Small and
Medium
Practices
Committee

Implementation Guide
December 2007

Guide to Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities

International Federation
of Accountants

The mission of the International Federation of Accountants (IFAC) is to serve the public interest, strengthen the accountancy profession worldwide and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession's expertise is most relevant.

Copies of this document may be downloaded free of charge from the IFAC website at http://www.ifac.org.

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Preface

This Guide was commissioned by the IFAC Small and Medium Practices (SMP) Committee to assist practitioners on the audit of small- and medium-sized entities (SMEs) and to promote consistent application of the International Standards on Auditing (ISAs).

The Guide, while developed by the Canadian Institute of Chartered Accountants (the CICA), is the full responsibility of the IFAC SMP Committee. International Auditing and Assurance Standards Board (IAASB) staff and a global advisory panel with members drawn from a broad cross-section of IFAC member bodies have assisted in reviewing the Guide.

The Guide provides non-authoritative guidance on applying ISAs issued by the IAASB as at December 31, 2006 as set out in the 2007 edition of IFAC's *Handbook of International Auditing, Assurance, and Ethics Pronouncements*.[1] The Guide is not to be used as a substitute for reading the ISAs, but rather as a supplement intended to help practitioners understand and consistently implement these standards on SME audits.

The Guide provides a detailed analysis of the ISAs and their requirements in the context of an SME audit. It addresses, amongst other things: the key concepts underlying risk assessment; planning and performing risk assessment procedures; understanding the client; responding to risks; evaluating audit evidence; and reporting. In addition, the Guide offers some useful practice aids and an in-depth illustrative case study based on a typical SME audit. It does not, however, provide a comprehensive toolkit with all the accompanying forms, checklists and programs necessary for conducting an audit.

The Guide is intended to explain and illustrate so as to develop a deeper understanding of an audit conducted in compliance with ISAs. This Guide provides practitioners with the analysis and some of the tools needed to effectively and efficiently implement ISAs. It offers a practical "how-to" audit approach that practitioners may use when undertaking a risk-based audit of an SME.

Ultimately it should help practitioners conduct high quality, cost-effective SME audits and so enable them to better serve the public interest. We also see it being used by member bodies, audit firms, and others as a basis for educating and training professional accountants and students.

We hope that member bodies and audit firms will use the Guide, either as it is, or tailored to suit their own needs and jurisdiction. We believe the Guide will be a basis from which member bodies and others can develop "derivative products" such as training materials, audit software, checklists, forms, and audit programs.

Sylvie Voghel
Chair, IFAC SMP Committee
December 2007

[1] For a free download go to: http://www.ifac.org/Store/Details.tmpl?SID=11707139611377889&Cart=11764775554101525

Request for Comments

This is the first version of the Guide. While we consider this Guide to be of high quality and useful in its present form, like any first edition it can be improved. Hence, we are committed to updating this Guide on a regular basis so as to ensure it reflects current standards and is as useful as possible.

The next update is scheduled for late 2009 and will be based on the newly clarified ISAs that take effect for audits of periods beginning on or after December 15, 2009.[2] In order to ensure the second version is even more useful than this one, we welcome comments from national standard setters, IFAC member bodies, practitioners, and others over the coming 18 months. These comments will be used to assess the Guide's usefulness and to improve it prior to publishing the second edition. Indeed, we may in due course undertake a survey of users. In particular, we welcome views on:

1. **How do you use the Guide? For example, do you use it as a basis for training and/or a practical reference guide, or in some other way?**
2. **Is the cross-referencing to the ISAs sufficient for you to easily refer to the ISAs while reading the Guide?**
3. **Do you believe that the Guide has appropriately integrated all of the relevant ISAs into the audit process?**
4. **Do you consider the guidance to be conducive to the performance of an efficient, effective and economic ISA-compliant audit of smaller entities?**
5. **Do you find the illustrative case study helpful? In particular, do you consider the case study example documentation to be comprehensive and of practical assistance, particularly in connection with the audit of smaller owner-managed businesses?**
6. **Do you find the Guide is easy to navigate? If not, can you suggest how navigation can be improved?**
7. **In what other ways do you think the Guide can be made more useful?**
8. **Are you aware of any derivative products – such as training materials, audit software, forms, checklists, and programs – that have been developed based on the Guide? If so, please provide details.**

Please submit your comments to Paul Thompson, Senior Technical Manager at:

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2 See http://www.ifac.org/IAASB/ProjectHistory.php?ProjID=0024

Disclaimer

This Guide is designed to assist practitioners in the implementation of the International Standards of Auditing (ISAs) on the audit of small- and medium-sized entities, but is not intended to be a substitute for the ISAs themselves. Furthermore, a practitioner should utilize this Guide in light of his or her professional judgment and the facts and circumstances involved in each particular audit. IFAC disclaims any responsibility or liability that may occur, directly or indirectly, as a consequence of the use and application of this Guide.

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How to Use the Guide

The purpose of this Guide is to provide practical guidance to practitioners conducting audit engagements for small- and medium-sized entities (SMEs). However, no material in the Guide should be used as a substitute for:

- **Reading of the ISAs**
  It is assumed that practitioners already have a knowledge of the 2007 edition of IFAC's *Handbook of International Auditing, Assurance, and Ethics Pronouncements*.
- **Use of sound professional judgment**
  Professional judgment is required throughout the audit based on the particular circumstances and where interpretation of a particular standard is required.

While it is expected that small- and medium-sized practices (SMPs) will be a significant user group, this Guide is intended to help all practitioners to implement ISAs on SME audits.

The Guide offers a practical "how-to" audit approach that practitioners may use when undertaking a risk-based audit of an SME.

This Guide can be used to:

- Develop a deeper understanding of an audit conducted in compliance with the ISAs;
- Develop a staff manual (supplemented as necessary for local requirement and a firm's procedure) to be used for day-to-day reference and as a basis for training sessions and individual study and discussion;
- Ensure staff adopt a consistent approach to planning and performing an audit; and
- Improve communication among the audit team.

This Guide often refers to an audit team, which implies more than one person is involved in conducting the audit engagement. However, the same general principles also apply to audit engagements performed exclusively by one person (the practitioner).

Customization of the Guide

Translation
To facilitate translation, the Guide has used ISA terminology to the maximum extent possible. In situations where ISA terminology was not available for use, the author made every attempt to use terminologies that could be easily translated.

Currency
A non-specific common currency unit of CU [€] has been used. During translation, individual countries may choose to change the currency to a local or standard international currency.

National Adaptation
In situations where the national standards differ from the ISAs (whether for legislative or other reasons), this Guide should be a starting point and adapted for the national requirements.

Content and Organization

The material in the Guide follows the activities outlined in the audit process chart found later in this section.

The Guide has four major sections:

- Part A: Basic Audit Concepts;
- Part B: Risk Assessment;
- Part C: Risk Response; and
- Part D: Reporting.

Summary of Content

The following chart summarizes the content in each part of the Guide.

A: Basic Concepts	B: Risk Assessment	C: Risk Response	D: Reporting
1.1 What is a Risk-based Audit?	2.1 Understanding the Entity	3.1 Detailed Audit Plan	4.1 Evaluating Audit Evidence
1.2 Nature of Internal Control	2.2 What are Risk Assessment Procedures?	3.2 Tests of Controls	4.2 Communicating with Those Charged with Governance
1.3 Financial Statement Assertions	2.3 Client Acceptance and Continuance	3.3 Substantive Procedures	4.3 The Auditor’s Report
	2.4 Overall Audit Strategy	3.4 Summary of ISAs not Addressed Elsewhere	4.4 Modifications to the Auditor’s Report
	2.5 Materiality	3.5 Extent of Testing	
	2.6 Audit Team Discussions	3.6 Documenting Work Performed	
	2.7 Business Risks	3.7 Management Representations	
	2.8 Fraud Risks		
	2.9 Significant Risks		
	2.10 Internal Control		
	2.11 Assessing Internal Control Design and Implementation		
	2.12 Assessing the Risks of Material Misstatement		

Appendices

The Appendices to this Guide include five additional resources:

- Appendix A —Forms of Internal Control Documentation;
- Appendix B — Walk-through Procedures;
- Appendix C —Risk Management Overview;
- Appendix D — Nature of Fraud; and
- Appendix E — Making Audit Inquiries.

Summary of Organization

Each chapter in this Guide has been organized in the following format:

- **Chapter Title**
- **Audit Process Chart – Extract**

  Most chapters contain an extract from the audit process chart (where applicable) to highlight the particular activities that will be addressed in the chapter. This chart is presented in its entirety in the section entitled The Audit Process.
- **Chapter Purpose**

  This outlines the content and purpose of the chapter.
- **Principal ISAs**

  The ISAs noted in bold at the start of each chapter refer to those standards that are most applicable to the subject matter addressed. This is not meant to infer that other ISAs are not applicable or do not need to be considered. For example, ISAs such as 200, 220, and 300 have applicability throughout the audit process but have only been addressed specifically in one or two chapters.
- **Overview and Chapter Material**

  The overview section provides:
  - The text of black letter requirements of the principal ISAs; and
  - An overview of what has been addressed in the chapter.

  The overview is followed by a more detailed discussion of the subject matter and practical step-by-step guidance/methodology on how to implement ISAs. This includes some cross-references to the applicable ISAs.
- **Consider Points**

  There are a number of Consider Points (included in a grey shaded box) located throughout the Guide. These Consider Points provide practical guidance on audit matters that can easily be overlooked or where practitioners often have difficulty in understanding and implementing certain concepts.

  The Guide also makes reference to, but does not outline, the requirements of the *IFAC Code of Ethics for Professional Accountants* (the IFAC Code) effective as of January 1, 2007 and the requirements of International Standards on Quality Control 1 (ISQC 1), "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements."

- **Case Study**
  To demonstrate how the ISAs can be applied in practice, the Guide includes a simple case study with commentary at the end of most chapters to show the practical application of the principles discussed.

  The purpose of the case study is purely illustrative. The data, analysis and commentary do not represent all of the circumstances and considerations that the auditor will need to address in a particular audit. As always, the auditor must exercise his or her professional judgment. The audit documentation provided is also illustrative. A complete audit file is outside the scope of this Guide.

The case study is based on a fictional entity, Dephta Furniture, a local, family-owned furniture manufacturer with 19 full-time employees. The entity has a simple governance structure, few levels of management, and straightforward transaction processing. The accounting function uses an off-the-shelf, standard software package.

Glossary of Terms
Refer to the glossary of terms in the 2007 edition of IFAC's *Handbook of International Auditing, Assurance, and Ethics Pronouncements* for terms that are used throughout the ISAs and in this Guide.

Acronyms Used in the Guide

Assertions	C= Completeness
	E = Existence
	A = Accuracy
	V = Valuation
CAATs	Computer assisted audit techniques
CU	Currency units (standard currency unit is referred to as "€")
F/S	Financial statements
HR	Human resources
IAASB	International Auditing and Assurance Standards Board
IC	Internal Control. The five major components of internal control are as follows:
	CA = Control activities
	CE = Control environment
	IS = Information systems
	MO = Monitoring
	RA = Risk assessment
IFAC	International Federation of Accountants
IFAC Code	IFAC Code of Ethics for Professional Accountants
IFRS	International Financial Reporting Standards
ISAs	International Standards on Auditing
ISAEs	International Standards on Assurance Engagements
IAPSs	International Auditing Practice Statements
ISQCs	International Standards on Quality Control

ISREs	International Standards on Review Engagements
ISRSs	International Standards on Related Services
IT	Information technology
PC	Personal computer
R&D	Research and development
RMM	Risks of material misstatement
RAPs	Risk assessment procedures
SME	Small- and medium-sized entities
SMP	Small- and medium-sized (accounting) practices
TOC	Tests of controls
TCWG	Those charged with governance

Other Terms Used in the Guide

Anti-fraud Controls
These are controls designed by management to prevent, detect and/or correct frauds. With respect to management override, these controls may not prevent a fraud from occurring but would act as a deterrent and make perpetrating a fraud more difficult to conceal. Typical examples are:

- Policies and procedures that provide additional accountability, such as signed approval for journal entries;
- Improved access controls for sensitive data and transactions;
- Silent alarms;
- Discrepancy and exception reports;
- Audit trails;
- Fraud contingency plans;
- Human resource procedures such as identifying/monitoring individuals with above-average fraud potential (for example, an excessively lavish lifestyle); and
- Mechanisms for reporting potential frauds anonymously.

