed. Instead, the auditor may choose to test the IT general controls (especially security and change controls) that clearly and directly relate to the operating effectiveness of the application control.

In determining the nature of the procedures to test the operating effectiveness of IT general controls, the auditor may consider the limited evidence provided by the procedures performed to simply confirm the control was implemented (placed in operation). Because the auditor's conclusion about the operating effectiveness of the IT application control throughout the period is based primarily on the operating effectiveness of the IT general controls (that is, the auditor has only assessed the design of the application control and determined that it has been placed in operation) the auditor should test the IT general control in a manner that results in sufficient audit evidence.

The follow up of exceptions generated by the performance of the IT application control is a separate manual control that is necessary to achieving the control objective. Testing the ability of the IT system to generate an accurate exception report provides no evidence relating to the user's ability to properly resolve the identified exceptions. Evidence regarding the manual component of the control might need to be obtained through a separate audit procedure.

6.26 Factors that the IT professional may consider in determining the extent of tests of controls include the following:

- General controls
  - The frequency of the event(s) occurring to which the control applies would determine the relevant population for sample or test selection.
  - The auditor should select tests that cover the entire period relevant for operational effectiveness. Normally this would be the fiscal period; however, it could

be shorter when the entity's environment does not change during the fiscal period.

   — When multiple general controls affect one or more financially relevant applications, the auditor may need to determine if some combination of general controls needs to be tested.

- Applications controls considerations
   — Normally, a test of one specific instance of an automated application control is a relevant basis for concluding on that control's effectiveness. However, the auditor would also need to confirm the deployment and operational effectiveness of general controls over access and program changes that help ensure the integrity of application controls.
   — When considering whether to use audit evidence for automated control testing from prior audits, the auditor should consider the effectiveness of general controls that help ensure the integrity of application controls. Evidence of highly effective general controls, especially change management, will provide a basis for the auditor to reduce, but not eliminate, tests of automated controls.

Tests of Spreadsheets

6.27 The development and use of spreadsheets typically lack the controls that usually are present for formal, purchased software. Absent audit evidence indicating that appropriate general controls over spreadsheets have been implemented, you may continue to test spreadsheet controls even after their implementation.

Dual Purpose Tests

6.28 Some audit procedures may simultaneously provide audit evidence that both

- supports the assertion or detects material misstatement and
- supports a conclusion about the operating effectiveness of related controls.

Tests that achieve both of these objectives concurrently on the same transaction typically are referred to as dual-purpose tests. For example, you may examine an invoice to determine whether it has been approved and also to provide substantive audit evidence about the existence and amount of the transaction.

6.29 When performing a dual purpose test, you may consider whether the design and evaluation of such tests can accomplish both objectives. For example, the population of controls and the population of substantive procedures are the same. If tests on components of a balance such as receivables are designed as dual purpose tests, only evidence of the controls operating over period-end balance items will be obtained.

6.30 Furthermore, when performing such tests, you may consider how the outcome of the tests of controls may affect your determination about the extent of substantive procedures to be performed. For example, if controls are found to be ineffective, you would consider whether the sample size you designed for the dual purpose test was adequate or whether the sample size for substantive procedures should be increased from that originally planned.

Audit Sampling in Tests of Controls

Observations and Suggestions

The guidance in this section applies to the use of audit sampling. However, many of the ideas and concepts presented here may be applicable to tests of controls when sampling is not used.

6.31 Audit sampling for tests of controls is generally appropriate when application of the control leaves documentary evidence of performance. Audit sampling for tests of controls that do not leave such evidence (such as some automated controls or other controls that can only be observed) might be appropriate, however, when you are able to plan the audit sampling procedures early in the engagement. For example, you might wish to observe the performance of prescribed control activities for bridge toll collections. In that case, a sample of days and

locations for observation of actual activities would be selected. You need to plan the sampling procedure to allow for observation of the performance of such activities on days selected from the period under audit.

Some Tests of Controls May Not Involve Audit Sampling

6.32 Sampling concepts do not apply for some tests of controls. For example

- tests of automated application controls are generally tested only once or a few times when effective IT general controls are present, and thus do not rely on the concepts of risk and tolerable deviation as applied in other sampling procedures.
- sampling generally is not applicable to analyses of controls for determining the appropriate segregation of duties (unless you are testing the client's documented analysis of the segregation of duties or a documented schedule of password permissions in an IT environment) or other analyses that do not examine documentary evidence of performance.
- sampling may not apply to tests of certain documented controls or to analyses of the effectiveness of security and access controls (unless examining a client's schedule of password permissions).
- sampling may not apply to some tests directed toward obtaining audit evidence about the operating effectiveness of the control environment or the accounting system. Some examples are the inquiry or observation of the effectiveness of the actions of those charged with governance or assessing the competence of key accounting personnel.

6.33 In addition, when the performance of a control is not documented or evidenced, such as the performance of an automated control where no record of the control performance is retained, the concept of sampling such a control in the conventional sense may not be meaningful. For example, such a test may be performed contemporaneously with its occurrence or tested with a *test deck* of data with known properties that are designed to test the programming of the automated controls. The extent of testing and the periods included in the test are determined based on the quality of the related IT general controls. Such tests often do not involve audit sampling.

General Considerations When Audit Sampling in Tests of Controls

6.34 This section provides a brief summary of the matters to consider when you plan to use audit sampling in your tests of controls.

Defining the Deviation Conditions

6.35 Based on your understanding of internal control, you will generally identify the characteristics that would indicate performance of the control you plan to test. You then define the possible deviation conditions. For tests of controls, a deviation is a departure from the expected performance of the prescribed control. Performance of a control consists of all the steps you believe are necessary to support your assessed level of control risk.

Considering the Population

6.36 You should consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn to determine that the population from which the sample will be drawn is appropriate for the specified audit objective. For example, if you wish to test the operating effectiveness of a control designed to ensure that all shipments are billed, it would be ineffective to sample items that have already been billed. Rather, you would sample the population of shipped items to determine whether selected shipments were billed. Similarly, you cannot identify unrecorded liabilities from the population of recorded liabilities. Instead you would examine support for liabilities entered and disbursements made after year end. (ISA 530 par. 6)

6.37 You select sampling units from a physical representation of the population. For example, if you define the population as all approved vendors as of a specific date, the physical representation might be the printout of the approved vendor list as of that date or an electronic file purportedly containing the list of approved vendors.

6.38 You should select items for the sample in such a way that you can reasonably expect the sample to be representative of the relevant population. If the physical representation and the desired population differ, you might make erroneous conclusions about the population. For example, if you wish to perform a test of controls for the vouchers issued in 20XX, such vouchers are the population. If you physically select the vouchers from a filing cabinet, the vouchers in the filing cabinet are the physical representation. If the vouchers in the cabinet represent all the vouchers issued in 20XX, the physical representation and the population are the same. If they are not the same because vouchers have been removed or vouchers issued in other years have been added, the conclusion applies only to the vouchers in the cabinet. (ISA 530 par. 8)

6.39 Making selections from a controlled source minimizes differences between the physical representation and the population. For example, you might make selections from a cash disbursements journal that has been reconciled with issued checks through a bank reconciliation. You might test the footing to obtain reasonable assurance that the source of selection contains the same transactions as the population.

6.40 If you determine that items are missing from the physical representation, you would select a new physical representation or perform alternate procedures on the missing items. You also would usually inquire about the reason that items are missing.

Defining the Sampling Unit

6.41 The individual items constituting a population are sampling units. (ISA 530 par. 5) A sampling unit for tests of controls may be, for example, a document, an entry, or a line item where examination of the sampling unit provides evidence of the operation of the control. Each sampling unit constitutes one item in the population. You may define the sampling unit in light of the control being tested. For example, if the test objective is to determine whether disbursements have been authorized and the prescribed control requires an authorized signature on the voucher before processing, the sampling unit might be defined as the voucher. On the other hand, if one voucher pays several invoices and the prescribed control requires each invoice to be authorized individually, the line item on the voucher representing the invoice might be defined as the sampling unit. Note that each sampling unit may provide evidence of the application of more than one control. For example, support for recording a receivable may indicate that the billed service was rendered or product shipped, the amounts were checked for accuracy, and the customer is listed on the approved customer list.

Observations and Suggestions

An overly broad definition of the sampling unit might not be efficient. For example, if you are testing a control over the pricing of invoices and each invoice contains up to 10 items, you could define the sampling unit as an individual invoice or as a line item on the invoice. If you define the invoice as the sampling unit, you would test all the line items on the invoice. If you define the line items as the sampling unit, only the selected line items need be tested. If either sampling unit definition is appropriate to achieve the test objective, it is commonly more efficient to define the sampling unit as the more detailed alternative (in this case, a line item).

An important efficiency consideration in selecting a sampling unit is the manner in which the documents are filed and cross-referenced. For example, if a test of purchases starts from the purchase order, it might not be possible to locate the voucher and canceled check in some accounting systems because the systems have been designed to provide an audit trail from voucher to purchase order but not necessarily vice versa.

Determining the Method of Selecting the Sample

6.42 Sample items should be selected in such a way so the sample can be expected to be representative of the population and thus the results can be projected to the population. Therefore, all items in the population should have an opportunity to be selected. (ISA 530 par. 8)

Determining the Timing of Tests of Controls

6.43 The timing of your tests of controls affects the relevance and reliability of the resulting audit evidence. In general, the relevance and reliability of the audit evidence obtained diminishes as time passes between the testing of the controls and the end of the period under audit. For this

reason, when tests of controls are performed during an interim period or carried forward from a previous audit, you should determine what additional audit evidence should be obtained to support a conclusion on the current operating effectiveness of those controls.

6.44 The timing of your tests of controls depends on your objective:

a. When controls are tested as of a point in time, you have obtained audit evidence that the controls operated effectively only at that time.

b. If you test controls throughout a period, you obtain audit evidence of the effectiveness of the operation of the control during that period.

(ISA 330 par. 11)

6.45 Audit evidence pertaining only to a point in time may be sufficient for your purpose, for example, when testing controls over the client's physical inventory counting at the period end. If, on the other hand, you need audit evidence of the effectiveness of a control over a period, audit evidence pertaining only to a point in time may be insufficient, and you may find it necessary to supplement your tests with others that provide audit evidence that the control operated effectively during the period under audit. For example, for an automated control, you may test the operation of the control at a particular point in time. You then may perform tests of controls to determine whether the control operated consistently during the audit period, or you may test with the intention of relying on general controls pertaining to the modification and use of that computer program during the audit period.

6.46 The tests you perform to supplement tests of controls at a point of time may be part of your tests of controls over your client's monitoring of controls.

6.47 *For example, suppose that the auditor tested Ownco's reconciliation of the accounts receivable trial balance to the general ledger account total for one month. That test provides evidence that the control operated effectively at that point in time, and so to draw a conclusion about the operating effectiveness of the control for the entire period, the auditor would have to supplement the one test. The auditor's test of Ownco's monitoring of this reconciliation may provide some additional audit evidence needed. Suppose that the controller monitors the performance of the control by making a timely review of each monthly reconciliation. If the auditor obtains evidence that the controller's review operated effectively during the period, the auditor may have sufficient audit evidence from his tests, including from the monitoring control to conclude that the reconciliation also operated effectively during the period.*

Updating Tests of Controls Performed During an Interim Period

6.48 You may test controls as of or for a period that ends prior to the balance sheet date. This date often is referred to as the *interim date* or *interim period*. The period of time between the interim date or period and the balance sheet date often is referred to as the *remaining period*.

6.49 When you test controls during an interim period or as of an interim date, you should

a. obtain audit evidence about the nature and extent of any significant changes in internal control that occurred during the remaining period and

b. determine what additional audit evidence should be obtained for the remaining period. Table 6-1 summarizes the factors you should consider when making this determination.

(ISA 330 par. 12)

Table 6-1

Updating Tests of Controls From an Interim Date to the Balance Sheet Date

To determine what additional audit evidence you should obtain to update tests of controls performed in advance of the balance sheet date, you may consider

a. the significance of the assessed risks of material misstatement at the assertion level.

b. the specific controls that were tested during the interim period.

c. the degree to which audit evidence about the operating effectiveness of those controls was obtained.

d. the length of the remaining period.

e. the extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.

f. the control environment.

g. the volume or value of transactions processed in the remaining period.

6.50 When you test controls as of or during an interim period, you should obtain evidence about the nature and extent of any significant changes in internal control, including personnel performing the control, that occur during the remaining period. If significant changes do occur, you may consider the effects on the audit strategy and audit plan, and you may revise your understanding of internal control and consider testing the changed controls. Alternatively, you may consider performing substantive analytical procedures or tests of details covering the remaining period. (ISA 330 par. 12)

6.51 You may obtain additional evidence about the operating effectiveness of controls during the remaining period by performing procedures such as

a. extending the testing of the operating effectiveness of controls over the remaining period or

b. testing the client's monitoring of controls.

6.52 Procedures you may perform during the remaining period include

- inquiries and observations related to the performance of the control, the monitoring of the control, or any changes to the control during the remaining period.
- a walkthrough covering the period between the interim date and the period end.
- the same procedures you performed at the interim, but directed to the period from interim to period end.

Observations and Suggestions

If you use audit sampling to test controls, you consider how your sampling plan will be affected by your decision to test controls as of an interim date. For example, if you define the population to include transactions from the entire period under audit, you can allocate your sample between transactions that occurred during the interim period and those that occurred during the remaining period.

For example, if in the first 10 months of the year the client issued invoices numbered from 1 to 10,000, you might estimate that another 2,500 invoices will be issued during the remaining 2 months and use 1 to 12,500 as the numerical sequence for selecting the desired sample. Invoices with numbers 1 to 10,000 would be subjected to possible selection during the interim work, and the remaining 2,500 invoices would be subject to sampling during the completion of the audit.

Use of Audit Evidence Obtained in Prior Audits

6.53 If certain conditions are met, you may use audit evidence obtained in prior audits to support your conclusion about the operating effectiveness of controls in the current audit. (This approach is not available for significant risks.) If you plan to use evidence obtained in prior periods, you should consider

a. whether the use of this evidence is appropriate and, if so,

b. the length of the time period that may elapse before retesting the control.

(ISA 330 par. 13)

Table 6-2 summarizes the factors you should consider when determining whether to use audit evidence about the operating effectiveness you obtained in a prior audit.

Table 6-2

Considerations When Determining Whether to Use Audit Evidence From Prior Audits

	Appropriateness of Using Evidence From Prior Audit		*Length of Time Before Retesting Control*	
	May Be Appropriate	*May Not Be Appropriate*	*Longer*	*Shorter*
Effectiveness of control environment, the client's risk assessment, monitoring, and IT general controls	Effective design and operation	Evidence of poor design or operation	Effective design and operation	Evidence of poor design or operation
Risk arising from characteristics of the control	Largely automated control	Significant manual or judgmental component to control	Largely automated control	Significant manual or judgmental component to control
Changes in circumstances at the client that may require changes in controls, including personnel changes that affect application of the control	Minor changes in client circumstances, including personnel	Significant changes in client circumstances, including personnel	Minor changes in client circumstances, including personnel	Significant changes in client circumstances, including personnel
Operating effectiveness of the control	Control operated effectively in prior audit	Control did not operate effectively in prior audit	Control operated effectively in prior audit	Control did not operate effectively in prior audit
Risks of material misstatement	Low risk of material misstatement for assertion	High risk of material misstatement for assertion	Low risk of material misstatement for assertion	High risk of material misstatement for assertion
Extent of reliance on the control to design substantive procedures	Low reliance on the control	High reliance on the control	Low reliance on the control	High reliance on the control

6.54 If you plan to use audit evidence about the operating effectiveness of controls obtained in prior audits, you should

a. obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit and

b. perform audit procedures to establish the continuing relevance of audit evidence obtained in the prior audit.

(ISA 330 par. 14)

6.54

6.55 Even when you use audit evidence about the operating effectiveness of controls obtained in prior periods, you still should evaluate the design effectiveness and implementation of controls in the current period. The procedures performed as described in paragraph 6.54 may help you to fulfill this responsibility; however, you may have to supplement these procedures with others. For example, if the controls have not changed from the previous period but the client's business process have changed, you will need to determine whether the design of controls remains effective in light of the changed business processes.

6.56 You may not rely on audit evidence about the operating effectiveness of controls obtained in prior audits for controls that

a. have changed significantly since the prior audit,

b. pertain to business processes that have changed significantly since the prior audit, or

c. mitigate significant risks. (Paragraphs 5.30–.37 of this publication describe the designation of certain risks as *significant risks*.)

For any control that meets one of the previously mentioned criteria, you should test operating effectiveness in the current audit.

(ISA 330 par. 14*a*)

6.57 For example, changes in a system that enable an entity to receive a new report from the system probably is not a significant change and therefore is unlikely to affect the relevance of prior-period audit evidence. On the other hand, a change that causes data to be accumulated or calculated differently probably is significant and therefore does affect the relevance of audit evidence obtained in the prior period, in which case the operating effectiveness of the control should be tested in the current period.

Rotating Emphasis on Tests of Controls

6.58 When you plan to rely on controls that have not changed since they were last tested, you should test the operating effectiveness of these controls at least once every third audit. There also may be some controls, such as over revenue recognition or inventories that, due to their importance to the client financial statements, might be subject to testing every two years or every year, depending on the risks, even when there are purported to be no changes in controls. (ISA 330 par. 14*b*)

6.59 When there are a number of controls for which you plan to use audit evidence obtained in prior audits, you may wish to test the operating effectiveness of *some* controls each audit. However, when you are testing controls for only one or two key classes of transactions in an entity, rotating the testing of these controls may not be warranted.

6.60 *For example, the auditors of Young Fashion tested controls related to certain assertions for revenue recognition, receivables, and inventory. All of these tests were performed in year 1. Assuming that none of the controls changed, the auditor should test them again at least once every third audit, in this case, year 4. However, the auditor also should test some controls each audit. Therefore, the auditor may test all three groups of controls in year 4 but might test some of them in years 2 and 3 as well.*

Furthermore, even when controls are not being tested between testing years, you should have a basis for asserting that the controls have not changed, such as through inquiries, walkthroughs, or other evidence.

Determining the Extent of Tests of Controls

6.61 The extent of your tests of controls affects the sufficiency of the audit evidence you obtain to support the auditor's assessment of the operating effectiveness of controls. You should obtain more persuasive audit evidence the greater your reliance placed on the effectiveness of a control. (ISA 330 par. 9) As such, you may increase the extent of testing the controls to obtain the desired level of assurance that the controls are operating effectively

a. at the assertion level and

b. either throughout the period or at the point in time when you plan to rely on the control.

Table 6-3 summarizes the factors you may consider in determining the extent of your tests of controls.

Table 6-3

Factors to Consider When Determining the Extent of Tests of Controls

Factors you may consider in determining the extent of tests of controls include the following:

a. The frequency of the performance of the control by the entity during the period.

b. The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.

c. The relevance and reliability of the audit evidence to be obtained in supporting that the control prevents, or detects and corrects, material misstatements at the assertion level.

d. The extent to which audit evidence is obtained from tests of other controls that meet the same audit objective.

e. The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (and thereby reduce substantive procedures based on the reliance of such control). The more the auditor relies on the operating effectiveness of controls in the assessment of risk, the greater is the extent of the auditor's tests of controls.

f. The expected deviation from the control. (See paragraph 6.73.)

Sampling Considerations

6.62 You may consider using an audit sampling technique to determine the extent of tests whenever the control is applied on a transaction basis (for example, matching approved purchase orders to supplier invoices) and it is applied frequently. When a control is applied periodically (for example, monthly reconciliations of accounts receivable subsidiary ledger to the general ledger), you might consider guidance appropriate for testing smaller populations (for example, testing the control application for two months and reviewing evidence the control operated in other months or reviewing other months for unusual items). ISA 530, *Audit Sampling*, provides further guidance on the application of sampling techniques to determine the extent of testing of controls.

6.63 As indicated in table 6-3, you may consider the expected deviation from the control when determining the extent of tests. As the rate of expected deviation from a control increases, you may increase the extent of testing of the control. However, if the rate of expected deviation is expected to be too high, you may determine that tests of controls for a particular assertion may not be effective. In this case you may conclude that a control deficiency exists and you should consider its severity and whether it should be communicated to those charged with governance or management. A control deficiency exists when the observed rate of deviation exceeds the expected rate of deviation used in designing the controls test.

The Use of Walkthroughs as a Test of Controls

6.64 As described in paragraphs 3.122–.125 of this publication, a walkthrough of a transaction process does not involve audit sampling. However, it may be one observation that is part of evidence gathering. A walkthrough generally is designed to provide evidence regarding the design and implementation of controls. However, a walkthrough may be designed to include procedures that are also tests of the operating effectiveness of relevant controls (for instance, inquiry combined with observation, inspection of documents, or reperformance). If such procedures are performed in the context of a walkthrough, you may consider whether the procedures have been performed at an adequate level to obtain some evidence regarding the operating effectiveness of the control. Such a determination would depend on

- the nature of the control (for example, automated versus manual) and
- the nature of your procedures to test the control (for example, inquiry about the entire year and observation versus examination of documents or reperformance).

6.65 For example, when a walkthrough includes inquiry and observation of the people involved in executing a control and where you are satisfied that a strong control environment

and adequate monitoring are in place, you may conclude that the process provides some evidence about operating effectiveness. You use professional judgment to evaluate the extent of evidence obtained. In some cases, the procedures performed during the walkthrough may provide sufficient evidence of operating effectiveness (for example, for a fully automated control procedure in a system with effective IT general controls). In other cases, you may conclude that the procedures performed during the walkthrough provide evidence to reduce but not eliminate other control testing.

6.66 If you perform procedures that are a test of operating effectiveness of a control as part of a walkthrough, you consider whether additional instances of the operation of the control need to be examined to allow a conclusion regarding the control's operating effectiveness.

6.67 If an audit sample of repeated occurrences of a control is deemed necessary (for example, examining documentation relating to a manual control), the test of controls performed in the context of the walkthrough is generally considered to yield the evidence regarding operating effectiveness that comes from a sample size of one for each item and control point walked through the system. In such circumstances, you generally select an audit sample to gather evidence relating to additional instances of the operation of the control in order to obtain a significant level of evidence relating to operating effectiveness. When repeated instances of a control's execution are required to draw a conclusion regarding operating effectiveness, the evidence obtained in the context of the walkthrough is generally insufficient to conclude that the control is operating effectively.

Extent of Testing IT Controls

6.68 Generally, IT processing is inherently consistent. An automated control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Therefore, you may be able to limit the testing of an IT application control to one or a few instances of the control operation, provided that you determine that related IT general controls operated effectively during the period of reliance.

Evaluating the Operating Effectiveness of Controls at a Service Organization

6.69 When the user auditor's risk assessment includes an expectation that controls at the service organization are operating effectively, the user auditor should obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:

a. Obtaining and reading a type 2 report, if available

b. Performing appropriate tests of controls at the service organization

c. Using another auditor to perform tests of controls at the service organization on behalf of the user auditor

Service Organization Controls

6.70 If the user auditor plans to use a type 2 report as audit evidence that controls at the service organization are operating effectively, the user auditor should determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by

a. evaluating whether the type 2 report is for a period that is appropriate for the user auditor's purposes.

b. determining whether complementary user entity controls identified by the service organization are relevant in addressing the risks of material misstatement relating to the assertions in the user entity's financial statements and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness.

c. evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls.

d. evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

(ISA 402 par. 16–17)

Fraud, Noncompliance With Laws and Regulations, and Uncorrected Misstatements Related to Activities at the Service Organization

6.71 The user auditor should inquire of management of the user entity about whether the service organization has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, noncompliance with laws and regulations, or uncorrected misstatements affecting the financial statements of the user entity. The user auditor should evaluate how such matters, if any, affect the nature, timing, and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report. (ISA 402 par. 19)

Performing Tests of Controls

6.72 After you have planned the nature, timing, and extent of your tests of controls, you will select the items to be tested to determine whether they contain deviations from the prescribed control. When making those determinations, you may encounter the following circumstances:

- *Voided or unused documents.* You might select a voided item to be tested. For example, you might be performing a test of controls related to the client's vouchers in which you match random numbers with voucher numbers. However, a random number might match with a voucher that has been voided. If you obtain evidence that the voucher has been properly voided and does not represent a deviation from the proscribed control, you replace the voided voucher.
- *Mistakes in estimating population sequences.* In some circumstances, you will need to estimate your population size and numbering sequence before the transactions have occurred. The most common example of this situation occurs when you perform tests of controls as of an interim date. If you overestimate the population size and numbering sequence, any numbers that are selected as part of the sample and that exceed the actual numbering sequence used are treated as unused documents. If you underestimate the population size and numbering sequence, you generally design additional audit procedures to apply to the items not included in your population.
- *Stopping the test before completion.* Occasionally you might find a number of deviations in auditing the first part of a sample. As a result, you might believe that even if no additional deviations were to be discovered in the remainder of the sample, the results of the sample would not support the planned assessed level of control risk or any reliance on the control being tested. Under these circumstances, you reassess the level of control risk and consider whether it is appropriate to continue the test.
- *Inability to examine selected items.* In some instances you might not be able to examine a selected item (for example, if the document cannot be found). If possible, you should perform alternative procedures to test whether the control was applied as prescribed. If it is not possible to perform alternative procedures, you should consider selected items to be deviations from the controls. Missing documentation is commonly encountered in certain types of fraud as a means to avoid or thwart discovery.

Assessing the Operating Effectiveness of Controls

Evidence About Operating Effectiveness

6.73 The concept of effectiveness of the operation of controls recognizes that some deviations in the way your client applies the controls may occur. Deviations from prescribed controls may be caused by factors such as changes in key personnel, significant seasonal fluctuations in volume of transactions, and human error.

6.74 When you encounter deviations in the operation of controls, those deviations will have an effect on your assessment of operating effectiveness. A control with an observed nonnegligible deviation rate is not an effective control. For example, if you design a test in which you select

a sample of, say, 25 items and expect no deviations, the finding of 1 deviation would be considered a nonnegligible deviation because, based on the results of your test of the sample, the desired level of confidence has not been obtained.

6.75 There are sources of audit evidence beyond your tests of controls that contribute to your assessment of the operating effectiveness of controls. The extent of misstatements you detect by performing substantive procedures also may alter your judgment about the effectiveness of controls in a negative direction (as described in paragraph 6.04). However, misstatement-free results of substantive procedures do not indicate that a lower assessment of control risk should be substituted for the one supported by the procedures you used to assess control risk. (ISA 330 par. 16)

Investigating Additional Implications of Identified Deviations

6.76 When you detect control deviations during the performance of tests of controls, you should make specific inquiries to understand these matters and their potential consequences, for example, by inquiring about the timing of personnel changes in key internal control functions. (ISA 330 par. 17)

6.77 Qualitative aspects of deviations from controls include (*a*) the nature and cause of the deviations, such as whether they result from fraud or errors, which may arise from misunderstanding of instructions or carelessness, and (*b*) the possible relationship of the deviations to other phases of the audit. The discovery of fraud ordinarily requires a broader consideration of the possible implications than does the discovery of an error, and it may elevate the severity of the related deficiency in internal control and the importance of the misstatements to designing other audit procedures.

6.78 Deviations in the application of control activities may be caused by the ineffective operation of indirect controls such as IT general controls, the control environment, or other components of internal control. To gain an understanding of the deviations in control, you may wish to make inquiries and perform other tests to identify possible weaknesses in the control environment or other indirect controls.

6.79 For example, suppose that one of your client's primary controls related to the existence of inventory—periodic test counts—had several instances where the number of items counted by the count teams did not agree to the actual physical count of the items on hand. When gaining a further understanding of the nature of these deviations, you determine that the underlying cause is poor training of the test count teams and a lack of written instructions. Training and written instructions are indirect controls that may affect the operating effectiveness of controls other than those related to existence. For example, the lack of training and instruction could result in the count teams reporting the wrong product number or description, which also could affect the valuation of inventory. This finding could cause the company and auditor to conclude that a re-count is necessary once the teams are properly trained.

Assessing Effectiveness

6.80 After considering the results of tests of controls and any misstatements detected from the performance of substantive procedures, you should determine whether the audit evidence obtained provides an appropriate basis for reliance on the controls. If the reliance on the controls is not warranted, you should determine whether

- additional tests of controls are necessary or
- how the potential risks of misstatement will be addressed using substantive procedures.

Once you have concluded that reliance on certain controls is not warranted, it is unnecessary to perform further tests of those controls.

(ISA 330 par. 17*b*–*c*)

Deficiencies in the Operation of Controls

6.81 You may consider whether deviations in the operation of controls have been caused by an underlying control deficiency. When evaluating the reason for a control deviation, you may consider

- whether the control is automated (in the presence of effective information technology general controls, an automated application control is expected to perform as designed),
- the degree of intervention by entity personnel contributing to the deviation (for example, was the deviation evidence of a possible override), and
- if management was aware of the deviation, its actions in response to the matter.

If you identify one or more deficiencies in internal control, you should determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.

(ISA 265 par. 9)

6.82 Regardless of the reason for the deviation, numerous or repeated instances of the deviation may constitute a significant deficiency. Table 6-4 provides examples of control deficiencies related to deviations you may identify as a result of performing tests of controls.

Sampling Considerations

6.83 When you identify control deviations and the deviation rate in the sample exceeds the expected deviation rate used in planning, deficiencies in the design or operating effectiveness of the control are implied. After you gain an understanding of the nature and cause of the deviations (as described in paragraphs 6.81–.82), you then may apply the following approaches:

- Consider whether other indirect controls exist that fully or partially mitigate the deficiency found in the tested control; if so, understand and test those controls to determine whether the control objective is achieved.
- Assess the likelihood and magnitude of the deficiency and adjust the audit plan accordingly.

Table 6-4

Example Control Deficiencies From Failures in the Operation of Controls

The following are examples of circumstances that may be control deficiencies of some magnitude:

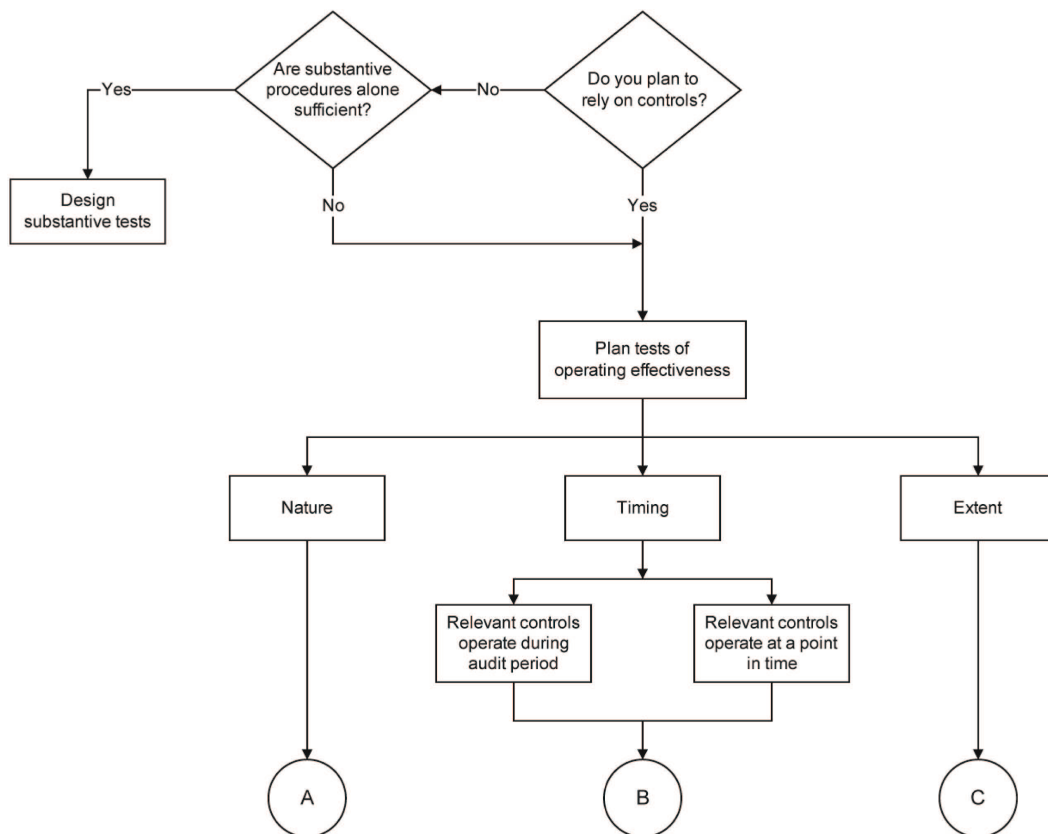
- Failure in the operation of properly designed controls within a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy; for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. For example, a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. However, a preventive control failure may be mitigated by an effective detective control that prevents the misstatement of the financial statements. Suppose the inventory security control fails. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement to the financial statements if performed effectively and timely (near or at the reporting date). In the absence of a timely count, a deficient preventive control may be a deficiency in internal control of some magnitude.
- Failure to perform reconciliations of significant accounts, for example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions; for example, consistent under accruals of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls that would enable the entity to prepare financial statements in accordance with generally accepted accounting principles (GAAP).

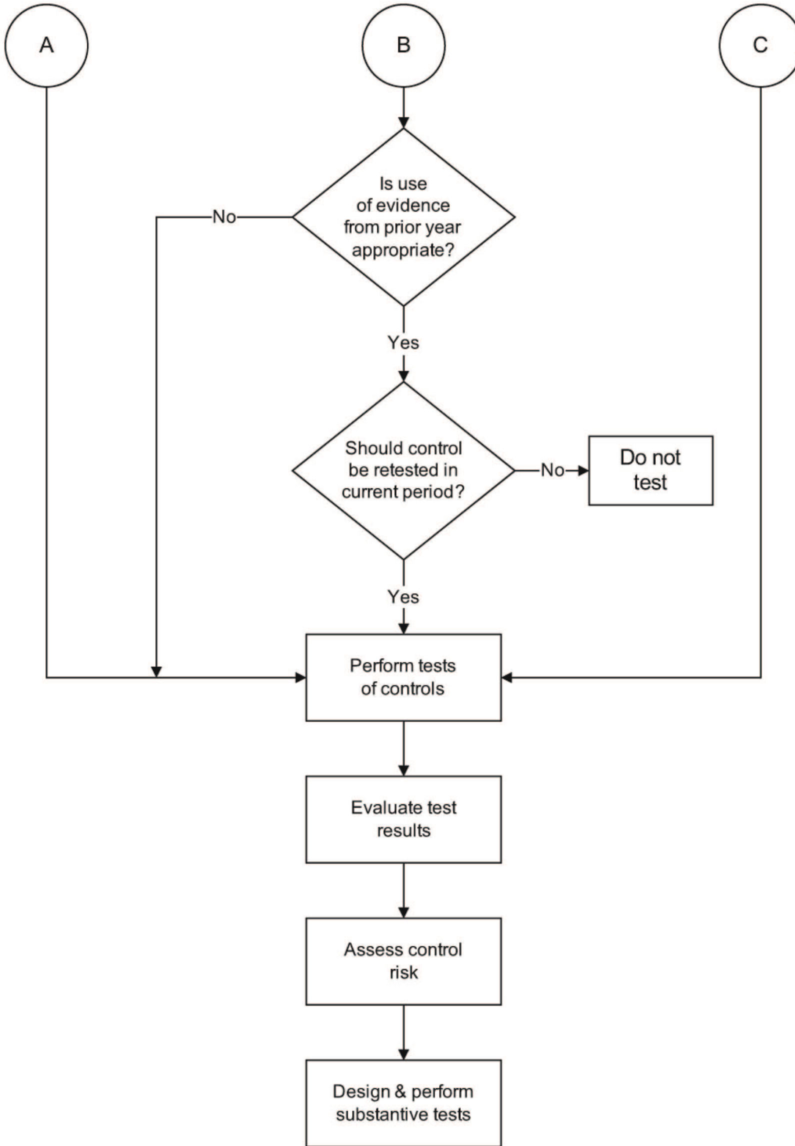
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.
- An observed deviation rate that exceeds the number of deviations you expected in a test of the operating effectiveness of a control. For example, if you design a test in which you select a sample and expect no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of your test of the sample, the desired level of confidence was not obtained.