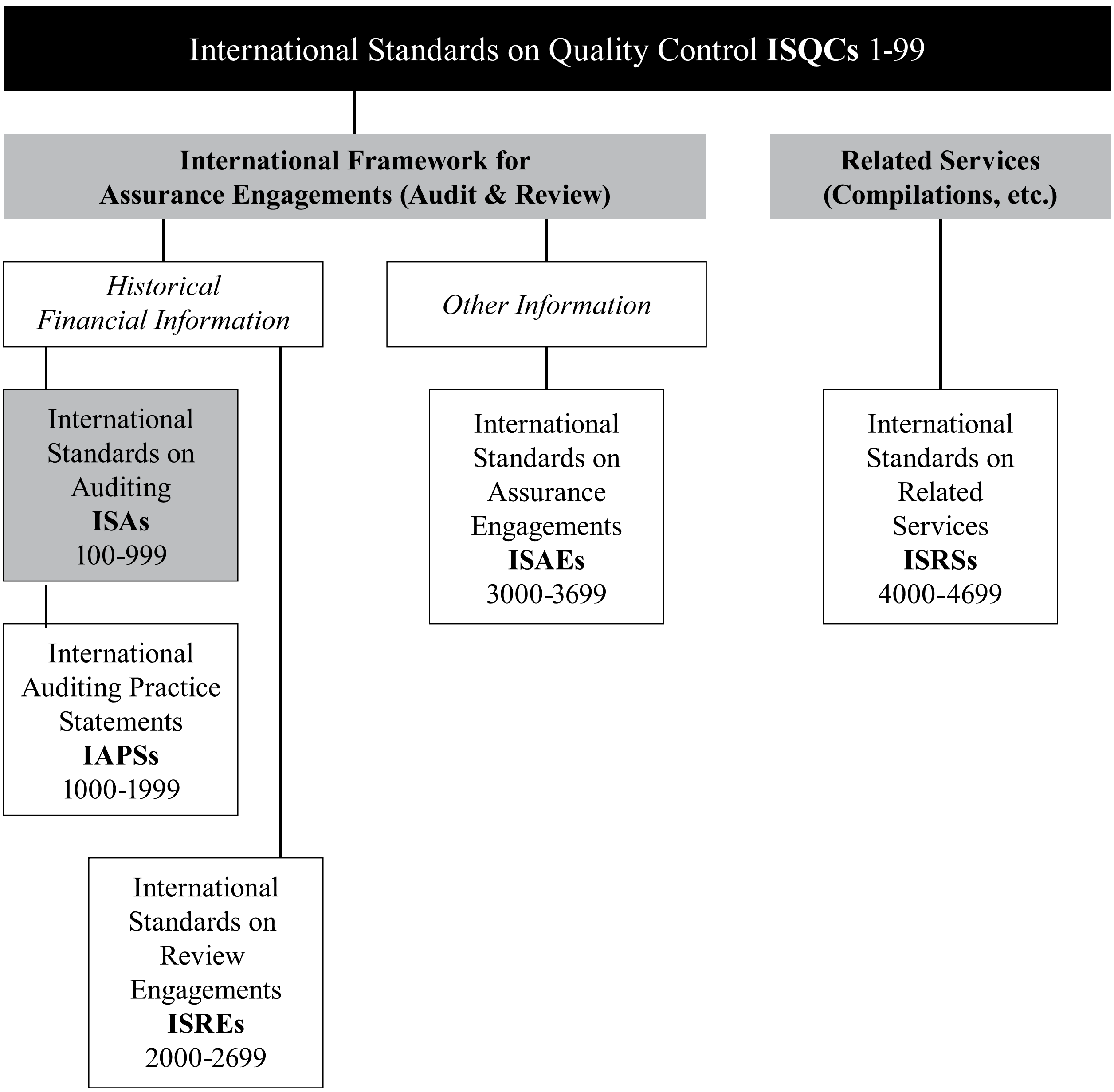
Senior Management
Senior management refers to the person or persons that has/have been assigned the highest levels of authority to manage particular aspects of the operations. These responsibilities might include the control and direction of functions such as day-to-day operations, sales and marketing, human resources, IT operations, financing activities, internal control, and the preparation and presentation of the financial statements. In smaller SMEs, many of these functions may well be the responsibility of just one or two people.

Those Charged with Governance
This term (TCWG) describes the role of persons entrusted with the supervision, control and direction of an entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting and reporting to interested parties. Those charged with governance include management only when it performs such functions. The respective

responsibilities of management and those charged with governance may vary depending on the legal responsibilities in the particular jurisdiction.

Owner-manager
This refers to the proprietors of an entity who are involved in the running of the entity on a day-to-day basis.

IAASB Pronouncements
This Guide focuses exclusively on the ISAs that apply to audits of historical financial information.



Cross-references

The following table cross-references the ISAs (relevant to SME auditing) to the corresponding chapters in the Guide. Note that many ISAs (such as the use of analytical procedures) apply at various stages of the audit. This table only includes cross-references to the principal chapters in the Guide in which the requirements are addressed. Some of the material in the ISAs is also addressed in other chapters.

ISA Reference	Title	Primary Guide Chapter
200	Objective and General Principles Governing an Audit of Financial Statements	1.1, 2.3
210	Terms of Audit Engagements	2.3
220	Quality Control for Audits of Historical Financial Information	2.3, 2.4, 4.1
230	Documentation	3.5, 3.6
240	Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements	2.6, 2.8, 2.9
250	Consideration of Laws and Regulations in an Audit of Financial Statements	3.4
260	Communication of Audit Matter to those Charged with Governance	4.2
300	Planning an Audit of Financial Statements	2.4, 2.5, 2.6, 3.1, 3.6
315	Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement	Chapters 1 and 2
320	Audit Materiality	2.5
330	Auditor's Procedures in Response to Assessed Risks	Chapter 3
402	Audit Considerations Relating to Entities Using Service Organizations	3.4
500	Audit Evidence	1.3, 3.3
501	Audit Evidence — Additional Considerations for Specific Items	3.4
505	External Confirmations	3.4
510	Initial Engagements — Opening Balances	3.4
520	Analytical Procedures	2.2, 3.3, 4.1
530	Audit Sampling and Other Means of Testing	3.5
540	Audit of Accounting Estimates	4.1
545	Auditing Fair Value Measurements and Disclosures	3.4
550	Related Parties	3.4
560	Subsequent Events	3.4
570	Going Concern	3.4
580	Management Representations	3.7
600	Using the Work of Another Auditor	3.4
610	Considering the Work of Internal Auditing	Not addressed
620	Using the Work of an Expert	3.4
700	The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements	4.3

ISA Reference	Title	Primary Guide Chapter
701	Modifications to the Independent Auditor's Report	4.4
710	Comparatives	4.3
720	Other Information in Documents Containing Audited Financial Statements	Not addressed

ISAs 610 and 720 were considered to have limited application in the audits of SMEs so they have not been addressed in this Guide.

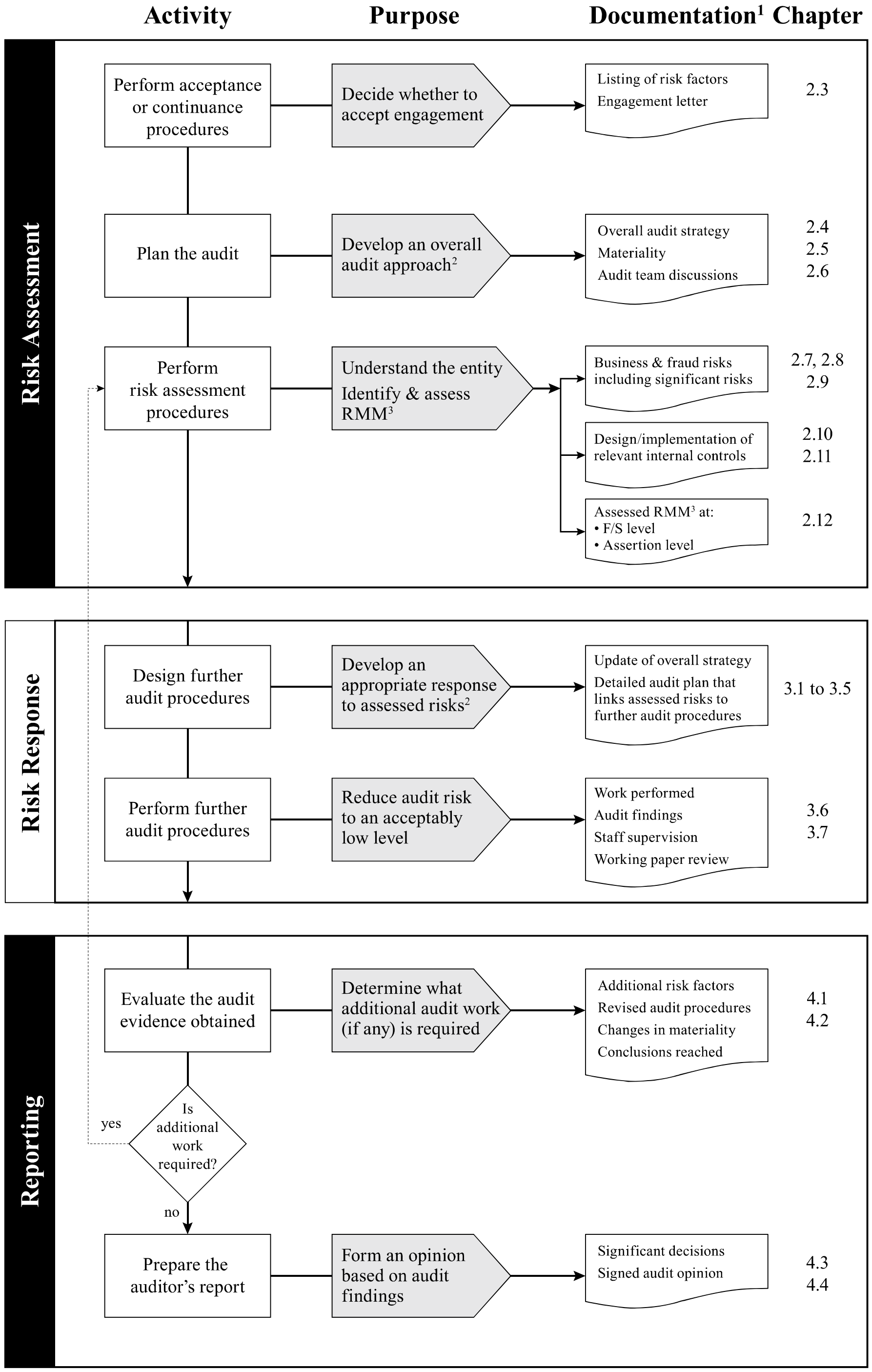
The following table cross-references the Guide's chapters to the principal ISA sections addressed.

Note: This is a general Guide. Many chapters in this Guide cover aspects addressed by more than one particular ISA.

Chapter	Title	Primary ISA Reference
1.1	What Is a Risk-based Audit?	200
1.2	Nature of Internal Control	315
1.3	Financial Statement Assertions	500
2.1	Understanding the Entity	315
2.2	What are Risk Assessment Procedures?	315
2.3	Client Acceptance and Continuance	ISQC 1, 200, 210, 220, 300
2.4	Overall Audit Strategy	220, 300
2.5	Materiality	320
2.6	Audit Team Discussions	240, 315
2.7	Understanding Business Risk	315
2.8	Understanding Fraud Risk	240, 315
2.9	Significant Risks	315, 330
2.10	Understanding Internal Control	315
2.11	Assessing Internal Control Design and Implementation	315
2.12	Assessing the Risks of Material Misstatement	315
3.1	Detailed Audit Plan	300
3.2	Tests of Controls	315, 330
3.3	Substantive Procedures (Tests of Detail)	330, 520
3.4	Summary of ISAs not Addressed Elsewhere	250, 402, 501, 505, 510, 545, 550, 560, 570, 600, 620
3.5	Extent of Testing	330, 530
3.6	Documenting Work Performed	230, 315
3.7	Management Representations	580
4.1	Evaluating Audit Evidence	220, 330, 520, 540
4.2	Communicating with Those Charged with Governance	260
4.3	The Auditor's Report	700, 710
4.4	Modifications to the Auditor's Report	701

The Audit Process

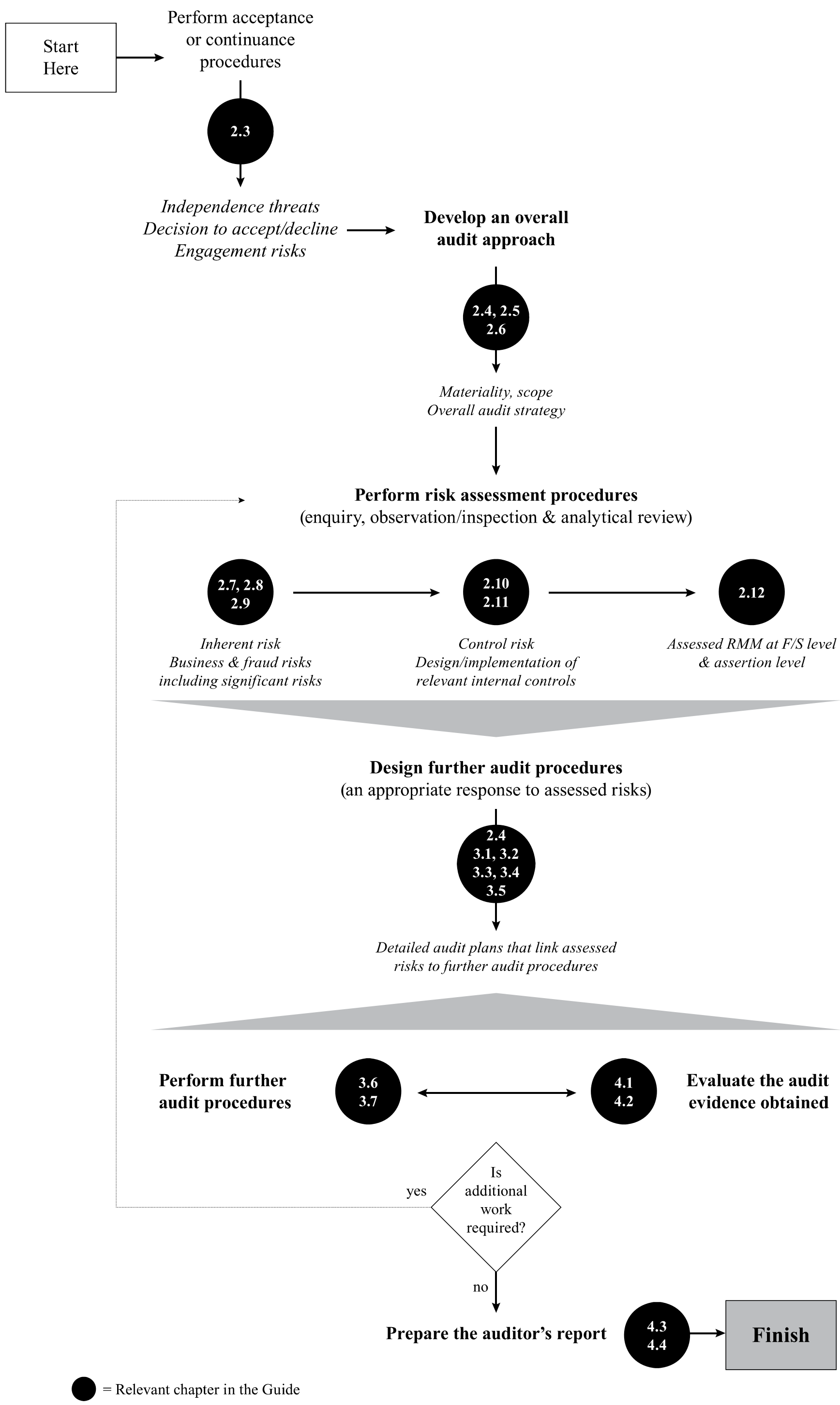
The audit approach outlined in this Guide has been divided into three phases – risk assessment, risk response and reporting. The following chart illustrates the nature of each phase and the interrelationships between the activities and phases.