6.84 Illustration 6-2 summarizes your considerations related to tests of controls.

Illustration 6-2

Considerations Relating to Tests of Controls





Substantive Procedures

6.85 The objective of your substantive procedures is to detect individual misstatements that alone or in the aggregate cause material misstatements at the assertion level. Substantive procedures include the following:

- Tests of details of transactions, account balances, and disclosures.
- Substantive analytical procedures. ISA 520, *Analytical Procedures*, provides guidance on the application of analytical procedures as substantive procedures.

(ISA 330 par. 4)

Substantive Procedures You Should Perform on Every Audit

6.86 Your substantive procedures should be responsive to your assessed risks of material misstatement. However, you should design and perform substantive procedures for all assertions related to each material class of transactions, account balances, or disclosures regardless of your risk assessment because your risk assessment may not identify all risk: (ISA 330 par. 6–7 and 18)

- *Substantive procedures of material items*. You should perform substantive procedures for all assertions for each material class of transactions, account balance, and disclosure. For example, if you determine that long-term debt is a material account, you should perform substantive procedures for all assertions that are relevant to long-term debt, even if you have determined that it is unlikely that the assertion could contain a material misstatement. You may determine that the risk of the entity not having the obligation to repay the debt (the obligation assertion) is low, but nevertheless, you should perform a substantive procedure (for example, confirming the terms of the debt with the lender) to address the risk. Because the account is material, you are precluded from relying solely on risk assessment procedures or tests of controls to support your conclusion. (ISA 330 par. 18)
- *Substantive procedures related to the financial statement closing process*. On all your engagements you should include audit procedures related to the financial statement closing process, such as
  - agreeing the financial statements, including their accompanying notes, to the underlying accounting records.
  - examining material journal entries and other adjustments made during the course of preparing the financial statements.

The nature and extent of your examination of journal entries and other adjustments depend on the nature and complexity of the client's financial reporting system and the associated risks of material misstatement.

(ISA 330 par. 20)

Observations and Suggestions

ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, directs the auditor to test the appropriateness of journal entries and other adjustments (for example, entries posted directly to financial statement drafts) in order to identify misstatements due to fraud.

The guidance provided by ISA 240 may help you design the nature, timing, and extent of testing of journal entries required by ISA 330, *The Auditor's Responses to Assessed Risks*. In addition, the tests of journal entries and adjustments you perform to meet the requirements of ISA 240 may be done concurrently with the tests of journal entries required by ISA 330. However, the nature, timing, and extent of procedures required under ISA 240 are different from those required under ISA 330. Therefore, the tests performed solely for one standard will not necessarily satisfy all requirements of the other. Care needs to be taken that the designed procedures can satisfy both purposes. For example,

- ISA 330 directs you to examine material journal entries and other adjustments made during the course of preparing the financial statements. Although ISA 240 acknowledges that your tests of journal entries typically focus on year-end entries and adjustments, you may also consider testing journal entries that were made throughout the period under audit.
- ISA 330 directs you to examine all material journal entries and other adjustments. ISA 240 requires you to consider materiality and additional factors when determining which journal entries to examine.

Supporting Documentation

Your client may use a spreadsheet application to provide the information supporting their journal entries and adjustments. As previously indicated, the controls related to spreadsheet applications typically are not designed effectively, and so you will want to perform other tests of the information produced by the spreadsheet to determine that journal entries, adjustments, and disclosures are proper.

Substantive Procedures Related to Significant Risks

6.87 Paragraphs 5.30–.37 of this publication define and describe *significant risks*, which arise on most audits and which require special audit consideration. When your audit approach to significant risks consists only of substantive procedures, your substantive procedures should include tests of details.

Audit evidence in the form of external confirmations received directly by you from appropriate confirming parties may assist you in obtaining audit evidence with the high level of reliability that you require to respond to significant risks of material misstatement.

(ISA 330 par. 21)

Nature of Substantive Procedures

6.88 To address any given assertion, your substantive procedures to detect material misstatements may consist of either tests of details or substantive analytical procedures, or both. In general, substantive analytical procedures are more applicable to large volumes of transactions that tend to be predictable over time.

6.89 Determining the mix of substantive procedures to perform depends on the risks of material misstatement. As the risks of material misstatement for a given assertion increase, the reliability of the audit evidence needed also increase. For example, you may determine that there is a relatively high risk of material misstatement related to the valuation of goodwill but a relatively low risk related to valuation of fixed assets. As such, the substantive procedures you perform to address the valuation of goodwill should provide more reliable audit evidence than those performed related to the valuation of fixed assets. (ISA 330 par. 7)

6.90 In designing substantive procedures related to the existence or occurrence assertion, you may select from items contained in a financial statement amount and should obtain the relevant audit evidence. On the other hand, in designing audit procedures related to the completeness assertion, you may select from audit evidence indicating that an item should be included in the relevant financial statement amount and should investigate whether that item is so included. A common example is examining subsequent cash disbursements to determine that accrued liabilities were complete as of year-end. The knowledge you gained by understanding the client's business and its environment may be helpful in selecting the nature, timing, and extent of audit procedures related to the completeness assertion.

Tests of Details

6.91 *Reliability of tests of details.* Table 2-7 and other text in chapter 2, "Key Concepts Underlying the Auditor's Risk Assessment Process," of this publication provide guidance on assessing the reliability of various types of audit evidence. Reviewing this guidance can help you determine the nature of your substantive procedure.

6.92 *For example, Ownco is involved in a dispute with a former employee who was terminated for cause and who now is seeking unemployment compensation. The outcome of the matter will affect the company's liability relating to employer's portion of accrued unemployment tax.*

To gather evidence relating to the matter, the auditor may perform tests of details, including making inquiries of management or requesting an opinion from the company's legal counsel. An inquiry of management will produce audit evidence that is based on an oral statement by someone inside the company—which generally is less reliable than a document prepared by a knowledgeable source outside the entity (which is the evidence the auditor would obtain if the auditor requested and received a letter from the company's legal counsel).

Either one of these substantive procedures may be appropriate, depending on the auditor's assessment of the risks of material misstatement relating to the accuracy of the unemployment tax accrual. If the auditor assesses that risk and exposure to be relatively high, more reliable audit evidence is needed (the letter from the attorney). If the assessed risk and exposure is low, less reliable audit evidence is needed.

Substantive Analytical Procedures

6.93 When designing substantive analytical procedures, you may consider matters such as

- the suitability of using substantive analytical procedures, given the assertions. Analytical procedures may not be suitable for all assertions. For example, transactions subject to management discretion (such as a decision to delay advertising expenses) may lack the predictability between periods or financial statement accounts that is necessary to perform and effective analytical procedure.
- the reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed. To assess the reliability of the data used in a substantive analytical procedure, you may consider its source and the conditions under which it was gathered.
- whether the expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance. The precision of your expectation depends on (among other things)
  - your identification and consideration of factors that significantly affect the amount being audited (for example, contributions to an employee 401(k) plan depends on compensation expense and the percentage of the employer contribution committed to by management).
  - the level of data used to develop your expectation. Typically, expectations developed at a detailed level have a greater chance of detecting a material misstatement than do broad comparisons.
- the amount of any difference in recorded amounts from expected values that is acceptable. The smaller the difference between your expected amount and the recorded amount that you can accept, the more precise your expectation should be.
- the risk of management override of controls. Management override of controls might result in adjustments to the financial statements outside of the normal financial reporting process, which may result in artificial changes to the financial statement relationships being analyzed. These artificial relationships may result in you drawing erroneous conclusions about your substantive analytical procedures.

Paragraphs A41–A44 of ISA 240 direct you to perform certain procedures to assess the risk of management override of controls.

The Reliability of Data Used in Analytical Procedures

6.94 Ultimately, the reliability of your substantive analytical procedures depends on the reliability of the data used in your analysis. Even if all other relevant factors indicate that your analytical procedures are reliable, the ultimate reliability of your procedure will be compromised if the underlying data is not reliable. Table 6-5 summarizes factors that affect the reliability of data used for analytical procedures.

Table 6-5

Factors That Affect the Reliability of Data Used in Analytical Procedures

The following factors influence your consideration of the reliability of data for performing analytical procedures:

- Whether the data was obtained from independent sources outside the entity or from sources within the entity
- If data was obtained from sources outside the entity, the credibility of those sources, for example, whether data obtained from Internet sources is reliable
- Whether the sources within the entity were independent of those who are responsible for the amount being audited
- Whether the data was developed under a reliable system with effectively designed (and, for high reliance on analytical procedures, operating) controls
- Whether the data was subjected to audit testing in the current or prior year
- Whether the expectations were developed using data from a variety of sources

6.95 You may consider testing the controls over your client's preparation of information you use in applying analytical procedures. Frequently, it is more efficient for you to test controls rather than establish the reliability of the data by performing other audit tests.

6.96 *For example, Young Fashions stores all data related to production, shipping, and sales, in a central database. This database is then accessed to produce a wide variety of reports of both financial and nonfinancial data. The auditors use these reports to perform analytical procedures on a number of items, including revenue, cost of sales, sales commissions, inventory obsolescence, sales returns, and bad debt allowance.*

Testing controls over the information processing system allows the auditor to establish the reliability of the data for all *reports used in their analytical procedures, which is more efficient than performing tests to determine the reliability of each and every report.*

6.97 Paragraphs A4–A5 of ISA 520 provide additional guidance on the design of substantive analytical procedures.

The Use of Computer Assisted Audit Techniques in Substantive Procedures

6.98 CAATs may be used to facilitate tests of details of transactions, account balances, and disclosures. When using CAATs, you will want to have comfort that the data has integrity and that there are controls over that data. Once those conditions have been met, CAATs allow you to use the client's data files to assess transactional and supporting data. CAATs allow you to take vast amounts of normalized data and integrate and analyze that data, allowing you to

- identify data that is potentially an outlier or anomaly and
- perform sample size determination, selections, and results projections.

6.99 The following are examples of substantive procedures you may perform using CAATs:

- Recalculation including the use of CAATs to recalculate report balance
- Reperformance
- Analytical procedures including using CAATs to test journal entry files for unusual entries

Observations and Suggestions

CAATs enable you to expand the extent of your substantive procedures. For instance, when testing an entity's transactions, of which there may be thousands or more, CAATs allow you to test across the entire population for specific characteristics as opposed to being limited to a sample of items. In general, the use of CAATs can provide you more flexibility and evidence than more traditional substantive procedures, perhaps at a lower cost. Once they are established, updating CAATs can be done with relative ease because it involves gaining access to current data (transactional information) and performing the same audit procedures as before to cover the remaining time period.

Timing of Substantive Procedures

Substantive Procedures Performed at an Interim Date

6.100 In some circumstances, you may choose to perform substantive procedures at an interim date. When you perform procedures as of a date before year end, you increase the risk that you will fail to detect a material misstatement that may exist at year end. This risk increases as the length of the period between your interim tests and year end increases. Table 6-6 summarizes factors you may consider when determining whether to perform substantive procedures at an interim date.

Table 6-6

Matters to Consider in Determining Whether to Perform Substantive Procedures at an Interim Date

Factor to Consider	*Likelihood of Performing Substantive Procedures at an Interim Date*	
	More Likely	*Less Likely*
Control environment and other relevant controls	Effectively designed or operating controls, including the control environment	Ineffectively designed or operating controls, including the control environment
The availability of information for the remaining period	Information is available that will allow you to perform procedures related to the remaining period	Lack of information necessary to perform procedures related to the remaining period
Assessed risk	Lower risk of material misstatement for the assertion	Higher risk of material misstatement for the assertion
Nature of transactions or account balances and assertions	Year-end balances are reasonably predictable with respect to amount, relative significance, and composition	Year-end balances can fluctuate significantly from interim balances, for example, due to rapidly changing business conditions, seasonality of business, or transactions that are subject to management's discretion
Ability to perform audit procedures to cover remaining period	You will be able to perform all necessary procedures to cover the remaining period	Your ability to perform procedures relating to the remaining period is limited, for example, by a lack of available information

6.101 The objective of some of the tests may make the results of the tests irrelevant if performed at an interim date. For example, tests related to the preparation of the financial statements or the client's compliance with debt covenants typically provide relevant audit evidence only if performed at the period end.

6.102 In addition to those items described in table 6-6, the circumstances of the engagement may result in you performing certain tests at an interim date. For example, your client may require you to identify all material misstatements shortly after year end (which is common for companies that wish to issue a press release of their earnings for the period). In that situation, you may decide to confirm receivables prior to year end because the time period between the end of the period and the release of earnings is too short to allow you to send and receive confirmations of customers and to complete your test work.

6.103 Your ability to perform audit procedures relating to the remaining period depends a great deal on whether the client's accounting system is able to provide the information you need to perform your procedures. That information should be sufficient to allow you to investigate

a. significant unusual transactions or entries (including those at or near the period end).

b. other causes of significant fluctuations or fluctuations that did not occur.

c. changes in the composition of the classes of transactions or account balances.

6.104 In addition to those items listed in table 6-2, when performing substantive procedures at an interim date, you also may consider whether related audit procedures are coordinated properly. This consideration includes, for example

- coordinating the audit procedures applied to related-party transactions and balances.
- coordinating the testing of interrelated accounts and accounting cutoffs.

- maintaining temporary audit control over assets that are readily negotiable and simultaneously testing such assets and cash on hand and in banks, bank loans, and other related items.

6.105 When you perform substantive procedures at an interim date, you should cover the remaining period by performing

a. substantive procedures, combined with tests of controls for the intervening period, or

b. if you determine that it is sufficient, further substantive procedures only, that provide a reasonable basis for extending the audit conclusion from the interim date to the period end.

(ISA 330 par. 22)

6.106 When you perform substantive procedures at an interim date, you may reconcile the account balance at the interim date to the balance in the same account at year end. The reconciliation may allow you to

- identify amounts that appear unusual.
- investigate these amounts.
- perform substantive analytical procedures or tests of details to test the intervening period.

6.107 If you detect misstatements in classes of transactions or account balances at an interim date that you did not expect when assessing the risks of material misstatement you should evaluate whether

- your assessment of risk and
- the nature, timing or extent of your planned substantive procedures covering the remaining period need to be modified.

(ISA 330 par. 23)

Observations and Suggestions

Paragraph 6.107 describes the matters you should evaluate when you detect misstatements in a class of transactions or account balance at an interim date. To comply with this guidance, it will help if you consider the underlying cause or causes of the misstatement. For example, suppose that you confirm accounts receivable as of October 31, and as a result of that procedure, discover that your client recorded the same sale twice. Both revenue and accounts receivable will be overstated and inventory will be understated as a result of this error.

To determine whether your initial assessment of risk remains appropriate and your planned substantive procedures for the remaining period are adequate, you will want to consider the reason the client billed its customer twice. Was it due to poorly designed controls over sales or to some other factor? The answer to that question will help you determine the most appropriate procedures to perform during the remaining period. For example, if poorly designed controls were the cause of the misstatement, the audit evidence you obtain from substantive analytical procedures for the remaining period may not be as reliable as it would be if controls were designed effectively.

When you detect misstatements at interim, you also will want to consider how the misstatement, if uncorrected, will affect year-end balances. In the example just discussed, a sale that is recorded twice, if left uncorrected by the client, will affect the account balance for sales and receivables at year end. As such, you will have to evaluate the matter when determining whether the financial statements are materially misstated. (See chapter 7, “Evaluating Audit Findings, Audit Evidence, and Deficiencies in Internal Control,” of this publication for guidance on evaluating audit findings.) On the other hand, the misstatement of inventory may not have any effect on year-end inventory account balance. If the client performed a physical inventory count subsequent to October 31, the misstatement of inventory and cost of sales caused by relieving inventory twice for the same sale most likely would have been detected and corrected through the client’s book-to-physical inventory adjustment.

However, even in those circumstances where the known misstatement is corrected by year end (in our example, through the book-to-physical adjustment), it would be important that you should

consider whether there might be other misstatements in the December 31 balance that are similar to those you detected at interim. This consideration will affect your judgments about likely misstatement at year end. You may calculate a likely misstatement based on further tests of the year-end balance.

Thus, in determining the effect that misstatements detected as of an interim date have on the final account balances, you will have to consider carefully how the client addressed those misstatements, if at all, during the remaining period as well as how your detection of the known misstatement at interim affects your year-end audit conclusions.

Substantive Procedures Performed in Previous Audits

6.108 In most cases, audit evidence from substantive procedures you performed in a prior audit provides little or no audit evidence for the current period. However, you may use audit evidence obtained during a prior period in the current period audit, provided both the audit evidence and the related subject matter are fundamentally the same. For example, a legal opinion would continue to be relevant audit evidence if it were received in a prior period related to the structure of a securitization transaction and no changes have occurred during the current period. Whenever you use audit evidence from a prior period in the current audit, you should determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (ISA 315 par. 9)

Extent of the Performance of Substantive Procedures

6.109 The greater the risks of material misstatement, the greater the extent of your substantive procedures. However, the nature of your audit procedures is of most importance in responding to assessed risks. Increasing the extent of an audit procedure is appropriate only if the procedure itself is relevant to the specified risk.

6.110 *Considerations for designing tests of details.* When determining the extent of your tests of details, you ordinarily think in terms of sample size. However, you also may consider other matters, including whether it is more effective to use other methods of selecting items for testing, such as selecting large or unusual items from a population, rather than performing sampling or stratifying the population into homogeneous sub-populations for sampling. ISA 530 provides guidance on the use of sampling and other means of selecting items for testing.