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

A Road Map to the Guide

The following chart provides a "road map" to the Guide setting out the phases of the audit process and the corresponding chapters. This is a handy reference for quickly finding the chapter that corresponds to a particular phase of the audit.



Introduction to the Case Study

A case study has been developed to accompany this Guide. The purpose of the case study is to illustrate how certain sections of the ISAs can be applied in practice. The following provides background information about the fictional company, Dephta Furniture Inc., which uses the IFRS reporting framework. The chapters that follow include commentary on the case study to illustrate the concepts in practice.

Readers are cautioned that this case study is purely illustrative. The data, analysis and commentary do not represent all of the circumstances and considerations that the auditor will need to address in a particular audit. As always, the auditor must exercise professional judgment.

Dephta Furniture Inc.

Dephta Furniture Inc. is a family-owned furniture manufacturing company. It produces various kinds of wooden household furniture, both ready-made and custom built. Dephta has an excellent reputation for producing quality products.

The company has three major product lines: bedroom sets, dining room sets, and tables of all sorts. Standard pieces of furniture can also be customized for specific needs. Recently, the company supplied a very unique dining room set to a local celebrity and, as a result, received a lot of press coverage. Amid a lot of excitement (and concern) by family members, they recently set up a web page where people can buy furniture directly and pay by credit card. During the last year, the company shipped custom orders as far as 900 kilometres away.

The manufacturing facility is located on an acre of land adjacent to owner Suraj Dephta's house. An addition on the west side of Suraj's home acts as Dephta Furniture's shop. Major decisions are often made around the dining room table (which is the first table that Suraj and his father built together). He likes the symbolism of sharing a meal on the product that produces his family's money for food.

Industry Trends

The furniture industry is expanding due to:

- A growing economy (more people can afford good furniture);
- Availability of skilled labour;
- Government policies that encourage business development; and
- Local lumber mills that can now produce raw materials at a competitive rate.

Because of this growth, the furniture industry is attracting new players and there is some consolidation of smaller manufacturers by larger, more profitable manufacturers. Retailers are placing larger orders but only in exchange for lower prices. This demand is driving production in assembly-line style factories that have a few standard product lines. As a result, the market for traditional, handcrafted furniture, for which the region was known, is beginning to dwindle.

Governance

The company was started in 1952 by Suraj's father, Jeewan Dephta. Jeewan first made wooden spindles and banisters with one lathe in a small workshop next to the family home.

The company does not have a formal governance structure. Jeewan and Suraj prepare a business plan each year and then meet regularly (once a month) with a successful local businessman, Ravi Jain, to review their progress against the plan. They also pay Ravi to comment on the practicality of their new dreams and ideas for the business, review the operating results and provide advice on how to deal with any specific issues that have arisen.

Ravi's daughter, Parvin (a lawyer by training) usually accompanies her father to the meetings with Suraj and Jeewan. Parvin does offer some legal advice, but her true passion lies in marketing and promotion. It was Parvin's idea that Dephta Furniture should expand its boundaries and start selling their products on the Internet. She also pushed for expansion outside their local region and even to neighbouring countries. Although Jeewan is somewhat skeptical about expanding beyond local boundaries, Suraj sees this as an opportunity to expand the business and become more profitable.

Employees

Dephta Furniture Inc. has a full-time staff of 19 employees. Over eight of these employees are related in some way to the family. However, during busy periods extra people are hired to fulfill larger orders when an order deadline exists. Some weeks there is no need for temporary workers, but at other times as many as three to seven temporary workers may be employed. A few of the temporary workers return regularly but because of low pay and lack of security, the turnover is quite high, a situation which makes training a high priority.

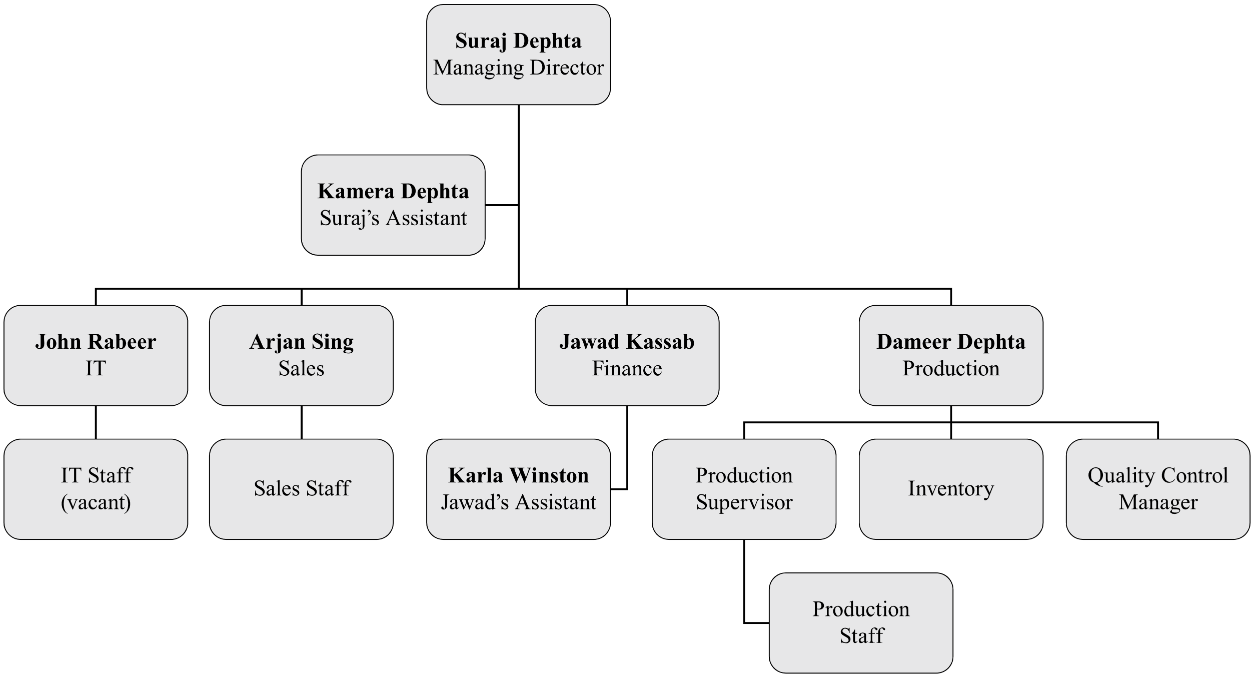
Suraj Dephta is the managing director. He oversees all aspects of the business with the help of his assistant, Kamera, who is his daughter-in-law.

Arjan Sing is in charge of sales and he is assisted by full-time salespeople.

Dameer, Suraj's brother, looks after production, which includes ordering raw materials and managing the inventory. There are also a production supervisor and a person in charge of quality control. Because the facility's space is limited, Suraj and Dameer are never too far away from the production process and so they share the task of supervising the staff.

Jawad Kassab (a cousin of Suraj) is in charge of the finance function and John Rabeer is in charge of information technology (IT).

Organizational Chart



At present the production supervisor is also responsible for inventory. Most of the full-time employees live close by. They either walk or take the bus to work. During busy periods, Suraj provides accommodation for temporary workers in some old buildings on his land. He supplies his workers with lunch each day as a benefit and also so that they can spend the maximum time working at the factory.

Ownership

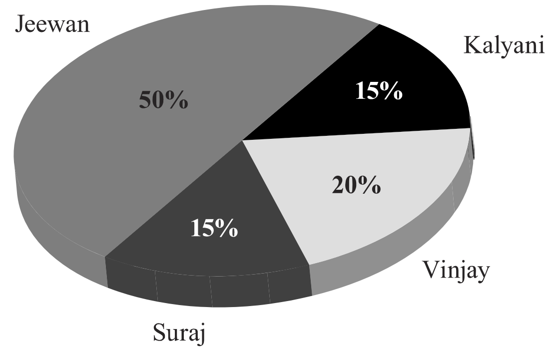
Jeewan is the principal shareholder with a 50% interest in the company. He has plans to start transferring the shares to his son, Suraj, as long as Suraj continues to manage the company full-time and the company remains profitable as a result.

Suraj and his sister Kalyani both hold a 15% interest respectively.

The remaining 20% is held by a family friend, Vinjay Sharma. Vinjay is a wealthy investor who has provided much of the capital needed to grow the company. He also provided Dephta with a 100,000€ loan to finance some new equipment needed for the larger orders. The loan bears annual interest of 12% and is repayable over 10 years, commencing January 1, 20x1. The debt is convertible to equity should the company ever default in repaying either the interest and/or the principal on the loan.

Last year, Vinjay (63 years of age) expressed disappointment that Dephta did not accept a larger manufacturer's very generous offer to buy the company. Jeewan had totally rejected the offer, stating this was a family company and it was not for sale. Vinjay saw this as a missed opportunity for the family to make money.

Ownership



Kalyani is a well-known singer and she travels extensively. She is not involved in the operations of the company and totally relies on her father and brother to look after her interests.

In June of each year, Jeewan organizes a more formal business meeting. The shareholders meet in the morning (primarily to review the financial statements) and, later in the afternoon, hold a party for all staff. Suraj uses this occasion to tell the staff how well the business is doing and what the plans are for the future.

Operations

The company started out manufacturing chairs, tables and spindles for railings and banisters, but has since expanded into making simple household furniture such as dressers, wardrobes and cabinets. Dephta Furniture has grown considerably through strategies such as:

- Providing quality products at fair prices to local customers;
- Accepting larger furniture orders from national retailers. These large orders come with a firm delivery deadline (there are major penalties for late delivery) and the profit margins are much tighter than those for custom-made furniture;
- Being the first company in the region to sell (limited products) over the Internet; and
- Manufacturing parts such as spindles and round table legs for other local furniture manufacturers. This has enabled the company to purchase expensive lathes and specialized tools that other companies cannot afford.

Dephta also sells scrap furniture and wood (pieces rejected in the quality control process) at the factory for cash only.

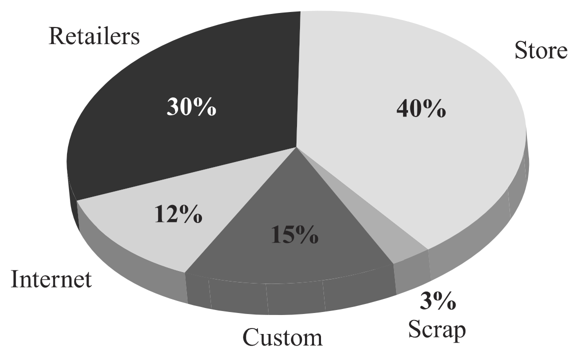
New initiatives being considered include:

- Exporting their furniture to neighbouring countries. Dephta recognizes that this will mean higher shipping costs, dealing with customs, foreign currency exchange risk and the potential for damage during transport. However, Parvin is very well connected. She knows many people in local government and thinks she can help to facilitate the extra paperwork involved.
- Redesigning some of its tables, chairs and cabinets so they can be assembled with screws, rather than relying on dove-tailing, glue and dowels. This will enable the company to sell and ship the furniture in parts for assembly later on.

Sales

The sales breakdown is approximately:

- Standard furniture (catalogue) from sales that are negotiated in person at the store: 40%
- Sales to furniture retailers: 30%
- Internet sales: 12%
- Made-to-order (custom-built) furniture: 15%
- Scrap sales from factory: 3%



Arjan Sing is a great dealmaker. He is very persistent when negotiating with customers and usually gets the sale, although the profit margins on these deals are sometimes very slim. Arjan loves to work hard, but he also likes to spend money. He recently bought a beautiful house overlooking the valley and a brand new Range Rover.

- **Notes on the sales system**
  - Sales contracts are prepared for retail and specialized orders. Deposits of 15% of the order are required on all custom orders, which are recorded as sales revenue when received. Two of the large retailers require Dephta to keep 30 days of inventory on hand so that orders can be shipped quickly to the stores when needed. These contracts also have provisions for inventory to be returned to Dephta if it doesn't sell within a specified time period.
  - Sales orders are manually filled at the time of sale, except for furniture sold directly from the shop or other small items on hand. All orders over 500€, or where the sales price is below the minimum sales price, must be approved by Arjan. Invoices are prepared when the items are shipped and sent to the customer.
  - For all sales out of the shop, invoices are prepared at the time of sale and entered into the accounting system, which automatically numbers each sale transaction and provides an order receipt if requested.
  - A summary of the day's Internet sales is downloaded from the website. Details of the items ordered are prepared and given to the production department. An invoice is prepared at the same time and recorded into revenue since the item has already been paid for by the customer's credit card. An invoice marked "paid in full" accompanies each Internet order that has been shipped.
  - Arjan rarely performs credit checks on customers. He knows most of them. Customers used to pay cash upon delivery but credit is granted today to match the terms that their competitors are providing. As a result, Dephta Furniture requires a line of credit from the bank. Each year, the number of bad debts seems to be growing.

- At the end of each month, Suraj reviews the sales and accounts receivable listing. He ensures there are no obvious mistakes and he personally calls every customer whose account is over 90 days.
- Each member of the sales staff (including Arjan) receives a commission of 15% on each sale in addition to a minimum base salary. To motivate the sales people, their base salary is well below the salaries of most of the other employees. The computer system tracks sales made by each sales person. Jawad prints off a report each month and prepares a listing of commissions that will be paid on the following week's payroll. Either Suraj or Dameer reviews the listing of commissions and the sales to ensure the staff are paid the correct amount. Arjan receives by far the most sales commissions.

Information Technology
John oversees the company's computer system and IT operations. The system consists of six PCs and a server which is used for hosting the Internet site. The internal system is mainly used for email, order taking and accounting.

The son of one of Jawad's friends, Remal, helped with the basic set-up of the system and installation of the programs. John ensures the PCs are well-maintained, helps users with problems and runs weekly backups of the accounting system on an external hard drive that is kept in the safe next to the computer room. Firewall protection and password protection have all been added by John in the last two years. Last year, several PCs were stolen from the office. John realized that although the factory area was well secured, the offices and computer systems were vulnerable. Access to the offices is now better secured, the PCs are chained to desks, and the server is locked in a separate and specially cooled office.

Internet sales are managed by John with oversight by Dameer. They have an agreement with the bank to process the credit cards before any order is approved for shipping. They pay the bank 7% on each order processed. The application program for Internet sales provides the details of each sale, including the customer's name, address, and the items ordered. Internet transactions are downloaded daily from the website and sales orders are prepared and forwarded to the production department.

Human Resources
All hiring decisions are made by Dameer and Suraj. Like his father, Suraj is committed to hiring competent people and expects loyalty from his employees. The company:

- Strives to hire the best talent it can find in the region and pays its full-time employees very competitive rates.
- Invests a considerable amount of time and money in training new employees. It holds training programs and has an informal mentoring process by which it requires newer employees to work with more experienced ones for a period of time.
- Posts many signs in the factory to remind workers about safety procedures. Last year, two temporary students were badly injured while using a lathe. This year, several new workers were disciplined for acting irresponsibly and endangering others.

Payroll
Employees are paid in cash at the beginning of each week. Jawad's assistant, Karla Winston, has a list of employees and calculates the payroll and deductions based on time card summaries that

Dameer provides her. Suraj reviews payroll each Monday morning before instructing Karla to hand the envelopes to employees. All employees sign a list when they pick up their envelope. The company does not keep formal employee records.

Purchasing and Production

Dameer is responsible for purchasing and production. Because the inventory system is not very sophisticated, he tends to over-order some items, which often results in inventory sitting in the warehouse for long periods of time. This is considered better than under-ordering supplies, which results in production delays. He is also responsible for hiring enough workers to fulfill orders. Because estimating worker needs is not very scientific, many times there are either too many or too few workers.

- **Notes on the purchasing function**
  - At least two quotes must be obtained before purchases over 5,000€ are approved. The exception is wood supplied by the local wood mill where Dephta has negotiated a five-year exclusive supply contract.
  - The company prepares purchase orders for all inventory or capital purchases over 1,000€.
  - Dameer approves all new vendors and supplies the details to Jawad. Jawad then sets up the vendors in the system and enters details of invoices received.
  - Dephta maintains 5,000€ in cash on the premises at all times, as a number of the smaller vendors like to be paid cash-on-delivery for raw materials.

Finance

Jawad studied accounting at university and is well versed in accounting and financial matters. When he joined Dephta two years ago, he quickly introduced the "Sound Accounting" software package by Onion Corp. with its integrated accounts payable, accounts receivable, and capital assets modules.

- **Notes on the accounting function**
  - At present, the company does not have a perpetual inventory system. Inventory is counted twice a year, once at year-end and once halfway throughout the year. This ensures that profit margins on sales can be accurately calculated at least twice a year.
  - Jawad has been frustrated by the lack of controls over inventory. He had suggested to Suraj that inventory be counted at least four times per year to ensure that margins are reviewed throughout the year. Suraj had overridden his recommendation, stating that it would be too disruptive to count inventory so often and it could cause the company to miss deadlines.
  - Although Dephta has been profitable, the gross margins have been inconsistent. Jawad does not have an explanation as to why inventory costs are not tracked by product line. For example, one of the most time-consuming areas is making the intricate spindles for which Dephta is known. The spindles are used in both the bedroom and dining room lines and are also sold to other manufacturers.
  - Jawad has also been pushing for costs to be tracked individually for custom pieces, including company overhead allocations. When he presented his calculations, Suraj could not believe that custom orders were losing money and asked Jawad to do the analysis again.
  - Suraj gets very annoyed at having to pay any form of income tax and usually pressures Jawad to ensure that accruals are "more than adequate".

The following income statement and balance sheet were prepared by management. Notes to the financial statements or a cash flow statement have not been included. Excerpts from significant accounting policies, terms and conditions for the loan payable, and details of related-party transactions have been included in the case study material used in the illustrations.

Appendix A
Dephta Inc.
Income Statement – Prepared by management

Dephta Furniture Inc.
Income Statement
(in Currency Units (€))

	For the year ended		
	20X6	**20X5**	**20X4**
Sales	1,437,317€	1,034,322€	857,400€
Cost of goods sold	879,933	689,732	528,653
Gross profit	557,384	344,590	328,747
Distribution costs	64,657	41,351	39,450
Administrative expenses	323,283	206,754	197,248
Depreciation	23,499	21,054	10,343
Profit from operations	145,946	75,431	81,706
Finance cost	19,471	19,279	15,829
Profit before tax	126,475	56,152	65,877
Income taxes	31,619	14,038	16,469
Net income	94,856.1€	42,113.8€	49,408.0€

Appendix B
Dephta Inc.
Balance Sheet – Prepared by management

Dephta Furniture Inc.
Balance Sheet
(in Currency Units (€))

	As at December 31		
	20X6	**20X5**	**20X4**
ASSETS			
Current assets			
Cash and cash equivalents	22,246€	32,522€	22,947€
Trade and other receivables	177,203	110,517	82,216
Inventories	156,468	110,806	69,707
Prepayments and other	12,789	10,876	23,876
Non-current assets			
Property, plant and equipment	195,821	175,450	103,430
	564,527€	440,171€	302,177€
EQUITY AND LIABILITIES			
Current liabilities			
Bank indebtedness	123,016€	107,549€	55,876€
Trade and other payables	113,641	107,188	50,549
Income tax payable	31,618	14,038	16,470
Current portion of interest-bearing loan	10,000	10,000	10,000
Non-current liabilities			
Interest-bearing loan	70,000	80,000	90,000
Capital and reserves			
Issued capital	18,643	18,643	18,643
Accumulated profits	197,609	102,753	60,639
	564,527€	440,171€	302,177€

Part A
Basic Concepts

1.1 What is a Risk-based Audit?

Chapter Purpose	Primary ISA Reference
An overview of the risk-based approach to auditing, the methodology, and key requirements.	**200**

1.1.1 Overview

ISA 200 states:

> **2. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.**

The auditor's objective in a risk-based audit is to obtain reasonable assurance that no material misstatements whether caused by fraud or errors exist in the financial statements. This involves three key steps:

- Assessing the risks of material misstatement in the financial statements;
- Designing and performing further audit procedures that respond to assessed risks and reduce the risks of material misstatements in the financial statements to an acceptably low level; and
- Issuing a suitably worded audit report based on the audit findings.

Reasonable Assurance
Reasonable assurance relates to the whole audit process. It is a high level of assurance but it is not absolute. The auditor cannot provide absolute assurance due to the inherent limitations in the work carried out, the human judgments required, and the nature of evidence examined. The following exhibit outlines some of the limitations in an audit.

Exhibit 1.1-1

Limitations	Reasons
Use of Testing	Any sample of less than 100% of a population introduces some risk that a misstatement will not be detected.
Internal Control Limitations	Even the best designed and most effective controls can be overridden or negated by management or by collusion among employees.
Fraud that Goes Undetected	Because fraud is specifically designed not to be detected, there is always the possibility that it will not be discovered.
Nature of Audit Evidence Available	Most audit evidence tends to be persuasive in character rather than conclusive.

Limitations	Reasons
Availability of Audit Evidence	Insufficient support may be available for drawing absolute conclusions on specific assertions such as fair value estimates.
Reliance on Judgments Made by the Auditor	Professional judgment is required to: • Appropriately identify and address risk factors; • Decide what evidence to gather; • Assess estimates made by management; and • Draw conclusions based on the evidence and management representations.
Difficulty in Ensuring Completeness	There is a risk that some important information is not known about, not obtained or has been concealed from the auditor.

Audit Risk

ISA 200 states:

> **24. The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.**

Audit risk contains two key elements:

- The risk that the financial statements contain a material misstatement (inherent and control risk); and
- The risk that the auditor will not detect such a misstatement (detection or engagement risk).

To reduce audit risk to an acceptably low level, the auditor has to:

- Assess the risks of material misstatement; and
- Limit detection risk. This may be achieved by performing procedures that respond to the assessed risks at the financial statement, class of transactions, account balance and assertion levels.

Assertions

Included in management's representations about the financial statements are a number of embedded assertions. These relate to the recognition, measurement, presentation and disclosure of the various elements (amounts and disclosures) in the financial statements.

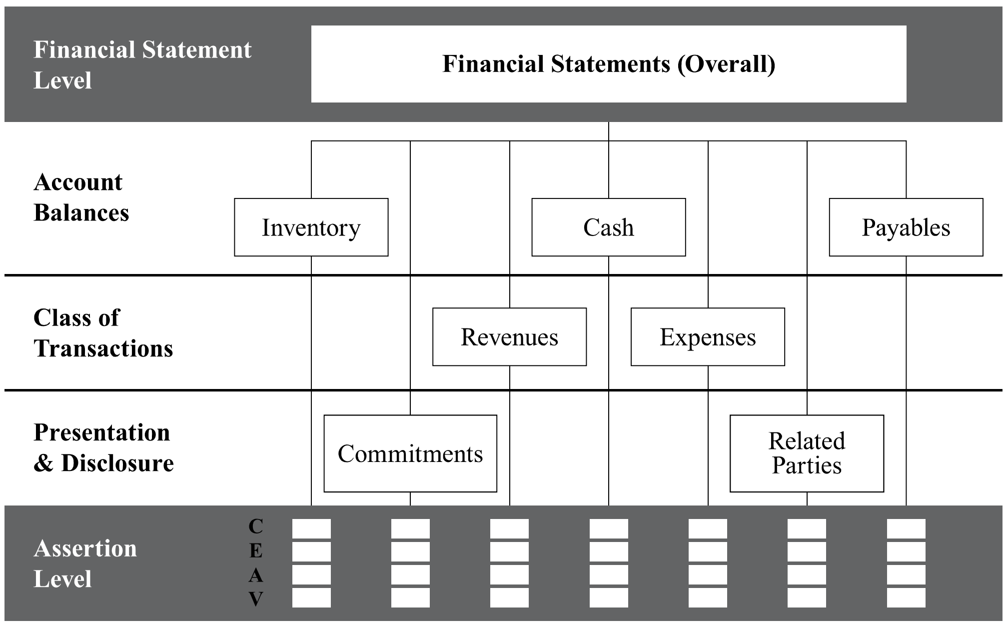
For ease of use, this Guide has combined some of the assertions outlined in ISA 500 as follows:

- C = Completeness;
- E = Existence, which includes occurrence;
- A = Accuracy, which includes cut-off, classification and rights and obligations; and
- V = Valuation.

The nature and use of assertions are addressed in Chapter 1.3 of this Guide.

Auditors are required to assess the risks of material misstatement at two levels. The first is at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. The second relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. This means that for each account balance, class of transactions and disclosure, an assessment of risk (such as high, moderate, or low) should be made for each individual assertion (C, E, A, and V in the diagram below) being addressed. The difference between assessing risk at the overall financial statement level and the assertion level is illustrated (in partial form only) below.

Exhibit 1.1-2



Note: The assertions used in this diagram are C = Completeness, E = Existence, A= Accuracy and cut-off, V = Valuation. Refer to Chapter 1.3 for more information on the use of assertions.

1.1.2 Audit Risk Components

The major components of audit risk are described in the exhibit below.

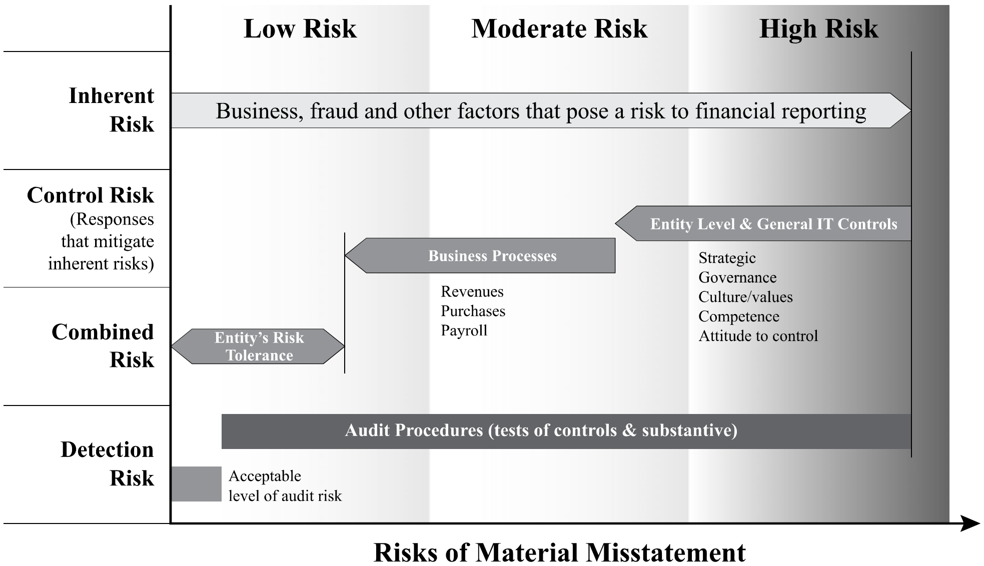
Exhibit 1.1-3

Nature	Description	Commentary
Inherent Risk	Susceptibility of an assertion to a misstatement that could be material, individually or when aggregated with other misstatements, assuming that there are no related controls. Inherent risk is addressed at both the financial statement level and at the assertion level.	These are the business and other risks that arise from the entity's objectives, nature of operations and industry, the regulatory environment in which it operates and its size and complexity. The risks of material misstatement will vary based on the nature of the account balance or class of transaction. Risks of particular concern to the auditor might include: • Complex calculations which could be misstated; • High value inventory; • Accounting estimates that are subject to significant measurement uncertainty; • A lack of sufficient working capital to continue operations; • A declining or volatile industry with many business failures; and • Technological developments that might make a particular product obsolete.
Fraud Risk **(Part of inherent or possible control risk)**	The risk of an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.	There are two types of intentional misstatement that are relevant to the auditor: • Misstatements resulting from fraudulent financial reporting; and • Misstatements resulting from misappropriation of assets.