Adequacy of Presentation and Disclosure

6.111 You should perform audit procedures to evaluate whether the overall presentation of the financial statements—including disclosures—is in accordance with GAAP. The procedures you perform to make this evaluation should be designed after considering the assessed risks of material misstatement. (ISA 330 par. 25)

6.112 Your evaluation of the financial statements includes consideration of both the individual financial statements and the financial statement disclosures. Your evaluation of disclosures includes matters such as

- the terminology used,
- the amount of detail provided, and
- the bases of amounts reported.

6.113 *Additional considerations.* With regard to individual financial statements, as discussed in paragraph 6.112, it is important that you should evaluate whether they are presented in a manner that reflects the appropriate classification and description of financial information. For disclosures, it is important that you consider whether management disclosed a particular matter in light of the circumstances and facts of which you are aware at the time. You also may consider whether information in disclosures is expressed clearly.

Performing Procedures to Address the Risks of Material Misstatement Due to Fraud

6.114 ISA 240 directs you to perform auditing procedures in response to assessed risks of material misstatement due to fraud. In many circumstances, these audit procedures also provide audit evidence related to material misstatements caused by error. For example, suggested audit procedures relating to revenue recognition, inventory quantities, management estimates, and responses to risks of misstatements arising from misappropriations of assets may be appropriate responses to your assessment of the risks of material misstatement described in chapter 4, "Understanding the Client, Its Environment, and Its Internal Control," of this publication.

Audit Documentation

6.115 With regard to the performance of further audit procedures, you should document

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 conclusions when such conclusions are not otherwise clear.

(ISA 330 par. 28)

6.116 If you plan to use audit evidence about the operating effectiveness of controls obtained in previous audits, you should include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit. (ISA sec. 330 par. 31)

6.117 Paragraphs 1.39–.41 of this publication provide additional, more general, guidance on the preparation of audit documentation.

Summary

6.118 In response to your assessment of the risks of material misstatement, you will develop an overall response to financial statement level risks and design further audit procedures, which consist of tests of controls and substantive procedures. This chapter focused on performing these further audit procedures, which include tests of controls and substantive procedures.

6.119 Your assessment of the risks of material misstatement, adjusted for results of your tests of controls will affect the nature, timing, and extent of your substantive procedures. If certain conditions are met, you may use the results of tests of controls performed in prior periods as audit evidence for your conclusion about control operating effectiveness in the current audit period.

6.120 During your tests of controls, you may identify deviations in the application of the control. These deviations may be indicative of one or more control deficiencies, the severity of which you will need to assess. If your tests of controls indicate that they may not be operating effectively, you will need to consider whether the nature, timing, and extent of your planned substantive procedures should be modified.

6.121 Substantive procedures include substantive analytical procedures and tests of details. Substantive procedures should be performed on each engagement.

6.122 Performing substantive procedures may lead to the identification of misstatements, which you will need to evaluate and communicate to management.

6.123 Chapter 7 of this publication provides guidance on the evaluation of the audit findings from your substantive procedures and of any identified control deficiencies.

6.124

Appendix — Answers to Frequently Asked Questions About Performing Further Audit Procedures

Question	*See Paragraphs*
What are the objectives of tests of controls?	6.02–.03
What factors should I consider when designing tests of controls?	6.06–.17
What procedures can I perform to test controls?	6.18–.42
Should I be testing controls as of a single point in time or throughout a period?	6.43–.47
What should I do to update tests of controls performed at an interim date?	6.48–.52
Can I use audit evidence obtained in prior periods to support a conclusion about control operating effectiveness in the current period?	6.54–.60
How many tests of controls should I perform?	6.61–.68
How do I test the operating effectiveness of controls when the client uses a service organization to process certain transactions?	6.69–.71
Once I have completed my tests of controls, how do I evaluate the results?	6.73–.86
What substantive procedures should I perform on every audit?	6.87–.90
In what circumstances should I consider performing substantive procedures at an interim date? If I do perform substantive procedures at an interim date, what should I do to test the rollforward period?	6.101–.110
How should I evaluate the adequacy of the financial statement presentation and disclosures?	6.111–.114

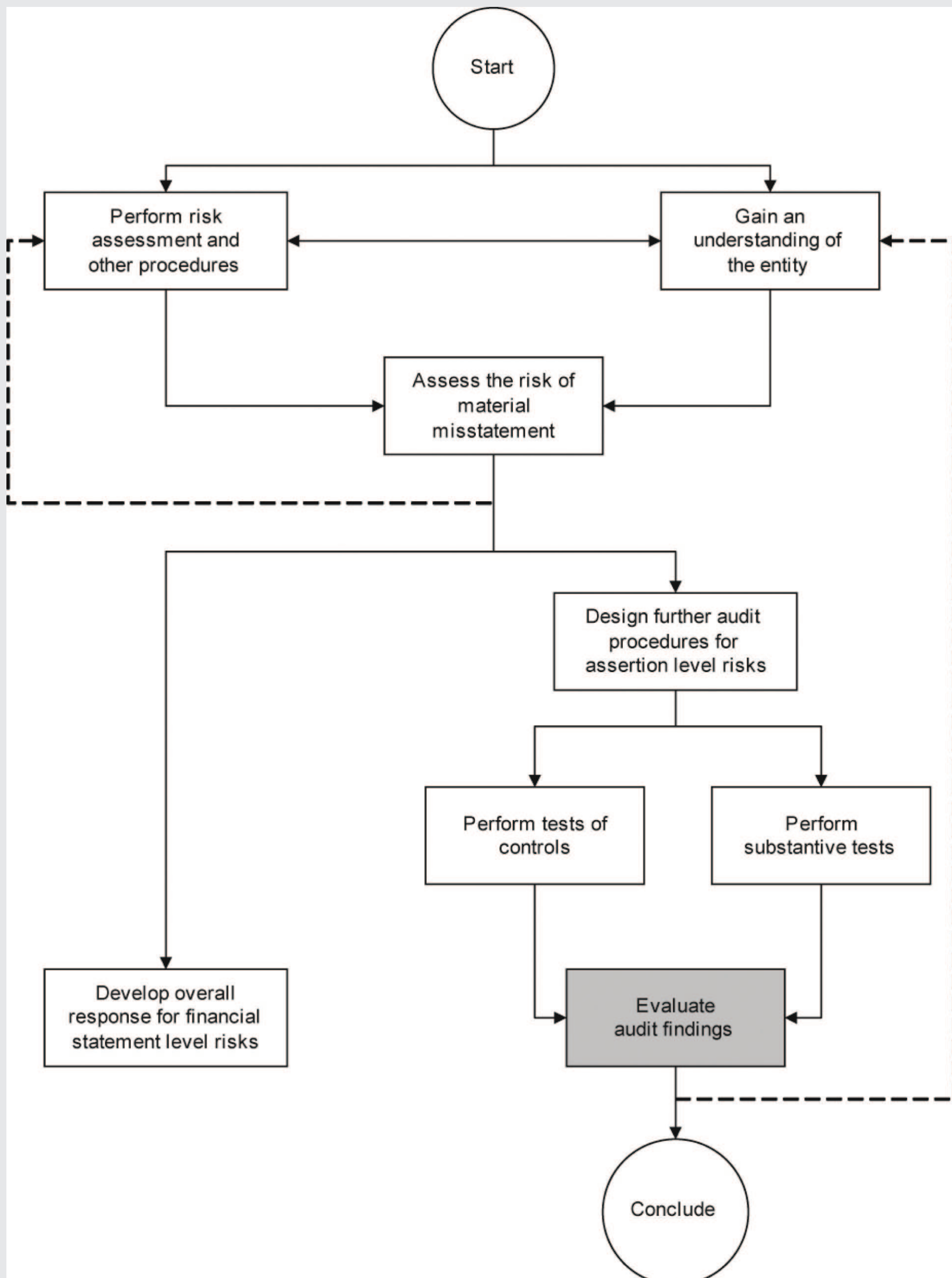
Chapter 7

Evaluating Audit Findings, Audit Evidence, and Deficiencies in Internal Control

Observations and Suggestions

Illustration 7-1

Overview of Evaluating Audit Findings and Audit Evidence



(continued)

As you perform your further audit procedures, you will need to evaluate the resulting audit evidence. That audit evidence may either confirm your risk assessments or cause you to reevaluate those risk assessments and design and perform additional audit procedures.

This chapter describes how you evaluate the results of your audit procedures.

You also may become aware of deficiencies either in the design or operation of your client's internal control. This chapter also describes how you evaluate and communicate deficiencies in internal control.

Evaluating Misstatements

The results of your substantive procedures may lead you to identify misstatements in accounts or notes to the financial statements. You should determine whether these misstatements, both individually and in the aggregate, are material. The auditor should accumulate all misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management. This communication should occur on a timely basis. You should also request management to correct all misstatements. In evaluating the aggregate effect of the misstatements, you also should consider the effect on the current period of the aggregate uncorrected misstatements from prior periods. Uncorrected misstatements should be included in the management representation letter and communicated to those charged with governance.

Evaluating Audit Evidence

At the end of the audit, you should conclude whether you have obtained sufficient appropriate audit evidence to support your opinion on the financial statements. Ultimately, you should evaluate whether your audit was performed at a level that allows you to conclude at a high level of assurance that the financial statements, as a whole, are free of material misstatement.

Identification of Deficiencies in Internal Control

You may become aware of deficiencies in internal control at any point during your audit, including during the performance of risk assessment procedures, the evaluation of control design, or the testing of internal control operating effectiveness. The results of your substantive procedures may cause you to reevaluate your earlier assessment of internal controls, and that reevaluation also may lead you to identify deficiencies in internal control.

Evaluation and Communication of Deficiencies in Internal Control

You should evaluate the severity of identified deficiencies in internal control. Some deficiencies may be considered significant deficiencies. You should communicate in writing to management and those charged with governance all significant deficiencies of which you become aware during the audit.

As the audit proceeds, and as misstatements and control deficiencies are identified, you may need to reassess the risk assessments you initially made and consider whether the audit plan is sufficient to be able to conclude at a low risk that the financial statements contain a material misstatement.

As you perform further audit procedures, you will need to evaluate the results of your tests. If you identify misstatements, you should communicate them to management and those charged with governance, and request management to correct all misstatements. At the conclusion of the audit, you should evaluate your audit evidence to determine whether it supports your opinion and allows you to conclude at a low level of risk that the financial statements are free of material misstatement.

This chapter provides guidance on evaluating the results of your audit procedures, communicating your findings to management and ultimately evaluating the audit evidence you obtained. Throughout your audit you may identify deficiencies in internal control. These too should be evaluated and, if necessary, communicated to management and those charged with governance.

Introduction

7.01 The results of further audit procedures may lead you to identify

a. misstatements of accounts or notes to the financial statements, as a result of your substantive procedures or

b. deficiencies in internal control, as a result of tests of controls or performing substantive procedures.

This chapter describes how you evaluate and, if necessary, communicate both misstatements and deficiencies.

Evaluating Misstatements of Accounts or Notes to the Financial Statements

7.02 When you identify misstatements in accounts or notes to the financial statements, you should

a. evaluate the misstatements, both individually and in the aggregate, and

b. communicate these misstatements, unless trivial, to management and those charged with governance.

Reevaluation of Your Risk Assessments

7.03 Based on the audit evidence you obtain from your audit procedures, you should reevaluate your assessment of the risks of material misstatement at the assertion level to determine whether they remain appropriate. (ISA 330 par. 25)

7.04 *For example, the auditors of ABC Company, Inc. determined that there was a relatively low risk that the company would fail to record year-end sales in the proper accounting period (cut-off assertion). The nature, timing, and extent of the auditor's substantives procedures relating to this assertion were designed based on this assessment.*

However, because December 31 fell on a Sunday, there was some confusion among warehouse and accounting personnel about how to record certain orders that were not picked up by the shipping service even though ABC Company had finished preparing the items for shipment.

A comment received on an accounts receivable confirmation led a staff auditor to investigate the discrepancy reported by the customer, which ultimately resulted in the identification of the underlying cause of the misstatement.

This misstatement of revenues and accounts receivable caused the auditors to reevaluate their initial risk assessment relating to shipping cut-off, including the risks relating to the effective design of controls. As a result of this reevaluation, the team increased the extent of their tests of details over shipping cut-off to obtain a higher level of assurance that they had identified all material misstatements relating to cut-off errors.

Observations and Suggestions

Your audit is a cumulative and iterative process. As you perform planned audit procedures, information may come to your attention that differs significantly from the information on which the risk assessments were based.

The identification of a misstatement of an account or a note to the financial statements is one example of new, unexpected information that you uncover during your audit. When you identify a misstatement, the communication of that misstatement to management and their correction of that misstatement is only a part of your responsibilities. In addition, you may

- determine whether the misstatement indicates the existence of a deficiency in internal control and

(continued)

- analyze the effect, if any, the new information has on your previous risk assessments. The results of this reevaluation may result in you performing additional procedures that you had not previously planned to perform.

In this way, a reevaluation of audit risk also may involve an update of your audit strategy and your audit plan.

Finally, you cannot simply assume that an instance of fraud or error is an isolated occurrence. To properly reevaluate your risks of material misstatement, the overall audit strategy and audit plan, you may need to perform audit procedures to gain an understanding of the underlying cause of the misstatement, as illustrated in the example in paragraph 7.04.

Materiality Considerations as Your Audit Progresses

7.05 Paragraph 3.06 of this publication describes how you should determine a materiality level for the financial statements as a whole to help you plan your audit. However, while planning the audit, it is not feasible for you to anticipate *all* the circumstances that may ultimately influence judgments about materiality in evaluating the audit findings at the completion of your audit. You should revise materiality for the financial statements as a whole in the event you become aware of information that would have caused you to have determined a different amount initially. (ISA 320 par. 12)

Observations and Suggestions

You should obtain a high level of assurance about whether the client's financial statements are free of material misstatement. The performance of risk assessment and further audit procedures help you gather the audit evidence required to obtain a high level of assurance, but ultimately, your ability to meet your overall responsibility depends on your judgment about what is "material" to the financial statements.

If you err in your judgment about materiality and set it at a level that is higher than appropriate, your audit procedures may not provide reasonable assurance of detecting misstatements at the appropriate materiality level.

For example, during planning, you set materiality based on income; because the company had projected income before tax of $100,000 at the beginning of the audit, you set materiality at $5,000 because you judged that aggregate misstatements affecting the company's income are not material. But suppose that information comes to your attention that income before tax will be half of what was projected, and thus you determine that the appropriate materiality is $2,500.

Unless you adjust your audit procedures to take into account this revised, lower level of materiality, you will not be able to conclude with a high level of assurance that you have detected all misstatements that truly are material. In this case, this could require you to greatly increase (for example, double) the extent of testing.

7.06 If you become aware of information during the audit that would have caused you to have determined a different (lower) amount of materiality than initially determined, you should revise materiality for the financial statements as a whole. Further, you should also revise the performance materiality level or levels for particular classes of transactions, account balances, or disclosures. If you conclude that a lower materiality amount is appropriate, you should also determine whether it is necessary to revise performance materiality and whether the nature, timing, and extent of planned further audit procedures remain appropriate. (ISA 320 par. 12–13)

Qualitative Aspects of Materiality

7.07 As indicated in paragraph 3.08 of this publication, judgments about materiality include both quantitative and qualitative information. However, judgments about materiality used for planning purposes are primarily determined using quantitative considerations.

7.08 For the purposes of evaluating misstatements, your judgments about materiality should consider qualitative factors. Table 7-1 summarizes qualitative factors that you may consider when determining whether misstatements are material. These circumstances presented in table 7-1 are only examples. Not all of these examples are likely to be present in all audits, nor is the list complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

Table 7-1

Qualitative Factors That May Influence the Determination of Materiality

Qualitative considerations influence your determination about whether misstatements are material. Qualitative factors that you may consider when making judgments about materiality include the following:

- The potential effect of the misstatement on trends, especially trends in profitability.
- A misstatement that changes a loss into income or vice versa.
- The potential effect of the misstatement on the entity's compliance with loan covenants, other contractual agreements, and regulatory provisions.
- The existence of statutory or regulatory reporting requirements that affect materiality thresholds.
- A change masked in earnings or other trends, especially in the context of general economic and industry conditions.
- A misstatement that has the effect of increasing management's compensation; for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation.
- The sensitivity of the circumstances surrounding the misstatement; for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions such as debt covenants, and conflicts of interest.
- The significance of the financial statement element affected by the misstatement; for example, a misstatement affecting recurring earnings as contrasted to one involving a nonrecurring charge or credit, such as an extraordinary item.
- The effects of misclassifications; for example, misclassification between operating and nonoperating income or recurring and nonrecurring income items or a misclassification between fund-raising costs and program activity costs in a not-for-profit organization.
- The significance of the misstatement relative to reasonable user needs; for example,
    - earnings to investors and the equity or cash flow amounts to creditors.
    - the magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy-sell agreement).
    - the effect of misstatements of earnings when contrasted with expectations.

Obtaining the views and expectations of those charged with governance and management may be helpful in gaining or corroborating an understanding of user needs, such as those illustrated previously.

- The definitive character of the misstatement; for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty.
- The motivation of management with respect to the misstatement; for example, (*a*) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates, (*b*) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process, or (*c*) an intentional decision not to follow generally accepted accounting principles.
- The existence of offsetting effects of individually significant but different misstatements.
- The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect; for example, that builds over several periods.
- The cost of making the correction. It may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management.
- The risk that possible additional undetected misstatements would affect the auditor's evaluation.