Nature	Description	Commentary
Control Risk **(Do internal controls in place mitigate the inherent risks?)**	Risk that the entity's internal control system will not prevent, or detect and correct on a timely basis, a misstatement that could be material, individually or when aggregated with other misstatements.	The entity should identify and assess its business and other risks (such as fraud) and respond by designing and implementing a system of internal control. Entity level controls such as board oversight, IT general controls, and HR policies are pervasive to all assertions whereas activity level controls generally relate to specific assertions. Some control risk will always exist because of the inherent limitations of any internal control system. The auditor is required to understand the entity's internal control and perform procedures to assess the risks of material misstatement at the assertion level.
Combined Risk	This is a term that is sometimes used to refer to the assessed (inherent and control risk) risks of material misstatement at both the financial statement level and the assertion level.	Auditors can make separate or combined assessments of inherent and control risks depending on preferred audit techniques or methodologies and practical considerations.
Detection Risk	This is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. The acceptable level of detection risk for a given level of audit risk bears an inverse relationship to the risks of material misstatement at the assertion level	The auditor identifies assertions where there are risks of material misstatement and concentrates audit procedures on those areas. In designing and evaluating the results of performing procedures, the auditor should consider the possibility of: • Selecting an inappropriate audit procedure; • Misapplying an appropriate audit procedure; or • Misinterpreting the results from an audit procedure.

1.1.3 Interrelationship of Audit Risk Components

Exhibit 1.1-4



Notes:

1. The term "entity level controls" incorporates many elements of the control environment, risk assessment and monitoring components of internal control. Refer to Chapter 1.2 for a complete description.
2. Many business risks can also be fraud risks. For example, a poorly controlled sales system may result in risks of misstatement and also provides opportunity for fraud to occur. For this reason, it is suggested that separate lists be maintained of business and fraud risk factors.

1.1.4 The Risk-based Approach

ISA 200 states:

> **6. The auditor should conduct an audit in accordance with International Standards on Auditing.**
>
> **11. In determining the audit procedures to be performed in conducting an audit in accordance with International Standards on Auditing, the auditor should comply with each of the International Standards on Auditing.**
>
> **15. The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.**
>
> **37. The auditor should determine whether the financial reporting framework adopted by management in preparing the financial statements is acceptable.**

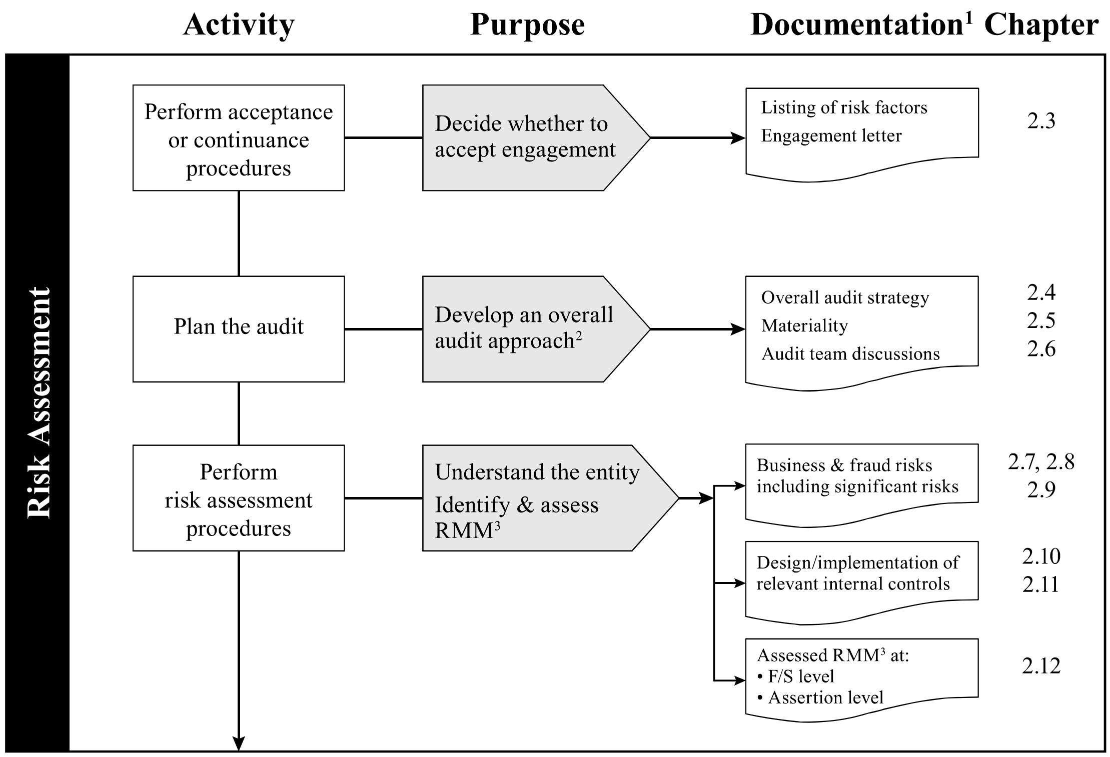
Throughout this Guide, the audit process is presented in three distinct phases:

- Risk assessment;
- Risk response; and
- Reporting.

The various tasks involved in each of these phases are outlined below. Each phase is addressed in more detail in subsequent chapters of this Guide.

Risk Assessment

Exhibit 1.1-5



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Risk-based audits require practitioners to understand the entity and its environment, including internal control. The purpose is to identify and assess the risks of material misstatement of the financial statements. Because risk assessments require considerable professional judgment, this phase will likely require the time of the audit partner and senior audit personnel in identifying and assessing the various types of risk and then developing the appropriate audit response.

The risk assessment phase of the audit involves the following steps:

- Performing client acceptance or continuance procedures;
- Planning the overall engagement;

- Performing risk assessment procedures to understand the business and identify inherent and control risks;
- Identifying relevant internal control procedures and assessing their design and implementation (those controls that would prevent material misstatements from occurring or detect and correct misstatements after they have occurred);
- Assessing the risks of material misstatement in the financial statements;
- Identifying the significant risks that require special audit consideration and those risks for which substantive procedures alone are not sufficient;
- Communicating any material weaknesses in the design and implementation of internal control to management and those charged with governance; and
- Making an informed assessment of the risks of material misstatement at the financial statement level and at the assertion level.

Parts of the risk assessment phase of the audit can often be carried out well before the year end.

The time involved in performing risk assessment procedures may be offset by reducing, or even eliminating, audit work in low risk areas. The knowledge and insight gained can also be used to provide the entity's management with practical comments and recommendations on how to minimize or reduce risk.

An effective risk assessment process requires that all members of the engagement team be involved and that they communicate effectively. The audit team1 should meet or talk together on a regular basis to share their insights. This can be achieved through:

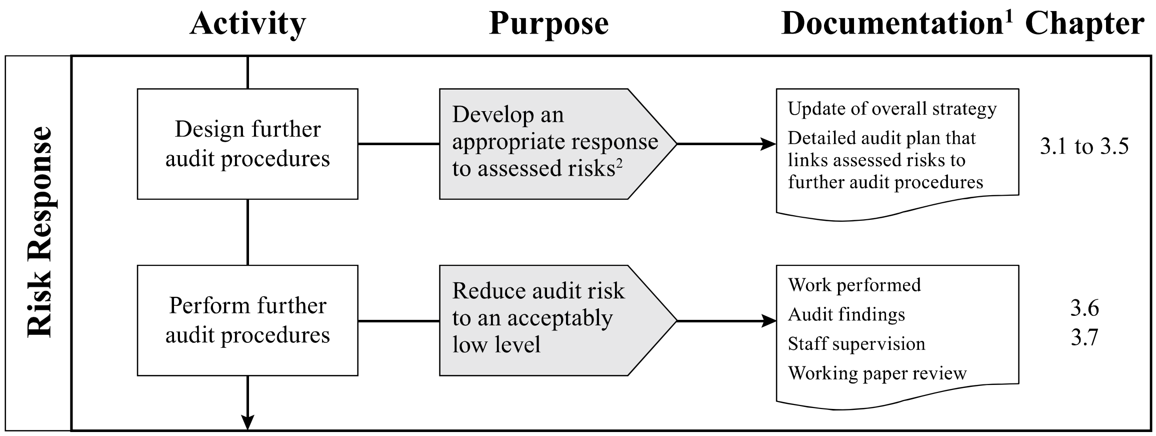
- A team planning meeting to discuss the overall audit strategy and detailed audit plan, brainstorm how fraud could occur, and design audit procedures that may detect whether such fraud did in fact occur; and
- A team debriefing meeting (towards or at the end of the fieldwork) to discuss the implications of audit findings, identify any indications of fraud and determine the need (if any) to perform any further audit procedures.

---

[1] This Guide often refers to an audit team, which implies more than one person is involved in conducting the audit engagement. However, the same general principles also apply to audit engagements performed exclusively by one person (the practitioner).

1.1.5 Risk Response

Exhibit 1.1-6



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.

The second phase of the audit is to design and perform further audit procedures that respond to the assessed risks of material misstatement and will provide the evidence necessary to support the audit opinion.

Some of the matters the auditor should consider when planning the audit procedures include:

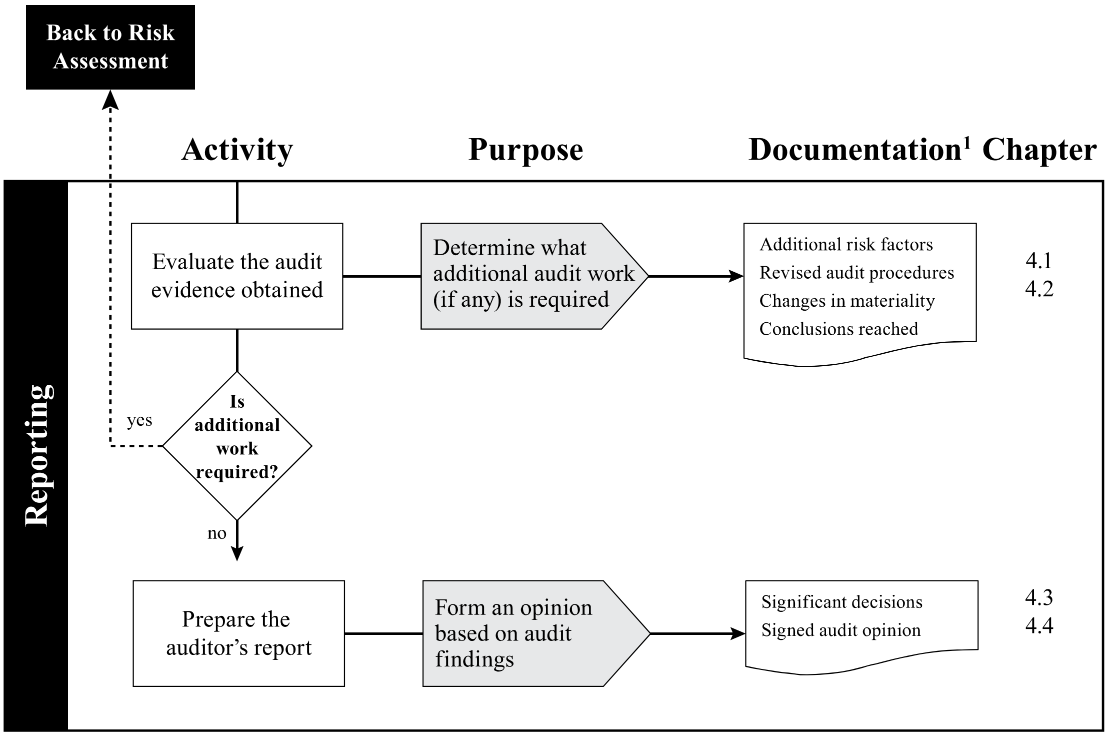
- Assertions that cannot be addressed by substantive procedures alone. This can occur where there is highly automated processing of transactions with little or no manual intervention.
- Existence of internal control that, if tested, could reduce the need/scope for other substantive procedures.
- The potential for substantive analytical procedures that would reduce the need/scope for other types of procedures.
- The need to incorporate an element of unpredictability in procedures performed.
- The need to perform further audit procedures to address the potential for management override of controls or other fraud scenarios.
- The need to perform specific procedures to address “significant risks” that have been identified. Refer to Chapter 2.9.

Audit procedures designed to address the assessed risks could include a mixture of:

- Tests of the operational effectiveness of internal control; and
- Substantive procedures such as tests of details and analytical procedures.

1.1.6 Reporting

Exhibit 1.1-7



Note:
1. Refer to ISA 230 for a more complete list of documentation required.

The final phase of the audit is to assess the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the risks of material misstatement in the financial statements to an acceptably low level.

ISA 200 states:

> **14. The auditor should not represent compliance with International Standards on Auditing unless the auditor has complied fully with all of the International Standards on Auditing relevant to the audit.**

It is important to take the time at this stage to determine:

- If there had been a change in the assessed level of risk;
- Whether conclusions drawn from work performed are appropriate; and
- If any suspicious circumstances have been encountered.

Any additional risks should be appropriately assessed and further audit procedures performed as required.

When all procedures have been performed and conclusions reached:

- Audit findings should be reported to management and those charged with governance; and
- An audit opinion should be formed and a decision made on the appropriate wording for the auditor's report.

1.1.7 Summary

The risk-based audit requires auditors to first understand the entity and then to identify/assess the risks of material misstatement in the financial statements. This enables auditors to identify and respond to:

- Possible account balances, classes of transactions or financial statement disclosures that may be incomplete, inaccurately stated or missing altogether from the financial statements. Examples might include:
  - Understated liabilities;
  - Unrecorded assets;
  - Assets such as cash/inventory that may have been misappropriated; and
  - Missing/incomplete disclosures.
- Areas of vulnerability where management override and manipulation of the financial statements could take place. Examples could include:
  - Preparation of journal entries;
  - Revenue recognition policies; and
  - Management estimates.
- Other control weaknesses that if not corrected could lead to material misstatements in the financial statements.

Some of the benefits of this approach are summarized as follows:

- **Time flexibility for audit work**
  Risk assessment procedures can often be performed earlier in the entity's fiscal period than was possible before. Because risk assessment procedures do not involve the detailed testing of transactions and balances, they can be performed well before the year end, assuming no major operational changes are anticipated. This can help in balancing the workload of staff more evenly throughout the year. It may also provide the client with time to respond to identified (and communicated) weaknesses in internal control and other requests for assistance before the commencement of year-end audit fieldwork.
- **Audit team's effort focused on key areas**
  By understanding where the risks of material misstatement can occur in financial statements, the auditor can direct the audit team's effort toward high-risk areas and away from lower-risk areas. This will also help to ensure audit staff resources are used effectively.
- **Audit procedures focused on specific risks**
  Further audit procedures are designed to respond to assessed risks. Consequently, tests of details that only address risks in general terms may be significantly reduced or even eliminated. The required understanding of internal control enables the auditor to make informed decisions on whether to test the operating effectiveness of internal control. Tests of controls (for which some

controls may only require testing every three years) will often result in much less work being required than performing extensive tests of details.

- **Communication of matters of interest to management**
  The improved understanding of internal control may enable the auditor to identify weaknesses in internal control (such as in the control environment and general IT controls) that were not previously recognized. Communicating these weaknesses to management on a timely basis will enable them to take appropriate action, which is to their benefit. Also, this may in turn save time in performing the audit.

- **Improved audit file documentation**
  The ISAs place a lot of emphasis on the need to carefully document each step of the audit process. Although this may add some additional cost at first, careful documentation will ensure that an audit file can stand by itself without the need for any oral explanations of what was done, why it was done, or how the audit conclusions were reached.

1.2 Nature of Internal Control

Chapter Purpose	Primary ISA Reference
To provide an overview of internal control over financial reporting and the five components of internal control that are to be addressed in an audit.	**315**

1.2.1 Overview

ISA 315 states:

> **41. The auditor should obtain an understanding of internal control relevant to the audit.**

Internal control is designed and implemented by management to address identified business and fraud risks that threaten the achievement of stated objectives such as the reliability of financial reporting.

Definition of Internal Control
Internal control is a process:

- Designed and effected by those charged with governance, management and other personnel; and
- Intended to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness, and efficiency of operations and compliance with applicable laws and regulations.

1.2.2 Internal Control Objectives

There is a direct relationship between an entity's objectives and the internal control it implements to ensure their achievement. Once objectives are set, it is possible to identify and assess potential events (risks) that would prevent the achievement of the objectives. Based on this information, management can develop appropriate responses, which will include the design of internal control.

Internal control can be designed to prevent potential misstatements from occurring in the first place or detect and correct misstatements after they have occurred.

An entity's objectives, and therefore its internal control, can be broadly grouped into four categories:

- Strategic, high-level goals that support the mission of the entity;
- Financial reporting (internal control over financial reporting);
- Operations (operational controls); and
- Compliance with laws and regulations.

Internal control relevant to an audit primarily pertains to financial reporting. This addresses the entity's objective of preparing financial statements for external purposes. Operational controls, such as production and staff scheduling, quality control, and employee compliance with health and safety requirements, would not normally be relevant to the audit, except where:

- The information produced is used to develop an analytical procedure; or

- The information is required for disclosure in the financial statements.

For example, if production statistics were used as a basis for an analytical procedure, the controls to ensure the accuracy of such data would be relevant. If non-compliance with certain laws and regulations has a direct and material effect on the financial statements, the controls for detecting and reporting on non-compliance would be relevant.

1.2.3 Internal Control Components

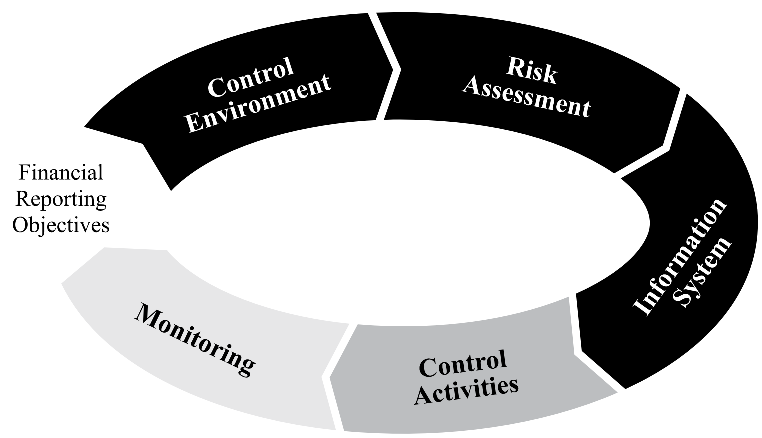
In ISA 315, the term "internal control" encompasses five components of internal control, which are:

- The control environment;
- The entity's risk assessment process;
- The information system, including the related business processes, relevant to financial reporting, and communication;
- Control activities; and
- Monitoring of internal control.

These components primarily relate to the entity's financial reporting objectives, as illustrated below.

The Five Components of Internal Control

Exhibit 1.2-1



The division of internal control into these five components provides a useful framework for auditors in understanding the different aspects of an entity's internal control system. However, it should be noted that:

- The way in which the internal control system is designed and implemented will vary based on the entity's size and complexity. Smaller entities often use less formal means and simpler processes and procedures to achieve their objectives. The five components of internal control may not be so clearly distinguished; however, their underlying purposes are equally valid. For example, an owner-manager may (and in the absence of additional staff should) perform functions belonging to several of the components of internal control.

- Different terminology or frameworks than those used in ISA 315 can be used to describe the various aspects of internal control, and their effect on the audit, but all five components are to be addressed in the audit.
- The auditor's primary consideration is whether, and how, a specific control prevents, or detects and corrects, material misstatements in classes of transactions, account balances or disclosures, and their related assertions, rather than its classification into any particular internal control component.

A summary of the five internal control components is provided below.

1.2.4 The Control Environment

ISA 315 states:

67. The auditor should obtain an understanding of the control environment.

The control environment is the foundation for effective internal control, providing discipline and structure for the entity. It sets the tone of an organization, influencing the control consciousness or awareness of its people.

The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

The auditor's evaluation of the design of the entity's control environment would include the elements set out below.

Exhibit 1.2-2

Key Elements to Address	Description
Communication and Enforcement of Integrity and Ethical Values	Essential elements which influence the effectiveness of the design, administration and monitoring of controls.
Commitment to Competence	Management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
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, accounting functions and personnel.

Key Elements to Address	Description
Organizational Structure	The framework within which an entity's activities for achieving its objectives are planned, executed, controlled and reviewed.
Assignment of Authority and Responsibility	How authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
Human Resources Policies and Practices	Recruitment, orientation, training, evaluating, counselling, promoting, compensating, and remedial actions.

The controls outlined above are pervasive to the entire entity and are often more subjective to evaluate than the traditional control activities (such as segregation of duties) that auditors address; therefore, the auditor must exercise professional judgment in this evaluation.

Control environment strengths can compensate or even replace weak transactional controls in some situations. However, the reverse is also true. Control environment weaknesses can undermine and even negate good design in other components of internal control. For example, if a culture of honesty and ethical behaviour did not exist, the auditor would have to consider carefully what types of audit procedures would be effective in finding material misstatements in the financial statements. In some cases, the auditor may conclude that internal control has broken down to such an extent that the only option is to withdraw from the engagement.

In smaller entities, some of the key questions to address in assessing the control environment are outlined in the exhibit below.

Exhibit 1.2-3

Control Elements	Key Questions to Consider
Communication and Enforcement of Integrity and Ethical Values	• What is management's reputation in the community? • What verbal/written communications exist? • What example does management set in day-to-day activities? • How were instances of unethical behaviour or lack of integrity handled?
Commitment to Competence	• What is the reputation or evidence (results, awards, etc.) of the management's or owner-manager's competence? • Does the entity hire the most competent people or the least expensive? • How does the entity deal with incompetent employees?

Control Elements	Key Questions to Consider
Management's Philosophy and Operating Style	• What is management's attitude toward internal control? • What is their approach to risk taking? • Are their bonuses paid based on performance? • What is management's level of involvement in financial statement preparation?
Organizational Structure	• Does the structure make sense for the nature and size of the entity involved (not overly complex, etc.)? • Does it differ from other similar sized entities in the industry?
Assignment of Authority and Responsibility	• Do entity staff know what is expected from them? • Are there clear job descriptions in place?
Human Resources Policies and Practices	• Are policies and procedures in place that address recruitment, orientation, training, evaluating, counselling, promoting, compensating, and remedial actions?

Consider Point

Domination of management by a single individual does not mean that internal control is weak or does not exist. In fact, the involvement of a competent owner-manager in the detailed day-to-day operations would be an important control environment strength. The opportunity for management override of internal control obviously exists, but this can be reduced to some extent (in virtually any size of entity) by implementing simple fraud control policies.

1.2.5 Risk Assessment

ISA 315 states:

> **76. The auditor should obtain an understanding of the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.**

A risk assessment process provides management with the information needed to determine what business/fraud risks should be managed and the actions (if any) to be taken. If the entity's risk assessment process is appropriate to the circumstances, it will assist the auditor in identifying risks of material misstatement. In smaller entities where a formal risk assessment process may not exist, the auditor would discuss with management how business risks are identified and how they are addressed.

Matters the auditor should consider are how management:

- Identifies business risks (inherent and residual risks) relevant to financial reporting;
- Estimates the significance of the risks;
- Assesses the likelihood of their occurrence; and
- Decides upon actions to manage them.

If the auditor identifies risks of material misstatement that management failed to identify, he or she should:

- Consider why. Did management's processes fail? Are the processes appropriate to the circumstances?
- If a material weakness exists in the entity's risk assessment process, communicate with those charged with governance.

1.2.6 Information System (Including the Related Business Processes, Relevant to Financial Reporting, and Communication)

ISA 315 states:

> **81. The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:**
>
> - **The classes of transactions in the entity's operations that are significant to the financial statements.**
> - **The procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed and reported in the financial statements.**
> - **The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions.**
> - **How the information system captures events and conditions, other than classes of transactions, that are significant to the financial statements.**
> - **The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.**

The information system (which includes the accounting system) consists of the procedures and records established to initiate, record, process, and report the entity's transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity.

Exhibit 1.2-4

	Matters to Consider
Sources of Information	• The classes of transactions in the entity's operations that are significant to the financial statements. • How transactions originate within the entity's business processes. • The related accounting records (whether electronic or manual), supporting information and specific accounts in the financial statements, in respect of initiating, recording, processing, and reporting transactions. • How the information system captures events and conditions other than classes of transactions that are significant to the financial statements.
Processing of Information	• The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures. • How the entity communicates financial reporting roles, responsibilities, and significant matters relating to financial reporting. • The risks of material misstatement associated with inappropriate override of controls over journal entries. • The procedures used to: – Initiate, record, process, and report significant and non-standard transactions in the financial statements (such as related party transactions and expense reports); – Transfer information from transaction processing system to general ledger or financial reporting system; – Capture information relevant to financial reporting for events and conditions other than transactions (such as the depreciation/amortization of assets and changes in the recoverability of accounts receivables); – Record and control the use of standard and non-standard journal entries; 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. • How the incorrect processing of transactions is resolved. This could be automated or require manual intervention. • Can automated controls be suspended in any circumstances and what happens if they fail to operate? • How are exceptions reported and acted on?
Uses of Information Produced	• What reports are regularly produced by the information system and how are they used to manage the entity? • What information is provided by management to those charged with governance and to external parties such as regulatory authorities?

1.2.7 Control Activities

ISA 315 states:

> **90. The auditor should obtain a sufficient understanding of control activities to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks.**

Control activities are the policies and procedures that help ensure management's directives are carried out. For example, these may include controls to ensure goods are not shipped to a bad credit risk or to ensure only authorized purchases are made. These controls address risks that if not mitigated would threaten the achievement of the entity's objectives.

Control activities, whether these are within information or manual systems, have various objectives, and are applied at various organizational and functional levels. Examples include:

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

Areas the auditor should consider include:

- What risks of material misstatement (related to significant classes of transactions, account balances, and financial statement disclosures) exist at the assertion level and require mitigation? The auditor's emphasis is to identify and understand control activities that address areas where material misstatements are more likely to occur. An audit does not require an understanding of all control activities.
- How do specific control activities, individually or in combination with others, prevent, or detect and correct, material misstatements in classes of transactions, account balances or disclosures?
- Have any anti-fraud controls been designed and implemented? These controls would be designed to address fraud risk factors identified within the entity such as management override.
- Significant risks. An understanding of controls over significant risks provides the auditor with information to develop an effective audit approach. Note that risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls.

In smaller entities, these controls will often be informal and may not be necessary as a result of management oversight and other measures. For example, management may:

- Foster a corporate culture that emphasizes the importance of control;
- Hire competent staff;
- Monitor revenues and expenditures against an established budget;
- Approve all major transactions;
- Monitor key performance indicators; and
- Assign responsibilities among staff so as to maximize the segregation of duties.

1.2.8 Monitoring of Controls

ISA 315 states:

> **96. The auditor should obtain an understanding of the major types of activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates corrective actions to its controls.**

Monitoring assesses the effectiveness of the internal control's performance over time. The objective is to ensure the controls are working properly and, if not, to take necessary corrective actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations or a combination of the two.

Ongoing monitoring activities in smaller entities are informal and are usually built into the normal recurring activities of an entity. This includes regular management and supervisory activities and the review of exception reports that may be produced by the information system. Where management is closely involved in operations, they will often identify significant variances from expectations and inaccuracies in financial data and take corrective action to the control.