Misstatements

7.09 *Misstatements* are defined as a difference between the 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 presented fairly in accordance with the applicable financial reporting framework. (ISA 450 par. 4)

You may find it useful to distinguish among factual misstatements, judgmental misstatements, and projected misstatements as follows:

a. *Factual misstatements* are misstatements about which there is no doubt.

b. *Judgmental misstatements* are differences between your judgments and management's judgments concerning accounting estimates that you consider unreasonable or the selection or application of accounting policies by the client that you consider inappropriate.

c. *Projected misstatements* are your best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn. Projected misstatements may include factual misstatements identified in specific items from which the projections are made.

7.10 You should accumulate misstatements (factual, judgmental, and projected) identified during the audit. (ISA 450 par. 5) You should determine whether uncorrected misstatements are material, individually or in aggregate, for purposes of determining whether the financial statements are free of material misstatement. (ISA 450 par. 11) You should also communicate misstatements to the appropriate level of management. (ISA 450 par. 8)

The Possibility of Undetected Misstatements

7.11 You typically do not test 100 percent of the transactions your client entered into during the year, nor do you usually identify and test all other events or circumstances that could affect the financial statements and related disclosures. As such, a sampling risk exists that, after performing your audit procedures, some misstatements in the financial statements may remain undetected. Also, an identified misstatement may not be an isolate occurrence but rather indicative of a breakdown in internal control or the use of inappropriate assumptions or valuation methods. Further, if the aggregate of misstatements accumulated approaches materiality, a greater than acceptably low level of risk may exist for possible undetected misstatements. You may find it necessary to consider the possibility of these undetected misstatements when evaluating audit findings.

Evaluating Results From Different Types of Substantive Procedures

Substantive Analytical Procedures

7.12 Substantive analytical procedures normally would not specifically identify a misstatement. Rather, the results of these procedures would provide you with only an indication of whether a misstatement might exist in the account or class of transactions.

7.13 If the difference between an amount recorded in the financial statements and the expectation you developed as part of your substantive analytical procedures is significant, that difference should be investigated. This investigation may involve

- making inquiries of management and obtaining appropriate audit evidence relevant to management's response and
- performing other audit procedures as necessary in the circumstances.

7.14 If the amount of the difference is not determinable from the procedures performed, you may request management to investigate, and you may need to expand your procedures to determine if a misstatement might exist.

Observations and Suggestions

Paragraph 7.13 describes your evaluation of the difference between your expectation and the recorded amount as one that requires a consideration of whether that difference is "significant." As used in this context, the "significance" of a difference typically is determined by comparing it to performance materiality. As the amount of the difference approaches performance materiality, the risk that a misstatement greater than performance materiality exists in the account increases.

Significant for analytical procedures is much less than material; it is an amount the auditor determines based on performance materiality.

Results of Audit Sampling

7.15 When you use audit sampling to test an assertion, you should project misstatements found in the sample to the population. (ISA 530 par. 14) That latter misstatement is considered a projected misstatement and evaluated as such.

Differences in Estimates

7.16 Financial statements typically include one or more accounting estimates. You should obtain an understanding of the requirements of the applicable financial reporting framework relevant to accounting for estimates; how the client identifies transactions, events, and conditions that may give rise to the need to recognize and disclose estimates; and how the client makes estimates and the data used. (ISA 540 par. 8)

7.17 No one accounting estimate can be considered accurate with certainty. Therefore, you may determine that a difference between an estimated amount best supported by your audit evidence and management's estimate included in the financial statements may not be significant. Such a difference would not be considered to be a misstatement. However, if you believe that the client's estimated amount included in the financial statements is unreasonable, you may treat the difference at least between that estimate and the nearest reasonable estimate as a judgmental misstatement.

7.18 The nearest reasonable estimate may be a point estimate or a range of acceptable amounts as follows:

a. *Point estimate*. If your estimate is a point estimate, the difference between that point estimate and management's estimate included in the financial statements constitutes a judgmental misstatement.

b. *Range of acceptable amounts*. If your analysis of an accounting estimate results in a range of acceptable amounts, management's estimate will fall either inside or outside of that acceptable range. For example, if your analysis leads you to conclude that the client's allowance for doubtful accounts is between $130,000 and $160,000, the client's estimate will either be inside or outside of that range.

   i. If management's recorded estimate falls within your range of acceptable amounts, you would conclude that management's estimate is reasonable.

   ii. If management's recorded estimate falls outside your range of acceptable amounts, the difference between the recorded amount and the amount at the nearest end of your range would be considered a judgmental misstatement.

Observations and Suggestions

Using a range of acceptable amounts is effective only if the range is relatively narrow—the spread of the range is less than performance materiality. In the example in paragraph 7.18, if the range was from $130,000 to $1,000,000, and performance materiality was $50,000, you may not have sufficient appropriate evidence about the estimate, so you would want to perform additional tests to narrow the estimate so the spread is less than performance materiality.

Consideration of Possible Bias

7.19 You should review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between management's estimate and your estimate was to increase income, you may find it necessary to reconsider whether other recorded estimates reflect a similar bias. If so, you may perform additional audit procedures to address those estimates. (ISA 540 par. 21)

7.20 In some instances, management's recorded estimates may be clustered at one end of the range of acceptable amounts in one year and clustered at the other end of the range of acceptable amounts in the subsequent year. Such a circumstance indicates the possibility that management is using swings in accounting estimates to offset higher- or lower-than-expected earnings. If you believe that management is making estimates in this fashion, you may consider communicating this matter to those charged with governance.

7.21 ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, directs you to perform a retrospective review of management's accounting estimates to identify indications of possible bias and, if identified, to respond appropriately.

Communication of Misstatements to Management

7.22 You should accumulate all misstatements you identify during the audit—except those you believe are trivial—and communicate them to management. In complying with this requirement

a. matters that are "trivial" are amounts you determine below which misstatements need not be accumulated. This amount is set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered. (ISA 450 par. 5)

b. the communication to management *should* occur on a timely basis, which enables management to evaluate the items and either to tell you that they disagree with you and why or to concur that the items are misstatements and to take action as necessary. (ISA 450 par. 8)

c. determining which level of management to communicate the misstatements to is a matter of judgment that depends on factors such as

   i. the nature, size, and frequency of the misstatement.

   ii. the level of management that can take the necessary action.

7.23 The nature of your communication and the related request you make of management depends on the type of misstatement:

- *Factual misstatements* are misstatements about which there is no doubt.
- *Projected misstatements* from a sample are the auditor's best estimate of the misstatement in the population.
- *Judgmental misstatements* are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate.
- In addition, you may find it necessary to
  - discuss with management the effect on the auditor's report if management does not examine the class of transactions, account balance, or disclosure to identify and correct misstatements found.
  - perform further audit procedure to reevaluate the reasonableness of the estimate after management has reconsidered its assumptions and methods, and corrected any misstatements found.

7.24 If management decides not to correct some or all of the misstatements, you should obtain an understanding of the reasons for not making the corrections and take those reasons into account when considering the qualitative aspects of the entity's accounting practices and the implications for the auditor's report. (ISA 450 par. 9)

7.25 *For example, the auditors of Ownco identified the following items when performing their substantive procedures:*

- *The company over-accrued office expenses by $325 because accounting personnel failed to consider a credit granted by the supplier for returned office supplies. This was based on the auditor's 100 percent examination of all accruals.*
- *At year end, the company had written checks totaling approximately $5,000 that it did not mail until 2 weeks of the new year had elapsed. This failure to mail the checks prior to year end was done intentionally so the bookkeeper could review the payments after he returned from vacation. The held checks were incorrectly recorded as a reduction of cash and accounts payable at year end.*
- *The company erred in pricing certain finished goods. The auditor detected the misstatements by examining the supporting documentation for a sample of inventory items and projecting an identified misstatement to the entire population from which it was drawn. The amount of the projected misstatement was approximately $12,000.*

The auditor responded to these items in the following ways:

- *The over-accrued office expenses fell below the amount the auditor considered trivial. That is, even a significant number of misstatements of $325, when aggregated, would not be material to the financial statements. As a trivial item, it was not accumulated by the auditor for further consideration and was not communicated to client management. Had this been based on a sample, the auditor would first calculate the projected misstatement and then determine whether the projected misstatement was trivial.*
- *The $5,000 of held checks was considered to be a factual misstatement, a specific misstatement arising from mistakes in overlooking facts and processing information. As such, the auditors communicated the matter to management and asked them to correct the financial statements.*
- *The $12,000 inventory pricing misstatement is a projected misstatement because the amount was identified in a sample that was extrapolated to the entire population. As a projected misstatement, the auditor did not request that the client correct the financial statements for the extrapolated amount. Rather, the auditor requested that the client investigate the pricing of inventory further to identify and correct any misstatements.*

The client did so and identified misstatements of $13,500. These were corrected. Because the auditor's estimate was based on an adequate sample, and management adjusted to an amount close to the auditor's estimate, no further testing was performed.

Consideration and Evaluation of Uncorrected Misstatements

7.26 Prior to evaluating the effect on uncorrected misstatements you should reassess materiality to confirm whether it remains appropriate in the context of the client's actual financial results. (ISA 450 par. 10) You should then determine whether the uncorrected misstatements are material, either individually or in the aggregate. To make this determination you should 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

b. 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.

(ISA 450 par. 11)

7.27 When applying the concept of materiality to the evaluation of audit findings you may consider

- both the quantitative (size) and qualitative (nature) aspects of the misstatements.
- the effect of the misstatements on both the financial statements taken as a whole and on particular classes of transactions, account balances, and disclosures.
- the particular circumstances related to the occurrence of the misstatements.

7.28 When evaluating misstatements in relation to individual classes of transactions, account balances, or disclosures, you should consider whether that misstatement has exceeded the materiality level for that particular class of transactions, account balances, or disclosures. Thus, you may use a relevant lower misstatement threshold in evaluating individual misstatements. Paragraph 3.14 of this publication provides guidance on reducing financial statement materiality for particular items.

Evaluating Uncorrected Misstatements Individually

7.29 You should consider separately each uncorrected misstatements before considering them in the aggregate. When considering a misstatement separately, you may consider

a. its effect on the relevant individual classes of transactions, account balances, or disclosures.

b. whether, the materiality level for that particular class of transactions, account balances, or disclosure has been exceeded.

7.30 If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. However, it is appropriate to offset misstatements when they are disclosed together in the financial statements. (ISA 450 par. A14)

For example, suppose your client failed to accrue for a purchase of office supplies. It also overestimated the accrual of contingent rent expense due for the year. If office supplies and rent expense are combined for the financial statements (for example, as "occupancy costs") and the accruals for both of these items are combined as accrued expenses, it may be appropriate to offset the two misstatements and evaluate only the net difference between them.

Evaluating Uncorrected Misstatements in the Aggregate

7.31 Uncorrected misstatements are aggregated in a way that enables you to consider whether they materially misstate the particular classes of transactions, account balances, or disclosures and financial statements taken as a whole. This aggregation allows you to compare the misstatements to both the financial statements and to individual amounts, subtotals, or totals. (ISA 450 par. 11*a*)

7.32 Your evaluation of aggregated misstatements includes the consideration of the risk of undetected misstatements is described in paragraph 7.11.

As the aggregate of the misstatements approaches the materiality level, the risk increases that those misstatements (in combination with undetected misstatements) exceed materiality. Accordingly, you determine whether your audit plan (nature, timing and extent) needs to be revised. (ISA 450 par. 6*b*)

Observations and Suggestions

In some instances it has been noted that management may deliberately immaterially misstate financial statement amounts in order to achieve objectives that might not be obvious. For example, a slight understatement of liabilities might have the effect of meeting a required debt covenant ratio, where the ratio would not be acceptable, but for the misstatement. In other situations a profit sharing or bonus award may be predicated on meeting certain benchmarks. When the financial metrics appear to be close to those benchmarks, there may be a motivation to meet the threshold by misstatement.

Thus, when waiving adjustments that may not be material, the auditor may consider other metrics and benchmarks before being satisfied that the misstatements do not require correction.

7.33 *For example, at the end of your audit, you had factual misstatements of $50,000 and judgmental misstatements of $200,000. The client investigated and corrected all the factual misstatements and $150,000 of the judgment misstatements; this left $50,000 of uncorrected judgmental misstatement. Materiality for the financial statement was $500,000. You need to consider whether there could be $450,000 of undetected misstatements given all the procedures you performed and the misstatements you detected. You made a judgment that you had a high level of assurance that this was unlikely, given the nature, timing, and extent of procedures performed.*

However, if materiality were $60,000, you might believe that it is possible that you could have missed $10,000 of misstatement in the audit process, given the nature, timing, and extent of your audit procedures and the audit findings. Thus, you might not be able to conclude at a low risk that the financial statements are free of material misstatement. In that case you might request the client to investigate and resolve some of the remaining potential misstatement or perform further audit procedures to reduce the potential misstatement amount and reduce audit risk to an appropriately low level.

Consideration of Prior Year's Uncorrected Misstatements

7.34 You should consider the effect on uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures and the financial statements as a whole for the current period. (ISA 450 par. 11*b*)

7.35 *For example, suppose that your client inappropriately applies accounting principles relating to the capitalization of fixed assets. As a result, expenditures that should be capitalized are expensed. In year 1, the total amount of expenditures that should have been capitalized was $15,000. Expenses for the year are overstated by $15,000 and fixed assets are understated by the same amount. The auditor should ask the client to adjust the financial statements for the misstatement. If not adjusted, the auditor should determine whether the $15,000 is considered immaterial individually and in the aggregate to both the income statement and the balance sheet. Assume no adjustment is made, although the item is included in the representation letter and those charged with governance are informed.*

In year 2, the company follows the same policy and $18,000 is inappropriately expensed. For the year, expenses are overstated by $18,000. But the cumulative effect of the incorrect application of an accounting principle is different for the balance sheet. At the end of year 2, fixed assets are understated by the amount that was not capitalized during year 2 ($18,000) plus the amount that was not capitalized in year 1, less depreciation ($15,000 less, say $1,000). That is, the balance sheet is misstated by $32,000. The auditor should ask the client to adjust for the misstatement of $32,000. If not, the auditor should evaluate whether the $32,000 is considered immaterial individually and in the aggregate to both the income statement and the balance sheet. Assume no adjustment is made, although the item is included in the representation letter and those charged with governance are informed.

In year 3 the policy continues. Additional expenditures are expensed rather than capitalized. In any given year, the amount that is expensed is not material to the income statement, but over time, the cumulative effect of the misstatements on the balance sheet continues to grow. And every year you need to ask management and those charged with governance to adjust both the balance sheet and the income statement. Management also needs to include their view that these amounts are not material in the management representation letter.

This example provides one perspective on how to assess such misstatements that relate to current and prior periods. A complete discussion of this issue is provided in appendix E, "Consideration of Prior Year Uncorrected Misstatements," of this publication.

7.36 You should determine whether uncorrected misstatements are material, individually or in the aggregate. In connection therewith you should consider

- 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
- 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.

Observations and Suggestions

The guidance related to misstatements from a prior period pertains only to *uncorrected* misstatements. If your client corrects all the misstatements you identify, there is nothing left that may affect subsequent periods.

7.37 Appendix E of this publication provides additional guidance and examples of how to consider uncorrected misstatements from a prior period.

Evaluating the Financial Statements as a Whole

7.38 You should evaluate whether the financial statements as a whole are free of material misstatement. In making this evaluation, you should evaluate the uncorrected misstatements and reassess materiality under paragraph 12 of ISA 320, *Materiality in Planning and Performing an Audit*.

7.39 When determining whether the effect of uncorrected misstatements, individually or in the aggregate, is material, you should consider the nature and size of the misstatements in relation to the nature and size of items in the financial statements. For example,

- an amount that is material to the financial statements of one entity may not be material to another entity of a different size or nature.
- an amount that is material to the financial statements of an entity in one year may not be material to that same entity in a different year.

(ISA 450 par. 11*a*)

7.40 If you believe that the financial statements as a whole are materially misstated and management refuses to make the necessary corrections, you should determine the implications for your audit report under ISA 700, *Forming an Opinion and Reporting on Financial Statements*.

7.41 If you conclude that the effects of uncorrected misstatements do not cause the financial statements to be materially misstated, you should consider the effect of undetected misstatements, which are described in paragraph 7.11. Because of the possibility of undetected misstatements, as the aggregate uncorrected misstatements approach materiality, the risk that the financial statements may be materially misstated also increases. As such, you should determine whether the audit plan needs to be revised if the aggregate of misstatements accumulated during the audit could be material. (ISA 450 par. 6)

Evaluating the Sufficiency of Audit Evidence

7.42 You should conclude whether you have obtained sufficient appropriate audit evidence. In forming your conclusion, you should consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the financial statement assertions. (ISA. 330 par. 26) Table 7-2 summarizes some of the factors that influence your consideration of whether the audit evidence you obtained during your audit was sufficient and appropriate.

7.43 If you determine that you have not obtained sufficient appropriate audit evidence about an assertion, you should attempt to obtain further evidence. If you are unable to obtain sufficient appropriate audit evidence, you would express a qualified opinion or a disclaimer of opinion on the financial statements. (ISA 330 par. 27)

Table 7-2

Sufficient Appropriate Audit Evidence

The sufficiency and appropriateness of audit evidence to support your conclusions throughout the audit are a matter of professional judgment. This judgment regarding what constitutes sufficient appropriate audit evidence is influenced by such factors as the

- 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 available information.
- persuasiveness of the audit evidence.
- understanding of the entity and its environment, including its internal control.

Identifying and Evaluating Deficiencies in Internal Control

7.44 ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, requires you to communicate to management and those charged with governance significant deficiencies identified in your audit. Chapter 2, "Key Concepts Underlying the Auditor's Risk Assessment Process," of this publication provides definitions of

- *deficiency in internal control*, and
- *significant deficiency*.

ISA 265 is not applicable if the auditor is engaged to report on the effectiveness of an entity's internal control over financial reporting.

7.45 Deficiencies in internal control may involve one or more of the five internal control components described in this publication that affect an entity's internal control over financial reporting.

Identification of Deficiencies in Internal Control

7.46 In an audit, you are not required to perform procedures to identify deficiencies in internal control. However, during the risk assessment process (for example, obtaining an understanding of the entity and its environment) and during other stages of the audit process (for example, performing further audit procedures to respond to assessed risk), you may become aware of deficiencies in internal control. (ISA 265 par. 2)

Classification of Deficiencies in Internal Control

7.47 You should determine whether you have identified one or more deficiencies in internal control. If you have identified such deficiencies you should evaluate each deficiency to determine whether the deficiencies, individually or in combination, are significant deficiencies. (ISA 265 par. 8)

A significant deficiency is a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. (ISA 265 par. 6)

Appendix F, "Assessing the Severity of Identified Deficiencies in Internal Control," of this publication contains additional examples to assist auditors in evaluating the severity of an identified deficiency in internal control.

7.48 Paragraph A7 of ISA 265 identifies the following indicators of significant deficiencies in internal control:

- Evidence of ineffective aspects of the control environment, such as the following:
  - Indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance
  - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control
  - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified
- Evidence of an ineffective response to identified significant risks (for example, absence of controls over such a risk)
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control
- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud
- Evidence of management's inability to oversee the preparation of the financial statements

Evaluating Deficiencies in Internal Control

7.49 You are required to evaluate each deficiency in internal control identified during the audit to determine, whether such deficiency individually or in combination with others, constitute significant deficiencies. (ISA 265 par. 7–8) A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct, a misstatement of the financial statements on a timely basis. (ISA 265 par. 6) The severity of a deficiency or combination of deficiencies, considers not only whether a misstatement has actually occurred but also

- the magnitude of the potential misstatement that could result from the deficiency or deficiencies and
- whether there is a reasonable possibility that the client's controls would fail to prevent, or detect and correct, a misstatement of an account balance or disclosure. A reasonable possibility exits when the chance of the future event or events occurring is more than remote.

Observations and Suggestions

To be clear, a control deficiency does not need to cause a misstatement in order for it to be a significant deficiency or just a deficiency. Likelihood of occurrence and potential materiality help classify the severity of a deficiency. However, a misstatement often implies that an internal control has failed, either in design or operating effectiveness. Similarly, the severity of a deficiency is not measured by the size of any associated misstatement, but by the likelihood and magnitude criteria. However, it would be difficult to see how the severity of a deficiency might be less than its observed magnitude, thus a material misstatement is an indicator of a failure in controls.

7.50 That a misstatement of the financial statements did not occur is not relevant to your identification of a deficiency or your evaluation and does not provide evidence that identified deficiencies are not significant deficiencies. Your evaluation of the severity of deficiencies depends on the potential for misstatement during the period under audit, not on whether a misstatement actually has occurred. Chapter 2 of this publication provides more guidance on the definition of *deficiency in internal control and a significant deficiency*.

7.51 Professional judgment is required to evaluate the severity of deficiencies in internal control, either individually or in combination. In making this judgment, factors that may affect the likelihood that a control could fail to prevent or detect and correct a misstatement, include, but are not limited to, the following:

- The nature of the financial statement accounts, classes of transactions, disclosures, and assertions involved; for example, suspense accounts and related party transactions involve greater risk
- The cause and frequency of the exceptions detected as a result of the deficiency or deficiencies
- The susceptibility of the related assets or liabilities to loss or fraud
- The subjectivity and complexity or extent of judgment required to determine the amount involved
- The interaction or relationship of the control with other controls
- The interaction among the deficiencies
- The possible future consequences of the deficiency
- The importance of the controls to the financial reporting process

7.52 Factors affect the magnitude of a misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity (in the current period or expected future periods) in the account or class of transactions exposed to the deficiency

The maximum amount by which an account balance or total of transactions can be overstated generally is the recorded amount, whereas understatements could be larger.

Table 7-3 provides examples of how you might consider likelihood and magnitude when evaluating the severity of a deficiency in internal control.

Table 7-3

Consideration of Likelihood and Magnitude

Factor to Consider	*Examples*
Likelihood of Misstatement	The following are examples of deficiencies in internal control and how their likelihood might be considered: • Failure to obtain required authorization for a valid disbursement. (In this case, you consider the likelihood of a misstatement resulting from recording an unauthorized disbursement.) • A deficiency identified as a result of a financial statement misstatement. (In this case, there is at least a reasonable possibility that a misstatement could occur because it did occur.)
Magnitude of Misstatement	When evaluating the magnitude of a potential misstatement resulting from a deficiency in internal control, you may consider the volume of activity in the account balance or class of transactions that would be exposed to the deficiency. You also may consider any effective compensating controls. A compensating control is a control that limits the severity of a deficiency and prevents it from rising to the level of a significant deficiency. Its precision is determined by the effectiveness of the procedure. The following is an example of a deficiency and how its magnitude might be considered when there is a compensating control:

(continued)

Factor to Consider	*Examples*
	An owner-managed entity does not segregate duties within the accounts payable function. As a compensating control, the owner reviews the supporting documentation for all disbursements exceeding $1,000. You would evaluate the effect of this compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the deficiency in the accounts payable function (the lack of segregation of duties).

Deviations in the Operations of Controls

7.53 A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively. When you test the operating effectiveness of controls, you may encounter deviations in their operation; for example, the control was not performed properly. When you identify control deviations and the deviation rate in the sample exceeds the expected deviation rate, you would conclude that deficiencies in the control exist. To evaluate the severity of a deficiency in internal control identified in your tests of controls, you will want to assess the potential magnitude of the related financial statement misstatement as discussed previously.

7.54 When you obtain evidence that a control does not operate effectively, you may become aware of indirect or compensating controls that, if effective, may limit the severity of the deficiency and prevent it from being a significant deficiency. In these circumstances, although you are not required to consider the effects of these compensating controls for the purpose of evaluating the severity of the deficiency; you may choose to do so.

7.55 To consider the effects of an indirect (for example, compensating) control when evaluating the severity of a deficiency in a control that does not operate effectively, you would evaluate the design and test the compensating control for operating effectiveness as part of your financial statement audit. Compensating controls can limit the severity of the deficiency, but they do not eliminate the deficiency.

7.56 Identified deficiencies in internal control that individually are not significant deficiencies may—when aggregated with other deficiencies in internal control—constitute a significant deficiency. As such, you should evaluate each deficiency to determine whether individually or in combination they constitute significant deficiencies. (ISA 265 par. 7–8) Multiple deficiencies that affect the same significant financial statement account or disclosure, assertion, or component of internal control may increase the risks of material misstatement to such an extent to give rise to a significant deficiency, even though such deficiencies, when evaluated individually, may be less severe.

Observations and Suggestions

Under these circumstances, you may determine that management failed to identify a material misstatement that your audit eventually uncovered. Even if management corrects the financial statements to properly account for the sale-leaseback, your identification of the matter, combined with their lack of identification of the matter, may lead you to determine that a significant deficiency exists in the controls relating to nonroutine transactions and possibly in other areas (for example, the control environment or the oversight of the financial reporting process by those charged with governance).

To help the client strengthen its internal control and eliminate the need for you to communicate a significant deficiency, you and your client will need to

- have a clear understanding of your respective responsibilities relative to the preparation of the financial statements and the implementation and maintenance of internal control.
- establish a clear understanding of the status of the financial information that is being presented to the auditor (for example, an incomplete draft of the financial statements) and what is expected of the auditor.

Process for Evaluating Deficiencies in Internal Control

7.57 When evaluating the severity of a deficiency in internal control, the first step is to determine whether the control deficiency is a significant deficiency. Some questions to consider when making this determination include the following:

- Is it reasonably possible that a misstatement of any magnitude could occur and not be prevented or detected and corrected on a timely basis by the client's internal control?
- Is the magnitude of a potential misstatement material to the financial statements? A misstatement is material, either individually or when aggregated with other misstatements, if it would cause the entity's financial statements to be materially misstated.

If the answer to both questions is *yes*, then the deficiency may be considered a significant deficiency.

7.58 Deficiencies considered important enough to merit the attention of those charged with governance are classified as significant deficiencies. Paragraph 7.48 contains additional information that may be useful in making the determination of whether a control deficiency is considered a significant deficiency.

Communication of Internal Control Matters

Observations and Suggestions

Before you communicate the existence of any significant deficiencies, you may need to clarify for your clients the role you can play with respect to their internal control. An auditor cannot be a part of a client's internal control.

How you respond to your client's deficiencies in internal control, in terms of designing and performing further auditing procedures, does not affect or mitigate the client's deficiencies in internal control. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a deficiency in internal control does not change the deficiency.

Form

7.59 Deficiencies identified during the audit and evaluated as significant deficiencies should be communicated in writing to those charged with governance on a timely basis. Such significant deficiencies include those that were remediated during the audit. (ISA 265 par. 9)

Observations and Suggestions

Management may already know of the existence of significant deficiencies, and the existence of these deficiencies may represent a conscious decision by management, those charged with governance, or both, to accept that degree of risk because of cost or other considerations. Management is responsible for making decisions concerning costs to be incurred and related benefits. You are responsible for communicating significant deficiencies, regardless of management's decisions.

7.60 Nothing precludes you from communicating to management and those charged with governance other matters related to the client's internal control. For example, you may communicate

- matters you believe to be of potential benefit to the client, such as recommendations for operational or administrative efficiency, or for improving controls.
- deficiencies that are not significant deficiencies.

You need not communicate these matters in writing.

Content

7.61 The written communication of significant deficiencies should include

- a description of the deficiencies and an explanation of their potential effects.
- sufficient information to enable those charged with governance and management to understand the context of the communication.

(ISA 265 par. 11)

7.62 To enable those charged with governance and management to understand the context of the communication you should also include the following elements:

- The purpose of the audit was for the auditor to express an opinion on the financial statements.
- The audit included consideration of internal control relevant to the preparation of the financial statements 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 internal control.
- The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

(ISA 265 par. 11)

7.63 In some circumstances, you may include additional statements in your communication regarding

- the general inherent limitations of internal control, including management override of controls or
- the specific nature and extent of your consideration of internal control during the audit.

7.64 Management may wish to, or may be required by a regulator to, prepare a written response to the auditor's communication regarding significant deficiencies identified during the audit. Such management communications may include a description of corrective actions taken by the entity, the entity's plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency would exceed the benefits to be derived from doing so.

7.65 If such a written response is included in a document containing the auditor's written communication to management and those charged with governance concerning identified significant deficiencies, you may add a paragraph to your written communication disclaiming an opinion on such information. The following is an example of such a paragraph:

ABC Company's written response to the significant deficiencies identified in our audit has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Timing

7.66 Your written communication of significant deficiencies is best made by the report release date (which is the date you grant the client permission to use your auditor's report in connection with the financial statements), but should be made no later than 60 days following the date of the auditor's report. (ISA 265 par. A13)

7.67 For some matters, early communication to management or those charged with governance may be important because of their relative significance and the urgency for corrective follow-up action. Accordingly, you may decide to communicate certain matters during the audit. These matters need not be communicated in writing during the audit, but significant deficiencies should ultimately be included in a written communication, even if they were remediated during the audit. (ISA 265 par. 9)

Observations and Suggestions

Your client may ask how it is possible to express an unqualified opinion on the financial statements when significant deficiencies in internal control were present.

You may wish to explain that your audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect and correct material misstatements. The auditor is not part of the client's internal control.

You can express an unqualified opinion on the financial statements even though significant deficiencies in internal control are present, by performing sufficient procedures and obtaining appropriate audit evidence to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct* deficiencies in internal control; the deficiencies in internal control could still result in a material misstatement not being prevented or detected and corrected on a timely basis by the client's internal control.

Audit Documentation for Misstatements

7.68 With respect to misstatements, you should document

a. the amount below which misstatements would be regarded as clearly trivial,

b. all misstatements accumulated during the audit and whether they have been corrected, and

c. your conclusion regarding whether uncorrected misstatements, individually or in the aggregate, are material and the basis for that conclusion.

(ISA 450 par. 15)

Chapter 1, "Overview of Applying the Audit Risk Standards," of this publication provides additional, more general guidance on the preparation of audit documentation.

Summary

7.69 As a result of performing your substantive procedures, you may identify misstatements and you should accumulate all misstatements (except those that are trivial) that you identify during the audit. Those misstatements may be categorized as factual, judgmental, or projected.

7.70 *Factual misstatements* are misstatements about which there is no doubt. *Judgment misstatements* are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate. *Projected misstatements* are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in auditing a sample to the entire population from which the sample was drawn.

7.71 You should communicate on a timely basis with the appropriate level of management all misstatements accumulated, and you should request management to correct those misstatements.

7.72 You should evaluate uncorrected misstatements to determine whether they are material, either individually or in the aggregate. This evaluation of uncorrected misstatements should include a consideration of uncorrected misstatements from previous periods that continue to effect the current year's financial statements. Further, such evaluation of uncorrected misstatements should also consider possible undetected misstatements, which are discussed in paragraph 7.11.

7.73 If you evaluate the uncorrected misstatements as not material, you may conclude that the financial statements are free of material misstatement. If you evaluate the uncorrected misstatements as material then the financial statements contain a material misstatement, and you should modify your auditor's report accordingly.

7.74 In the course of performing your audit, you may identify deficiencies in internal control, which you will need to evaluate and communicate to management.

7.75 Deficiencies in internal control may range in severity from inconsequential to significant deficiencies. For deficiencies in internal control not specifically identified as ordinarily significant deficiencies, you determine their severity by considering the likelihood and significance of any misstatement that could result from the deficiency. That process notwithstanding, once you have made an initial evaluation of the severity of a deficiency in internal control, you should consider whether prudent officials, in the conduct of their own affairs, would agree with your conclusion about the deficiency.

7.76

Appendix — Answers to Frequently Asked Questions About Evaluating Audit Findings, Audit Evidence, and Deficiencies in Internal Control

Question	*See Paragraphs*
How is materiality used at the end of the audit to evaluate misstatements?	7.05–08
What is the distinction among factual, judgmental, and projected misstatements? How are these types of misstatements considered when determining whether the financial statements are free of material misstatements?	7.09–10
How do I evaluate the results from substantive analytical procedures, sampling, and differences in estimates?	7.12–21
What misstatements should I communicate to management? What requests should I make of management with regard to these misstatements?	7.22–25
How do I evaluate uncorrected misstatements to determine whether the financial statements are *presented fairly in all material respects*?	7.26–33
How do prior year's uncorrected misstatements affect my determination of whether the current year's financial statements are presented fairly?	7.34–37 and appendix E
How do I know if I have obtained enough audit evidence to support my audit opinion?	7.42–43
What is the difference between a control deficiency and a significant deficiency?	7.47
What steps should I follow to evaluate deficiencies in internal control?	7.57
If I identify deficiencies in internal control, what should I communicate to management? When should I make this communication?	7.59–67
What matters regarding the evaluation of audit findings should I document?	7.68

Part 2
Additional Resources

Appendix A

Considerations in Establishing the Overall Audit Strategy[1]

A.01 This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters also will influence the auditor's detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. Although some of the following matters may be required by other ISA sections, not all matters are relevant to every audit engagement, and the list is not necessarily complete.

Characteristics of the Engagement

A.02 The following are some examples of characteristics of the engagement:

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework
- Industry specific reporting requirements, such as reports mandated by industry regulators
- The expected audit coverage, including the number and locations of components to be included
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated
- The extent to which components are audited by other auditors
- The nature of the business segments to be audited, including the need for specialized knowledge
- The reporting currency to be used, including any need for currency translation for the financial information audited
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them
- The expected use of audit evidence obtained in previous audits; for example, audit evidence related to risk assessment procedures and tests of controls
- The effect of IT on the audit procedures, including the availability of data and the expected use of computer assisted audit techniques
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews
- The availability of client personnel and data

Reporting Objectives, Timing of the Audit, and Nature of Communications

A.03 The following examples illustrate reporting objectives, timing of the audit, and nature of communications:

- The entity's timetable for reporting, such as at interim and final stages
- The organization of meetings with management and those charged with governance to discuss the nature, timing, and extent of the audit work

[1] This section is reprinted from the appendix of ISA 300, *Planning an Audit of Financial Statements*.

- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters, and communications to those charged with governance
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement
- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

A.04 The following examples illustrate significant factors, preliminary engagement activities, and knowledge gained on other engagements:

- The determination of materiality, in accordance with ISA 320, *Materiality in Planning and Performing an Audit*, and, when applicable, the following:
  - The determination of materiality for components and communication thereof to component auditors in accordance with ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*
  - The preliminary identification of significant components and material classes of transactions, account balances, and disclosures
- Preliminary identification of areas in which there may be a higher risk of material misstatement
- The effect of the assessed risk of material misstatement at the overall financial statement level on direction, supervision, and review
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity
- Evidence of management's commitment to the design, implementation, and maintenance of sound internal control, including evidence of appropriate documentation of such internal control
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control
- Importance attached to internal control throughout the entity to the successful operation of the business
- Significant business developments affecting the entity, including changes in IT and business processes, changes in key management, and acquisitions, mergers, and divestments
- Significant industry developments, such as changes in industry regulations and new reporting requirements

- Significant changes in the financial reporting framework, such as changes in accounting standards
- Other significant relevant developments, such as changes in the legal environment affecting the entity

Nature, Timing, and Extent of Resources

A.05 The following examples illustrate the nature, timing, and extent of resources:

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas in which there may be higher risks of material misstatement
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas in which there may be higher risks of material misstatement

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Appendix B

Understanding the Entity and Its Environment

B.01 This appendix provides additional guidance on matters the auditor may consider when obtaining an understanding of the industry, regulatory, and other external factors that affect the entity; the nature of the entity; objectives and strategies and related business risks; and measurement and review of the entity's financial performance. The examples provided cover a broad range of matters applicable to many engagements; however, not all matters are relevant to every engagement and the list of examples is not necessarily complete. Additional guidance on internal control is contained in paragraph A42 of ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

Industry, Regulatory, and Other External Factors

B.02 Examples of matters an auditor may consider include the following:

- Industry conditions, such as the following:
  - 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

  (ISA 315 par. A17)
- Regulatory environment, such as the following:
  - Accounting principles and industry-specific practices
  - Regulatory framework for a regulated industry
  - Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities
  - Taxation (corporate and other)
  - Government policies currently affecting the conduct of the entity's business, such as the following:
    - Monetary, including foreign exchange controls
    - Fiscal
    - Financial incentives (for example, government aid programs)
    - Tariffs or trade restrictions policies
  - Environmental requirements affecting the industry and the entity's business

    (ISA 315 par. A19)
- Other external factors currently affecting the entity's business, such as the following:
  - General economic conditions
  - Interest rates and availability of financing
  - Inflation or currency revaluation

  (ISA 315 par. A22)

Nature of the Entity

B.03 Examples of matters an auditor may consider include the following:

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

(ISA 315 par. A24)

Objectives and Strategies and Related Business Risks

B.04 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 the following:

- 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 not compatible)
- 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)

(ISA 315 par. A32)

Measurement and Review of the Entity's Financial Performance

B.05 Examples of information used by management for measuring and reviewing financial performance, and which the auditor may consider include the following:

- Key ratios, trends, and operating statistics
- Key performance indicators (financial and non-financial)
- Employee performance measures and incentive compensation policies
- Forecasts, budgets, variance analysis, segment information and divisional, departmental, or other level performance reports
- Employee performance measures and incentive compensation policies
- Comparisons of an entity's performance with that of competitors

(ISA 315 par. A38)

Appendix C

Internal Control Components

C.01 This appendix further explains the components of internal control set out in paragraphs 4, 14–24, and A69–A104 of ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, as they relate to a financial statement audit.