Periodic monitoring (separate evaluations of specific areas within the entity), such as an internal audit function, is not common in smaller entities. However, periodic evaluations of critical processes can be conducted by qualified employees not directly involved or by hiring an external person.

Monitoring provides feedback to management on whether the internal control system they have designed to mitigate risks is:

- Effective in addressing the stated control objectives;
- Properly implemented and understood by employees;
- Being used and complied with on a day-to-day basis; and
- In need of modification or improvement to reflect changes in conditions.

Management's monitoring activities may also include using information from external parties such as complaints from customers or comments from regulatory bodies that may indicate problems, highlight areas in need of improvement, or require communications relating to internal control from external auditors.

Appendix 2 of ISA 315 contains a detailed discussion of the five internal control components.

1.2.9 Levels of Internal Control

The type of controls used to address the five internal control elements vary in nature and precision. For example, certain control environment controls such as integrity and the commitment to competence are pervasive in nature and impact on all activities undertaken by the entity. These higher level controls (often referred to as "entity level controls") do not directly prevent or detect a misstatement from occurring but have an important indirect effect. Other controls such as the segregation of duties relate directly to a specific function within a particular business process (such as payroll, sales and purchases). These lower level or business process controls are precisely designed to prevent or detect specific misstatements.

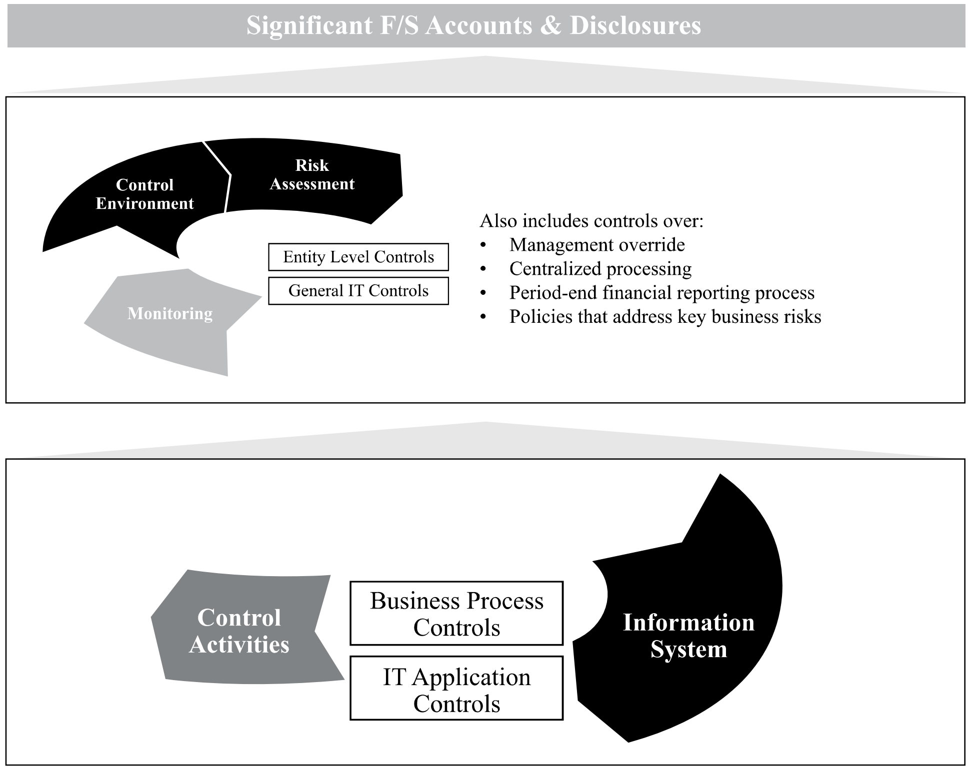
Entity level controls are particularly important in smaller entities. The lack of precise business process controls (due to limited staff and resources) is often offset by the high degree of involvement by senior management in performing controls. These entity level controls may sometimes operate at a level of precision that can, in fact, prevent or detect specific misstatements. Because of this increased involvement of senior management in performing controls and preparing financial statements, the entity level controls over management override are also very important for smaller companies.

ISA 315 states:

> **89. The auditor should understand how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting.**

The interrelationship between the significant financial statement accounts and disclosures, the underlying five control components, and the various types of controls are summarized in the exhibit that follows.

Exhibit 1.2-5



Notes:

1. The above illustration is a general guide. In some instances, entity level controls can be designed to operate at a level of precision that would prevent or detect specific misstatements at the business process level. For example, a detailed budget approved by those charged with governance may be used by management to detect unauthorized administration expenditures. In other instances, there may be control activities and information systems that relate to entity level activities.

2. Entity level controls (sometimes called "head office controls") are usually pervasive and have an impact on virtually all aspects of operations. The "tone at the top" (established by those charged with governance) which is what management actually does on a day-to-day basis, not what the entity says it will do, is an example. Entity level controls, therefore, set the standard for all of the internal control system. Poorly designed entity level controls may actually encourage all types of error and fraud to take place. For example, an entity may have a highly controlled and effective sales process. However, if senior management has a poor attitude toward control and could easily override these controls, a material error is still likely to occur in the financial statements. Management override and poor "tone at the top" are common themes in corporate wrongdoing.

3. Entity level controls (such as the commitment to competence) may be less tangible than those at the business process level (such as matching goods received to a purchase order) but are just as critical in preventing and detecting fraud and error.

4. General information technology (IT) controls are similar to entity level controls except that they focus on how IT operations (such as organization, staffing, data integrity) are managed across the entity.

5. The period-end financial reporting process includes procedures to:
   - Enter transaction totals into the general ledger;
   - Select and apply accounting policies;
   - Initiate, authorize, record, and process journal entries in the general ledger;
   - Record recurring and nonrecurring adjustments to the financial statements; and
   - Prepare the financial statements and related disclosures.
6. IT application controls are similar to business process controls. They relate to how specific transactions are processed at the business process level.

1.2.10 Information Technology Controls

ISA 315 states:

> **93. The auditor should obtain an understanding of how the entity has responded to risks arising from IT.**

In many entities today, information technology (IT) applications are managed on a central basis. In smaller entities, IT management may be the responsibility of just one or even a part-time or outsourced person. As the entity grows, more people may be involved. Regardless of size, there are a number of risk factors relating to IT management that, if not mitigated, could result in a material misstatement in the financial statements.

The benefits and risks of using IT controls to mitigate risks are summarized below.

Exhibit 1.2-6

Benefits and Risks of IT Controls

Benefits of IT Controls	• 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 internal control will be circumvented. • Enhance the ability to achieve effective segregation of duties by implementing security internal control in applications, databases, and operating systems.

Risks Associated with IT Internal Controls	• Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both. • Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions (particular risks may arise where multiple users access a common database). • The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties. • Unauthorized changes to data in master files. • Unauthorized changes to systems or programs. • Failure to make necessary changes to systems or programs. • Inappropriate manual intervention. • Potential loss of data or inability to access data as required.

There are two types of IT controls that need to work together to ensure complete and accurate information processing:

- **General IT controls**
  These controls operate across all applications and usually consist of a mixture of automated controls (embedded in computer programs) and manual controls (such as the IT budget and contracts with service providers); and

- **IT application controls**
  These controls are automated controls that relate specifically to applications (such as sales processing or payroll).

General IT Controls
The following exhibit outlines the general IT controls.

Exhibit 1.2-7

The IT Control Environment	• The IT governance structure. • How IT risks are identified, mitigated, and managed. • The information system, strategic plan, and budget. • IT policies, procedures, and standards. • The organizational structure and segregation of duties.
Day-to-day Computer Operations	• Acquisitions, installations, configurations, integration, and maintenance of the IT infrastructure. • Delivery of information services to users. • Management of third-party providers. • Use of system software, security software, database management systems, and utilities. • Incident tracking, system logging, and monitoring functions.

Access to Programs and Data	• Security of passwords. • Internet firewalls and remote access controls. • Data encryption and cryptographic keys. • User accounts and access privilege controls. • User profiles that permit or restrict access. • Revoking employee passwords and user IDs when employees resign or are terminated.
Program Development and Program Changes	• Acquisition and implementation of new applications. • System development and quality assurance methodology. • The maintenance of existing applications including controls over program changes.
Monitoring of IT Operations	• Policies and procedures regarding the information system and reporting that ensure that users comply with IT general controls and that IT is aligned with business requirements.

IT Application Controls
IT application controls relate to the particular software application that is used at the business process level. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records.

Typical application controls relate to procedures used to initiate, record, process, and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data with correction at the point of data entry and numerical sequence checks with manual follow-up of exception reports.

1.2.11 Business Process Controls

Business processes are structured sets of activities designed to produce a specified output. Business process controls relate to everyday activities such as transaction processing.

Business process controls can generally be classified as preventive, detective, compensating or steering:

- Preventive controls avoid errors or irregularities;
- Detective controls identify errors or irregularities after they have occurred so corrective action can be taken;
- Compensating controls provide some assurance where resource limitations may preclude other more direct controls; and
- Steering controls (that is, policies) are designed to guide actions towards the desired objectives.

The nature of business process controls will vary based on the specific application.

Typical controls at the business process level would include segregation of duties, transaction approval levels and automated controls such as the automatic numbering of sales invoices, preparing and reviewing bank and other reconciliations on a timely basis, and reviewing actual operating results against budget.

In addition to the benefits and risks of general IT controls, there are also benefits and risks of using manual controls, as described in the exhibit below.

Exhibit 1.2-8

Benefits and Risks of Manual Controls

Benefits of Manual Controls	• Better suited to areas where judgment and discretion are required over large, unusual or non-recurring transactions. • Are beneficial when errors are difficult to define, anticipate, or predict. • Changing circumstances may require a control response outside the scope of an existing automated control. • Can monitor the effectiveness of automated controls.
Risks Associated with Manual Controls	• Less reliable than automated controls, as they are performed by people. • More easily bypassed, ignored, or overridden. • Prone to simple errors and mistakes. • Consistency of application cannot be assumed. • Less suitable for high volume or recurring transactions where automated controls would be more efficient. • Less suitable for activities where the specific ways to perform the control can be adequately designed and automated.

Manual controls may be independent of IT or use information produced by IT. They may also be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions.

Consider Point

When the entity has a mix of manual and automated controls, it is important to identify who is responsible for the operation of each control. For example, suppose a warehouse manager is responsible for shipping goods. Is that manager only responsible for inputting the data or does this responsibility extend to the computer controls that match the shipment to the order? If something went wrong in the matching process, is it the responsibility of the warehouse, the IT department, or the accounting department? Unless one person is assigned responsibility for the entire process, departments will inevitably blame each other when errors are made.

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1.3 Financial Statement Assertions

Chapter Purpose	Primary ISA Reference
To understand the nature of management's assertions in relation to the presentation and disclosure of the various elements of financial statements and related disclosures.	**500**

1.3.1 Overview

ISA 500 states:

> **16. The auditor should use assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures.**

A representation by management, such as that the financial statements as a whole are presented fairly in accordance with the applicable financial reporting framework, contains a number of embedded assertions. These relate to the recognition, measurement, presentation, and disclosure of the various elements (amounts and disclosures) in the financial statements.

Examples of management's assertions include:

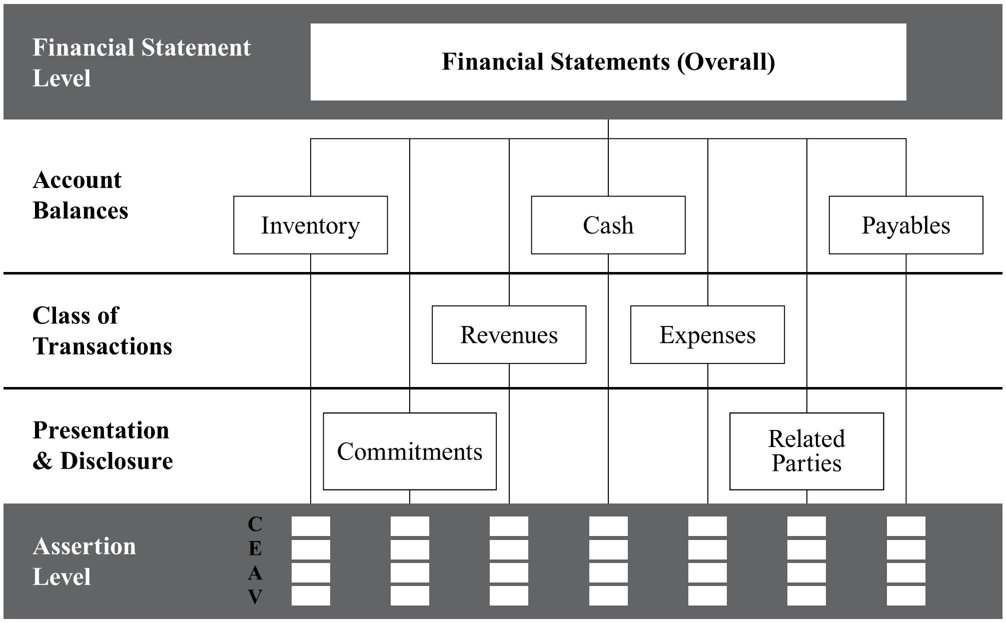
- All the assets exist;
- All sales transactions have been recorded;
- Inventories are properly valued;
- Payables are proper obligations of the entity;
- All recorded transactions occurred in the period under review; and
- All amounts are properly presented and disclosed in the financial statements.

These assertions are often summarized by a single word such as completeness, existence, occurrence, accuracy, valuation, etc. For example, when considering the sales balance, management is asserting that sales revenue is complete (completeness assertion), the transactions occurred (occurrence assertion), and transactions have been appropriately recorded in the accounting records (accuracy assertion).

The relevance of an assertion to an individual account balance will vary based on the characteristics of the balance and the potential risks of material misstatement. For example, the valuation assertion would not be relevant to assessing the sales balance but is highly significant when assessing the inventory balance. Conversely, the risks of material misstatement due to completeness in the inventory balance may be small, but highly significant in relation to the sales balance.