Control Environment

C.02 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 values are essential elements of the control environment that influence the effectiveness of the design, administration, and monitoring of other components of internal control. 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. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity values and behavioral standards to personnel through policy statements and codes of conduct and by example.

b. Commitment to competence. Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

c. Participation of those charged with governance. An entity's control consciousness is significantly influenced by those charged with governance. Attributes include those charged with governance's independence from management, the experience and stature of its members, the extent of its involvement and scrutiny of activities, the appropriateness of its actions, the information it receives, the degree to which difficult questions are raised and pursued with management, and its interaction with internal and external auditors. The importance of responsibilities of those charged with governance is recognized in codes of practice and other 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 of 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. An entity's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and reviewed. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. An entity develops an organizational structure suited to its needs. 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 regarding the control consciousness of an entity. For example, standards for recruiting the most qualified individuals, with an 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.

Application to Small- and Mid-Sized Entities

C.03 Small- and mid-sized entities may implement the control environment elements differently than larger entities. For example, smaller entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Similarly, those charged with governance in smaller entities may not include independent or outside members.

The Entity's Risk Assessment Process

C.04 For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation and fair presentation 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.

Risks relevant to reliable financial reporting include external and internal events, as well as 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.

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

C.05 An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems rely extensively on IT.

C.06 The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether IT or manual, and records established to initiate, authorize, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Transactions may be initiated manually or automatically by programmed procedures. Authorization includes the process of approving transactions by the appropriate level of management. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation, whether performed by IT or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that the entity uses in measuring and reviewing the entity's financial performance and in other functions. 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.

C.07 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.

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 memorandums. Communication also can be made electronically, orally, and through the actions of management.

Control Activities

C.08 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*. This includes controls that encompass the
  - physical security of assets, including adequate safeguards, such as secured facilities over access to assets and records.
  - authorization for access to computer programs and data files.
  - 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.

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, nonroutine transactions, such as major acquisitions or divestments, may require specific high level approval, including, in some cases, that of shareholders.

Application to Small- and Mid-Sized Entities

C.09 The concepts underlying control activities in small- or mid-sized organizations are likely to be similar to those in larger entities, but the formality with which they operate varies. Further, smaller entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's retention of authority for approving credit sales, significant purchases, and draw-downs on lines of credit can provide strong control over those activities, lessening or removing the need for more detailed control activities. An appropriate segregation of duties often appears to present difficulties in smaller organizations. Even companies that have only a few employees, however, may be able to assign responsibilities to achieve appropriate segregation or, if that is not possible, to use management oversight of the incompatible activities to achieve control objectives.

Monitoring of Controls

C.10 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 also is done 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.

C.11 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; communicate information about strengths and deficiencies in internal control; and provide recommendations for improving internal control.

C.12 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.

Application to Small- and Mid-Sized Entities

C.13 Ongoing monitoring activities of small- and mid-sized entities are more likely to be informal and are typically performed as a part of the overall management of the entity's operations. Management's close involvement in operations often will identify significant variances from expectations and inaccuracies in financial data.

Appendix D

Illustrative Financial Statement Assertions and Examples of Substantive Procedures Illustrations for Inventories of a Manufacturing Company

D.01 This appendix illustrates the use of assertions in designing substantive procedures and does not illustrate tests of controls. The following examples of substantive procedures are not intended to be all-inclusive, nor is it expected that all of the procedures would be applied in an audit. The particular substantive procedures to be used in each circumstance depend on the auditor's risk assessments and tests of controls.

Illustrative Assertions About Account Balances	*Examples of Substantive Procedures*
Existence	
Inventories included in the balance sheet physically exist.	• Physical examination of inventory items • Obtaining confirmation of inventories at locations outside the entity • Inspection of documents relating to inventory transactions between a physical inventory date and the balance sheet date
Inventories represent items held for sale or use in the normal course of business.	• Inspecting perpetual inventory records, production records, and purchasing records for indications of current activity • Reconciling items in the inventory listing to a current computer-maintained sales catalog and subsequent sales and delivery reports using computer assisted audit techniques (CAATs) • Inquiry of production and sales personnel • Using the work of specialists to corroborate the nature of specialized products
Rights and Obligations	
The entity has legal title or similar rights of ownership to the inventories.	• Examining paid vendors' invoices, consignment agreements, and contracts • Obtaining confirmation of inventories at locations outside the entity
Inventories exclude items billed to customers or owned by others.	• Examining paid vendors' invoices, consignment agreements, and contracts • Inspecting shipping and receiving transactions near year end for recording in the proper period
Completeness	
Inventory quantities include all products, materials, and supplies on hand.	• Observing physical inventory counts • Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities • Inspecting shipping and receiving transactions near year end for recording in the proper period
Inventory quantities include all products, materials, and supplies owned by the company that are in transit or stored at outside locations.	• Obtaining confirmation of inventories at locations outside the entity • Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities

(continued)

Illustrative Assertions About Account Balances	*Examples of Substantive Procedures*
Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.	• Inspecting shipping and receiving transactions near year end for recording in the proper period • Examining the inventory listing for inclusion of test counts recorded during the physical inventory observation • Reconciliation of all inventory tags and count sheets used in recording the physical inventory counts using CAATs • Recalculation of inventory listing for clerical accuracy using CAATs • Reconciling physical counts to perpetual records and general ledger balances and investigating significant fluctuations using CAATs
Valuation and Allocation	
Inventories are properly stated at cost (except when market is lower).	• Examining paid vendors' invoices and comparing product prices to standard cost build-ups • Analytically comparing direct labor rates to production records • Recalculation of the computation of standard overhead rates • Examining analyses of purchasing and manufacturing standard cost variances
Slow-moving, excess, defective, and obsolete items included in inventories are properly identified.	• Examining an analysis of inventory turnover • Analyzing industry experience and trends • Analytically comparing the relationship of inventory balances to anticipated sales volume • Walk-through of the plant for indications of products not being used • Inquiring of production and sales personnel concerning possible excess or defective or obsolete inventory items • Logistic and distribution business process (for example, cycle time, volume of returns, or problems with suppliers)
Inventories are reduced, when appropriate, to replacement cost or net realizable value.	• Inspecting sales catalogs or industry publications for current market value quotations • Recalculation of inventory valuation reserves • Analyzing current production costs • Examining sales after year end and open purchase order commitments

Illustrative Assertions About Presentation and Disclosure	*Examples of Substantive Procedures*
Rights and Obligations	
The pledge or assignment of any inventories is appropriately disclosed.	• Obtaining confirmation of inventories pledged under loan agreements
Completeness	
The financial statements include all disclosures related to inventories specified by generally accepted accounting principles.	• Using a disclosure checklist to determine whether the disclosures included in generally accepted accounting principles were made

Illustrative Assertions About Presentation and Disclosure	*Examples of Substantive Procedures*
Understandability	
Inventories are properly classified in the balance sheet as current assets.	• Examining drafts of the financial statements for appropriate balance sheet classification
Disclosures related to inventories are understandable.	• Reading disclosures for clarity
Accuracy and Valuation	
The major categories of inventories and their bases of valuation are accurately disclosed in the financial statements.	• Examining drafts of the financial statements for appropriate disclosures • Reconciling the categories of inventories disclosed in the draft financial statements to the categories recorded during the physical inventory observation

Appendix E

Consideration of Prior Year Uncorrected Misstatements

E.01 At the final stage of the audit, the auditor assesses uncorrected misstatements that affect the current year financial statements to determine whether they are material, individually or in the aggregate.

E.02 Misstatements affecting the current financial statements include those arising in the current period and those that arose in a prior period that were not corrected, but still have an effect on the current financial statements. The cumulative effect of uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements.

E.03 Management may decide not to correct some misstatements remaining in the financial statements at the end of a period when they are not material. Unadjusted misstatements can arise from a variety of circumstances. For example, management may be willing to adjust for factual misstatements, but more reluctant to adjust some or all judgmental misstatements related to estimates, or projected misstatements, especially when the client disagrees with them. In addition, a projected likely misstatement from a small audit sample may not be sufficient to determine an amount to be recorded. Another example is that an insignificant accrual might not be recorded because it would have an immaterial effect on income in the current period. The balance sheet accrual misstatement will remain until it is deliberately corrected in some future period. Some misstatements may arise in one period and then correct themselves over time. For example, inventory overstatement misstatements in one period increase income in the period in which they occur, then flow through earnings of the next period (via the cost of sales) and reduce income in the next period when final inventories are "trued-up" at the end of the second period. The effects of this misstatement only affected these two periods. Similarly, over the depreciable life of an asset, mistakes in computing annual depreciation amounts will be corrected.

E.04 Over the years, several approaches to assessing the effect of current and prior year misstatements have evolved. Management and those charged with governance decide how to correct for misstatements.

- *The income-statement-focused approach.* One approach to assessing the effect of uncorrected misstatements is to focus on the combined income statement effects of current and prior year misstatements affecting current income to determine that the combined effect of these misstatements does not materially misstate current period income. An adjustment is required when the effect of the misstatements on current period income is greater than materiality.
- *The balance-sheet-focused approach.* Another approach followed by some companies and their auditors is to assess the aggregate misstatements remaining uncorrected in the year-end balance sheet and determine that misstatements that could affect future periods when they correct themselves or are corrected do not materially misstate income in future periods. An adjustment is considered to be required when the cumulative misstatements on the balance sheet exceed materiality.
- *Applying both approaches.* Other companies and their auditors apply both approaches and require an adjustment if either approach indicates an adjustment is necessary. Applying both approaches consistently over time retains the benefits of each approach and overcomes the weaknesses of each approach.

E.05 The intent of ISA 450, *Evaluation of Misstatements Identified during the Audit*, is not to prescribe the use of a specific approach, but to allow existing practice, which recognizes all of the approaches previously discussed. If past accumulated misstatements are corrected, accounting standards provide guidance on the correction of prior period misstatements.

E.06 Following are simple, but commonly encountered, examples of applying the approaches to a specific situation.

Example 1 — Accrued Sick Pay

E.07 Under generally accepted accounting principles, sick pay that is earned but not taken, and can be carried forward until paid out or taken at retirement, should be accrued. This scenario is found in some municipal school districts. Suppose that materiality for the entity was $100,000, and that in the initial year of operation, $25,000 of accrued sick pay should have been accrued, but was not corrected as it was not material. Net receipts over expenditures would be overstated by $25,000 and liabilities would be understated by $25,000. Neither the income-statement-focused approach nor the balance-sheet-focused approach would require an adjustment because neither financial statement is materially misstated under this fact pattern.

E.08 However, assume this fact pattern reoccurs annually. After 5 years, the cumulative liability would be understated by $125,000. However, because the annual misstatement of net receipts is still immaterial ($25,000), a strict application of the income-statement focused approach would ignore the growing balance sheet problem. If, at some point in time, the balance sheet liability account were partially or fully corrected, there would be an effect on current income (or a restatement of prior periods, or both) from the correction of the past uncorrected amounts.

E.09 From the balance-sheet-focused approach perspective, and only considering this one issue, the balance sheet misstatement after the fourth year would be capped at materiality, and in year 5 an accrual would need to be recognized and expense recorded for at least $25,000, as after that point, any further understatement of the liability would exceed materiality (for example, $100,000).

E.10 When there are multiple accounts and misstatements, the net aggregate of the misstatements flowing through the income statement (income-statement-focused approach) or remaining in various balance sheet accounts (balance-sheet-focused approach) would to be compared to materiality.

Example 2 — Inventory

E.11 Another example illustrates the case where prior year waived adjustments reverse through income in later periods. Although both approaches consider the implications of the reversal of any prior year waived adjustments, they do so from a different perspective. Suppose inventory was, based on sample evidence, possibly overstated by $25,000 in year 1. The amount was assessed as immaterial. The inventory account and income in year 1 would be overstated by $25,000. Neither approach to waived adjustments would require an adjustment to be made. If the inventory amount is correct in the ending balance sheet in year 2, the income-statement-focused approach would recognize that income in year 2 was *understated* by $25,000 (an immaterial amount) because the prior year unadjusted misstatement flowed through income (via increasing cost of sales and the opening inventory balance) in year 2. Under a balance-sheet-focused approach, "all has become right in the world," because the ending balance sheet in year 2 would be correct. The income statement effect of the prior year misstatement would not be considered in year 2.

E.12 Applying one approach or the other can sometimes result in different auditor actions because potential adjustments are aggregated at year end, and the potential income and balance sheet effects will differ between the two approaches. This may result in situations where one approach may indicate an adjustment is required, but the other may not.

E.13 To continue the illustration, suppose further that in year 2, instead of correcting the ending inventory, the ending inventory was again overstated, but this time by $50,000. The income-statement-focused approach would recognize the $25,000 net effect of the current and prior period misstatement on income ($50,000 year 2 overstatement minus $25,000 year 1 overstatements that reverse, create a net $25,000 overstatement of income). Under the pure income-statement-focused approach, the misstatement of the balance sheet would be ignored.

E.14 Some companies and their auditors may follow a hybrid approach that suggests that balance sheet misstatements might be considered if they breach balance sheet materiality.

E.15 The balance-sheet-focused approach would focus on the $50,000 overstatement in ending inventory. However, the balance-sheet-focused approach would cap any cumulative balance sheet misstatement at materiality ($100,000), if the cumulative balance sheet account misstatement ever increased to that level.

Strengths and Weaknesses of the Two Approaches

Income-Statement-Focused Approach

E.16 The strengths of the income-statement-focused approach (sometimes referred to as the *rollover method*) are that it considers the income effect of netting current period and prior period misstatements that are flowing through income and it is designed to determine that current income is not materially misstated. The weakness of this approach is that, if strictly applied with no consideration of the balance sheet, immaterial misstatements could accumulate over time on the balance sheet to more than material amounts. Correcting some or all of these amounts in some future period could have a significant effect on current income or force a restatement. These balance sheet misstatements also create prime opportunities for earnings management, as it can later be difficult for auditors to argue that companies should not correct amounts that auditors and companies both believe to be misstated.

E.17 The maximum exposure on balance sheet misstatement created by applying solely the income-statement-focused approach is potentially unlimited because cumulative balance sheet misstatements are not considered by this approach.

E.18 However, many companies and their auditors intuitively recognize this practical issue and may indeed cap the balance sheet misstatement at some point, but they may not have a formalized approach to deciding when and how to do this.

Balance-Sheet-Focused Approach

E.19 The strength of the balance-sheet-focused approach (sometimes referred to as the *iron curtain method*) is that aggregate misstatements in the balance sheet are capped at materiality. The weakness of this approach is that in an unusual circumstance, it could allow income in a particular year to be misstated by more than a material amount if there were a swing in the misstatements affecting income of greater than a material amount (for example, a swing between overstated and understated amounts on the balance sheet).

E.20 For example, using an inventory example, if in year 1 a $90,000 potential inventory overstatement was unadjusted, and the next year a potential $90,000 inventory understatement was unadjusted based on the balance sheet not being materially misstated, the income effect of the two misstatements would not be considered under the pure balance-sheet-focused approach. However, we know that the net income effect of the misstatements was a $180,000 understatement in year 2 because the year 1 $90,000 overstatement flowed through cost of sales to reduce income in year 2 and the $90,000 understatement in ending inventory in year 2 also worked to reduce income that year (assuming purchases were properly accounted for as a component of cost of sales). This combined effect on income exceeds materiality, even though the balance sheet at the end of year 2 is not materially misstated. The maximum exposure on income created by applying solely the balance sheet approach is nearly twice materiality (a swing between a marginally material overstatement and a marginally material understatement). It is considered rare that such an issue would arise due to one account, but it may be more common and less visible when multiple account misstatements aggregate to near-material amounts.

E.21 In this latter example, the income-statement-focused approach would recognize the net $180,000 understatement of income, and require at least an $80,000 adjustment of the income statement and inventory account (income and inventory would be adjusted upward) to determine that income is not materially misstated.

Applying Both Approaches

E.22 Some companies and their auditors, to avoid the potential weaknesses of the income or balance sheet approaches, consider the misstatements in the ending balance sheet *and* also the misstatements flowing through income in the current period, and require an adjustment to determine that neither income nor the balance sheet is materially misstated. When this approach is followed from the inception of the business, cumulative material balance sheet misstatements are unlikely to ever occur (unless materiality levels decline significantly between periods). Auditors that advocate this approach also point out that this approach provides more accurate periodic financial information to users.

E.23 The correction of all factual misstatements on an annual basis will contribute to fewer instances where balance sheet misstatements will accumulate and become troublesome in future periods.

ISA 450 Is Not Prescriptive

E.24 Paragraph 11 of ISA 450 states

> The auditor should determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor should 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
>
> *b.* 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.

E.25 Because the application of the income-statement-focused or the balance-sheet-focused or both approaches together would consider the effects of uncorrected misstatements, albeit from different perspectives, any of these approaches could be used to satisfy the requirements of ISA 450.

E.26 In recent years, companies have been more open to adjusting for all factual and some portion of judgmental or projected misstatement, so the overall differences in outcome from applying one approach versus another may be less today than in prior years. Indeed, the auditor should request management to correct all misstatements accumulated during the audit, other than those that the auditor believes are trivial. This may include the effect of prior period misstatement.

Furthermore, if understatements in some accounts and overstatements in other accounts can be validly netted, the effects of any differences in the approaches may also be mitigated.

E.27 When selecting an appropriate approach for an engagement, auditors can consider the strengths and weaknesses of the various approaches and the risks that a selected approach might have for the client and the auditor.

E.28 If the approach selected is not followed consistently from year to year, current and prior period misstatements can have an erratic effect on the reported amounts. Changing approaches might also raise the issue of whether a prior period adjustment is necessary when correcting prior period balance sheet misstatements.

Appendix F

Assessing the Severity of Identified Deficiencies in Internal Control

F.01 This appendix contains examples to help you evaluate the severity of a control deficiency identified during a financial statement audit. Like all examples, this appendix should supplement and not supplant auditor judgment. Use of the examples and analyses may result in more consistent judgments between engagements and across individual audit practices.

F.02 Additional examples of circumstances that may be classified as significant deficiencies are listed in paragraph A7 of ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*. That section of ISA 265 is reproduced in paragraph 7.48 of this publication. Additional guidance on assessing the severity of some types of deficiencies is contained within that standard. The definitions used in this appendix of deficiency and significant deficiency are also taken from that standard.

Examples of Evaluating the Significance of Deficiencies in Internal Control in Various Situations

F.03 The following examples illustrate a thought process for evaluating the significance of deficiencies in internal control in various situations. These examples are for illustrative purposes only.

Deficiency 1 — Reconciliations of Inter-Entity Accounts Are Not Performed on a Timely Basis

Situation 1A — Significant Deficiency

F.04 The entity processes a significant number of routine inter-entity transactions on a monthly basis. Individual inter-entity transactions are not material and primarily relate to balance sheet activity; for example, cash transfers between business units to finance normal operations.

F.05 A formal management policy requires monthly reconciliations of inter-entity accounts and confirmation of balances between business units. However, the entity does not have a process in place to ensure that these procedures are performed. As a result, detailed reconciliations of inter-entity accounts are not performed on a timely basis. Management performs monthly procedures to investigate selected large-dollar inter-entity account differences. In addition, management prepares a detailed monthly variance analysis of operating expenses to assess their reasonableness.

F.06 Based on only these facts, the auditor might determine that this deficiency represents a significant deficiency. The magnitude of a financial statement misstatement resulting from this deficiency is probably less than material, because individual inter-entity transactions are not material and the compensating controls operating monthly are sufficient in the auditor's judgment to detect a material misstatement. Furthermore, the transactions are primarily restricted to balance sheet accounts. However, the compensating detective controls are designed to detect only material misstatements. Because the stated control policies have not been implemented effectively and the combination of controls that are in place do not address the detection of misstatements that are less than material. The matter is important enough to warrant the attention of those charged with governance.

Further Analysis of Situation 1A

F.07 Because the entity does not have a process in place to ensure that the monthly procedures are performed, these controls were not operating, so the likelihood test has been met and the auditor proceeds to assess the potential magnitude of the deficiency.

F.08 The auditor then considers whether the exposure is more than material. Because if it is not, the auditor would apply the "prudent official" test before concluding that the deficiency is a significant deficiency.

F.09 When applying the deficiency evaluation framework, the auditor may quantify the gross exposure and assumed effectiveness of the compensating controls based on an analysis of the facts and circumstances. This may facilitate the documentation of the judgments and decisions leading to the auditor's final conclusions.

Deficiency 2 — Modifications of Standard Sales Contract Terms Are Not Reviewed to Evaluate Their Effect on the Timing and Amount of Revenue Recognition

Situation 2A — Significant Deficiency

F.10 The entity uses a standard sales contract for most transactions. Individual sales transactions are not material to the entity. Sales personnel are permitted to modify sales contract terms. Personnel in the entity's accounting group review significant or unusual modifications of the sales contract terms but do not review changes in the standard shipping terms. The changes in the standard shipping terms could cause a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. There have been a limited number of instances in which revenue was inappropriately recorded in advance of shipment, but the related amounts have not been material.

F.11 Based on only these facts, the auditor might determine that this deficiency represents a significant deficiency. The magnitude of a financial statement misstatement resulting from this deficiency could reasonably be expected to be less than material, because individual sales transactions are not material and the compensating detective controls, which operate monthly and at the end of each financial reporting period, are assessed as sufficient to limit a misstatement to less than a material amount. Furthermore, the risk of material misstatement is limited to revenue recognition misstatements related to shipping terms, as opposed to broader sources of misstatement in revenue recognition. However, the compensating detective controls are designed to detect only material misstatements. These compensating controls do not effectively address the detection of misstatements that are less than material, as evidenced by situations in which transactions were improperly recorded. Therefore, it would seem that this situation is important enough to merit attention of those charged with governance.

Further Analysis of Situation 2A

F.12 The description of situation 2A indicates that the entity does not have a control to review changes in shipping terms, which is an identified risk for this business. Analysis of this design weakness meets the likelihood criteria and is then evaluated regarding the potential magnitude of the deficiency when assessing its severity.

F.13 Management's review of gross margins and period-end inventories are noted as compensating controls.

F.14 The gross dollar exposure of transactions exposed to the deficiency is noted as less than material. The effectiveness of the compensating controls is not specifically quantified, but the description of the preceding situation states that these controls were designed to detect only material misstatement, thus they probably would not be useful in limiting the deficiency to inconsequential.

F.15 The severity of the deficiency may be limited to a significant deficiency based on the compensating controls.

F.16 The auditor might further consider the reasonableness of the assertion that the compensating controls would limit misstatements to less than a material amount by considering the tests management performed and the threshold that management used for investigating differences, and noting evidence that the review was performed. This assessment would serve as a basis for the auditor's judgment that the likelihood of a material misstatement as a result of this deficiency is remote.

F.17 The deficiency needs to be further considered relative to the "prudent official" consideration before concluding that the deficiency is limited to a significant deficiency.

F.18 Even though misstatements related to this issue were not detected in the past, this is not evidence that an effective control is in place. The focus should be on the *potential* misstatement due to the design deficiency.

F.19 When assessing the severity of the deficiency, the auditor may quantify the exposure and assumed effectiveness of compensating controls based on an analysis of the facts and circumstances. This may facilitate the documentation of the judgments and decisions leading to the auditor's final assessment.

Deficiency 3 — IT General Control Deficiency—Security and Access

F.20 The entity has an Internet connection that enables sales personnel to communicate sales information back to the company on a timely basis and use selected entity applications, such as time and expense reporting. Access through the Internet is restricted to selected applications that are necessary for the users' purpose. An assessment of the password and firewall protection indicates an effective design to prevent unauthorized third-party access.

F.21 The entity provides a standard software platform image[1] on the workstations of all employees connected to its internal network. There is password protection at the network level. The image includes all of the accounting software packages used.

F.22 No issues have been reported relating to Internet or internal network security or access controls.

Situation 3A — Not a Deficiency

F.23 The entity uses an effective application-level password system that permits access to application level programs and data only to authorized individuals. Based on an analysis of personnel duties and their access, the auditor assesses, supported by observation, inquiry, and an examination of evidence, that the access and security control design is appropriate to achieve both segregation of duties and effective security and access control.

Further Analysis of Situation 3A

F.24 Neither management nor the auditor has identified any design or operating deficiencies related to the Internet access of sales personnel.

F.25 The use of a standard software platform image that lists all accounting applications and data sources (rather than only the applications and data available to the specified user) is a potential security and access IT general control deficiency. However, the implementation of effective application and data level security that restricts access to only authorized persons is considered a sufficiently strong control to achieve the control objective.

Situation 3B — Control Deficiency

F.26 Neither management nor the auditor have identified any design or operating deficiencies related to the Internet access of certain software packages by sales personnel.

F.27 However, in this situation, the network does not control access to various applications once the user has logged in. Access to all accounting software and data is available to all employees from all employee office workstations. The honesty of employees and the perceived lack of competence of unauthorized individuals to initiate and authorize transactions or change data in the system (because they have not received training) has been the chief source of comfort to management regarding the risk of fraud or loss. Management also has taken comfort from the lack of any detected problems to date.

Further Analysis of Situation 3B

F.28 Based on the fact pattern, from an IT general controls perspective, this situation would be considered a significant deficiency because control over access to the internal network system is ineffective in preventing unauthorized persons from creating a material misstatement or

[1] Every computer lists all the software application options.

fraud. Also, there is no application level security to prevent any individual who is logged into the system from initiating and processing a transaction within the system. Thus, application level controls are not able to detect that unauthorized transactions might have been posted to the various accounts, a significant fraud risk. Redundant or compensating controls that achieve the same control objective were not identified.

F.29 Even if specific deficiencies at the application level were not identified, the deficiency at the IT general control level might preclude reliance on the underlying application controls over the period of time the deficiency existed. Although ineffective general IT controls do not by themselves cause misstatements, they may permit application controls to operate improperly and allow misstatements to occur and not be detected. For example, if deficiencies in the general IT controls over access security exist and applications are relying on these general controls to prevent unauthorized transactions from being processed, such general IT control deficiencies may have a more severe effect on the effective design and operation of the application control. General IT controls are assessed with regard to their effect on applications and data that become part of the financial statements.

F.30 In this situation the entity did not identify any compensating controls that would limit the severity of the weakness to less than materiality.

F.31 The fact that no issues have been identified regarding this matter is not relevant in its potential classification for audit purposes as a significant deficiency.

F.32 This weakness might preclude the auditor from concluding that the security and access component of IT general controls was effective for purposes of relying on the continued operation of application controls during the period. Even if the auditor did not wish to rely extensively on application controls, the ineffective design of the security and access controls provides easy access for fraud or error to be introduced into the financial statements. Furthermore, ineffective security and access controls could permit an individual to modify accounting applications or data and then also disguise the changes to escape detection.

Deficiency 4 — IT General Controls—Lack of a Formal Process for Changes in Application Controls

F.33 The entity lacks a formal documented process to ensure that changes in programs that relate to accounting application packages are authorized and implemented effectively, including appropriate testing of the changes. The entity does not rely on any spreadsheets for accounting functions and all transactions are processed directly through the accounting software.

Situation 4A — Not a Deficiency

F.34 The entity uses only packaged software applications, as its accounting needs are very simple. The packaged software systems used do not have functions that enable the entity to modify the operation of the software. No new versions of the software were installed during the year.

Further Analysis of Situation 4A

F.35 The "change control" element within the IT general control environment is not relevant to this entity because the software cannot be modified. Thus, the lack of a formal change control function is not currently considered an IT general control deficiency for this company in this period.

F.36 This conclusion is analogous to a situation in which no new systems are implemented during the period of the financial statements. In this case, deficiencies in the general IT controls over application system acquisition and development may not be relevant to the financial statements being audited.

Situation 4B — A Potential Significant Deficiency

F.37 The entity's accounting and financial reporting related application software is relatively sophisticated and permits customization by the entity. Each year, a number of changes are made to the software to improve performance or respond to the changing business needs of the entity. Although change control procedures and controls do exist, and qualified programmers seem to be used, tests and past experience indicate that these controls are not working at a

highest level of reliability, and several inconsequential errors were detected in the current year that were traced back to change control procedures.

Further Analysis of Situation 4B

F.38 The existence of issues arising from the change control procedures indicates a deficiency of some magnitude. The facts of the situation do not indicate that there are compensating controls that achieve the same control objective. Further analysis of the potential severity of the deficiency indicates that there *are* compensating controls at the user and monitoring levels that are effective in limiting the severity of the deficiency to less than materiality. These controls were assessed as effective in limiting the severity of the deficiency to less than a significant deficiency based on their ability to detect certain issues in the current period.

F.39 Even though the identified deficiencies were inconsequential, the auditor may conclude that inconsequential misstatements might not always be detectable on a timely basis by the compensating controls and therefore would merit the attention of those charged with governance.

Appendix G

Matters to Consider in Determining Performance Materiality

G.01 You should determine an amount lower than the materiality level for the financial statements as a whole for purposes of designing further audit procedures to respond to risks of material misstatement and significant risks. This lower amount is called *performance materiality*. Establishing performance materiality creates an allowance for the possibility that individually immaterial misstatements could, in the aggregate, be significant or material, and it allows for the possibility that undetected misstatements may exist after the auditor applies procedures to the populations. Both the consideration of possible aggregate misstatements and creating an allowance for possible undetected misstatements are considerations when planning any audit.

G.02 Some auditors may use a fixed proportion of materiality to establish performance materiality, which is then applied to all accounts. The performance materiality percentages of materiality commonly used by auditors include thresholds between 50 percent and 75 percent of materiality. However, a fixed dollar amount (or fixed proportion of materiality) may not be the most effective and efficient approach to use in every engagement. Unfortunately, precise calculations of the optimal relation between materiality and performance materiality would have to be worked out on an engagement-by-engagement basis and perhaps an account-by-account basis using a statistical framework, and might also consider the relative costs of auditing various accounts. In most cases, making such a precise determination is impractical. Thus, the use of a generally conservative rule of thumb is a commonly applied approach and does simplify the judgment process.

G.03 Although in some cases performance materiality may appropriately be set closer to materiality, in other cases a greater cushion is needed to ensure that when the overall audit results are aggregated, an adequate allowance for undetected misstatement (further possible misstatement in addition to factual, judgmental, and projected misstatements) has been made, thus supporting an overall "low risk" audit conclusion.

G.04 Performance materiality need not be set at the same amount for each account. The objective is to set the performance materiality amounts at the planning stage so that after aggregating the audit results there remains a sufficient allowance for undetected misstatement to support the conclusion that a low risk audit has been performed. For example, at the end of an audit, aggregate misstatements consisting of factual, judgmental, and projected misstatement totals $85,000 and materiality is $100,000, the auditor should consider if the nature, timing, and extent of the aggregate procedures performed indicate that there is a low risk that $15,000 or more of undetected misstatement remains in the remaining untested populations. If not, additional procedures or an adjustment of some of the misstatements may need to be performed for the auditor to conclude at a low risk that the financial statements are not materially misstated or additional adjustments need to be made to reduce potential undetected misstatements.

G.05 For example, if only one account balance or stream of transactions is significant to the financial statements and the primary source of assurance for that account is derived from a single substantive procedure of details and other accounts will be able to be tested with relative certainty, then performance materiality might be set closer to materiality. When there are numerous accounts where uncertainty exists or the results of numerous tests at various locations, performance materiality might be set at 50 percent or less of materiality. Across many engagements, ranges of 50 percent to 75 percent (performance materiality as a percentage of materiality) are often observed. Although some auditors set a single relationship for all accounts, others may vary the relationship somewhat to reflect risk and efficiency characteristics. Whether the relationship between performance materiality and materiality is varied between accounts, the audit risk and allowance for sampling risk is still to be determined for the aggregate of samples.

In practice, some auditors have found that initially setting the performance materiality at a lower threshold, such as 50 percent better motivates auditors to consider and document the reasons that the performance materiality should be set at a higher level, and thus justify a reduced audit effort.

When performing multiple tests on an account balance or class of transactions, the concept of tolerable misstatement is applied to the test. In the same way performance materiality "steps down" from materiality, tolerable misstatement "steps down" from performance materiality when, for example, only a portion of the total population is involved in the test, the test needs to allow for expected misstatement in the results and when multiple estimation or sampling results will need to be combined when summarizing results for the account, balance, or class of transactions.

Table G-1

Factors to Consider in Setting Performance Materiality

Factor to Consider in Setting Performance Materiality	*Conditions Leading to a Performance Materiality Much Lower Than Materiality*	*Conditions Leading to a Performance Materiality Closer to Materiality*	*Comments*
Expected total amount of factual and judgmental and projected misstatements (based on past significant misstatements and other factors).	A greater number of misstatements.	A lesser number of misstatements.	The allowance for undetected misstatements is typically greater when more misstatements are identified.
Management's attitude toward proposed adjustments.	Management is generally resistant to adjustments.	Management is open to considering adjustments and usually corrects all known misstatements and many likely misstatements.	More adjustments of factual and judgmental and projected misstatements will lessen the amount needed to allow for undetected misstatements.
Number of accounts where amounts will be subject to estimation and will not be able to be determined with precision.	A significant number of accounts.	One or a few accounts.	A greater allowance for undetected misstatements is needed when there are more accounts that are subject to estimation procedures.
Locations, subsidiaries, or samples within an account where separate procedures are applied for each location but that will be aggregated in reaching audit conclusions.	A significant number of locations, subsidiaries, or samples within an account.	One or a few locations, subsidiaries, or samples within an account.	A greater allowance for undetected misstatements is needed for the imprecision of many samples.

Note: In any sample, the projected misstatement is not "the amount" that corrects the financial statements. This is because of the inherent limitations of a sample in providing precise results.

The statistical limits of the projection (generally unknown for nonstatistical samples) provide reliable limits (upper or lower) on the amounts at a specified confidence (assurance) level. Consequently there is a high probability that *some* of the projected misstatement is indeed misstated and could, with confidence, be proposed as an adjustment to the financial statements. The projected amount is the best (most likely) estimate of the misstatement.