The relationship of assertions to account balances is illustrated in partial form in the exhibit below.

Exhibit 1.3-1



Note: This chart refers to the combined assertions which have been used for the purposes of this Guide. These combined assertions are explained below.

1.3.2 Description of Assertions

Paragraph 17 of ISA 500 describes the categories of assertions as follows in the exhibit below.

Exhibit 1.3-2

	Assertion	Description
Classes of Transactions and Events	**Occurrence**	Transactions and events that have been recorded, have occurred, and pertain to the entity.
	Completeness	All transactions and events that should have been recorded have been recorded.
	Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately.
	Cut-off	Transactions and events have been recorded in the correct accounting period.
	Classification	Transactions and events have been recorded in the proper accounts.

	Assertion	Description
Presentation and Disclosure	**Occurrence, rights and obligations**	Disclosed events, transactions, and other matters have occurred and pertain to the entity.
	Completeness	All disclosures that should have been included in the financial statements have been included.
	Classification and understandability	Financial information is appropriately presented and described, and disclosures are clearly expressed.
	Accuracy and valuation	Financial (and other) information is disclosed fairly and at appropriate amounts.

Paragraph 18 of ISA 500 states that auditors may use the assertion descriptions as described above or express them differently, provided all aspects have been covered.

1.3.3 Combined Assertions

To make the use of assertions a little easier to apply to smaller entities, this Guide has combined a number of the assertions. The four combined assertions and the assertions they address are illustrated in the exhibit below. When the auditor uses combined assertions, it is important to remember that the accuracy and cut-off assertion also include classification and rights and obligations.

Exhibit 1.3-3

Combined Assertions	Classes of Transactions	Account Balances	Presentation and Disclosure
Completeness	Completeness	Completeness	Completeness
Existence	Occurrence	Existence	Occurrence
Accuracy and Cut-off	Accuracy Cut-off Classification	Rights and obligations	Accuracy Rights and obligations Classification and understandability
Valuation		Valuation and allocation	Valuation

The following exhibit describes the four combined assertions used in this Guide.

Exhibit 1.3-4

Combined Assertion	Description
Completeness	Everything that should be recorded or disclosed in the financial statements has been included. There are no unrecorded or undisclosed assets, liabilities, transactions or events; there are no missing or incomplete financial statement notes.
Existence	Everything that is recorded or disclosed in the financial statements exists at the appropriate date and should be included. Assets, liabilities, recorded transactions, and financial statement notes exist, have occurred, and pertain to the entity.
Accuracy and Cut-off	All liabilities, revenues, expense items, rights to assets (in the form of a hold or control), and financial statement disclosures are the property or obligation of the entity and have been recorded at the proper amount and allocated (cut-off) to the proper period. This also includes proper classification of amounts in the financial statements.
Valuation	Assets, liabilities, and equity interests are recorded in the financial statements at the appropriate amount (value). Any valuation or allocation adjustments required by their nature or applicable accounting principles have been appropriately recorded.

1.3.4 Using Assertions in Auditing

The auditor should use assertions in sufficient detail to form a basis for:

- Considering the different types of potential misstatements that may occur;
- Assessing the risks of material misstatement; and
- Designing audit procedures that are responsive to the assessed risks.

Considering Types of Potential Misstatement

The auditor should ask questions about financial statement amounts and disclosures to identify the relevant assertions that, if not controlled, could result in a material misstatement in the financial statements.

In considering the examples of management's assertions outlined above, the auditor would ask questions such as:

- Does the asset exist? (Existence)
- Are all sales transactions recorded? (Completeness)
- Is inventory properly valued? (Valuation)
- Are payables proper obligations of the entity? (Accuracy)
- Did the transaction occur? (Existence)
- Are amounts properly presented and disclosed in the financial statements? (Accuracy)

Assessing Risks of Material Misstatement

Once the auditor has identified the types of potential misstatement, the next step is to identify what controls have been implemented to address the relevant assertions. For example, how does management ensure transactions are recorded (completeness) or that significant estimates are based on reasonable assumptions and properly recorded in the financial statements (accuracy)? It is then possible to assess the risks of material misstatement at both the financial statement and assertion levels.

Designing Audit Procedures

In designing audit procedures to be responsive to assessed risks, the auditor should place emphasis on addressing the relevant assertions where misstatements could occur. For example, if the risk is high that receivables are being overstated, the audit procedures should be designed to specifically address the valuation assertion. Similarly, when the auditor designs tests of controls, emphasis should be placed on testing controls over the relevant assertions rather than just significant controls.

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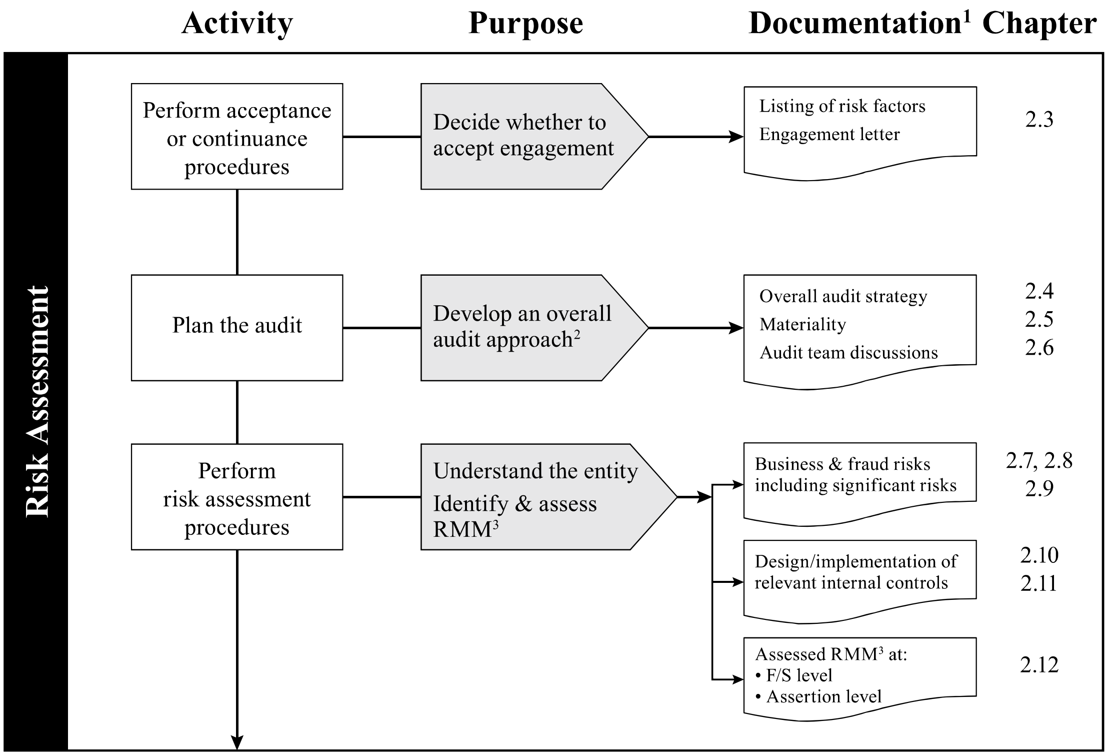
Part B
Risk Assessment

2.1 Understanding the Entity

Exhibit 2.1-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA Reference
To provide guidance on what is involved in understanding the entity and its environment necessary to: • Identify and assess potential risk factors; and • Sufficiently design and perform further audit procedures.	**315**

2.1.1 Overview

ISA 315 states:

> **2. The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.**

Understanding the entity is an iterative process, continuing throughout the entire duration of the audit.

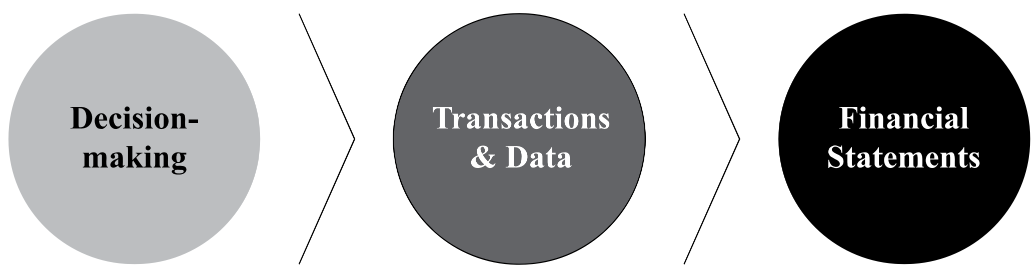
ISA 315 states:

> **22. The auditor should obtain an understanding of relevant industry, regulatory, and other external factors including the applicable financial reporting framework.**
>
> **25. The auditor should obtain an understanding of the nature of the entity.**
>
> **28. The auditor should obtain an understanding of the entity's selection and application of accounting policies and consider whether they are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.**
>
> **30. The auditor should obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements.**
>
> **35. The auditor should obtain an understanding of the measurement and review of the entity's financial performance.**

Each year, the auditor's understanding of the entity should be updated and details of significant changes documented.

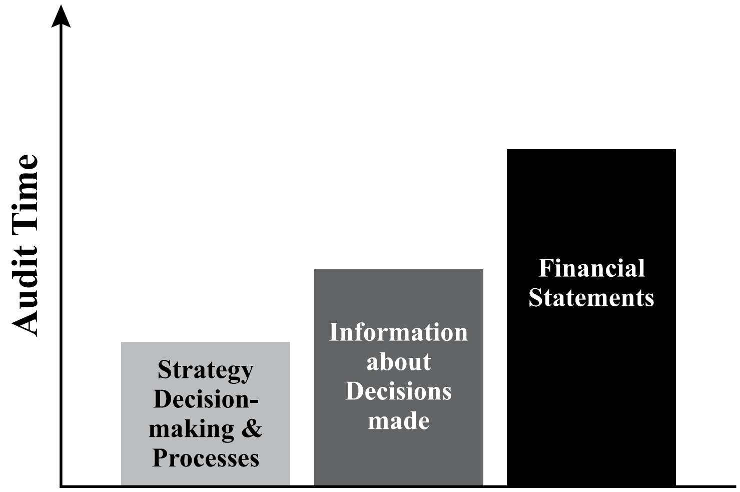
Financial statements provide a formal record of an entity's financial activities. Financial activities start with the entity's decision-making process, which will result from the business strategy, the control environment, and the business processes in place. As the decision-making process is implemented, business transactions take place which are recorded in the accounting records and summarized in financial statements. This is illustrated below.

Exhibit 2.1-2



Until the current ISAs were issued, auditors would often gain a basic knowledge of the entity and then focus on obtaining sufficient audit evidence to support the content of the financial statements. Audit effort was primarily directed at the information about decisions made by management and the content of the financial statements.

Exhibit 2.1-3



Note: The audit time shown in this chart and the exhibit below is relative and not an absolute figure.

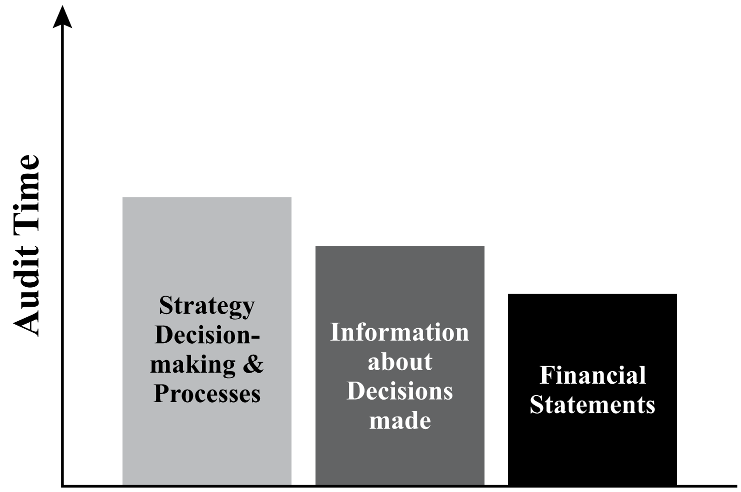
The weakness of this approach was that the auditor may not be aware of, or fully comprehend, the significance of the information being recorded about decisions made by management. It is only by spending time to understand the nature of the business, the business strategy, its culture and values (control environment), the competence of the people, and the entity's structure and processes that it is possible to develop expectations about what types of information should, in fact, be recorded by the information system.

ISAs require the auditor to take the time to really understand the entity's decision-making processes. This includes the business strategy, the business and fraud risks factors, the culture, people and accountability relationships (control environment), and the internal controls established to address the risks. This foundation of understanding about the entity will enable the auditor to:

- Identify business trends, risk factors, and key information that should be recorded in the entity's information system; and
- Plan more focused audit procedures (by responding to the specific risks identified) and thereby reduce the time being spent auditing certain financial statement balances.

The exhibit below illustrates this approach.

Exhibit 2.1-4



Understanding the nature of the entity and its environment includes the following steps, as discussed in the corresponding chapters:

- What are Risk Assessment Procedures Chapter 2.2
- Business Risk Chapter 2.7
- Fraud Risk Chapter 2.8
- Significant Risks Chapter 2.9
- Internal Control Chapter 2.10
- Assessing Internal Control Design and Implementation Chapter 2.11
- Assessing the Risks of Material Misstatement Chapter 2.12

Understanding the nature of the entity and its environment, including internal control, provides the auditor with a frame of reference for making judgments about risk assessments and developing appropriate responses to risks of material misstatement in the financial statements.

This understanding will assist the auditor in:

- Establishing materiality (refer to Chapter 2.5);
- Assessing management's selection and application of accounting policies;
- Considering the adequacy of financial statement disclosures;
- Identifying audit areas for special consideration (for example, related-party transactions, unusual or complex contractual arrangements, going-concern or unusual transactions);
- Developing expectations needed for performing analytical procedures;
- Designing/performing further audit procedures to reduce audit risk to an acceptably low level; and
- Evaluating sufficiency/appropriateness of audit evidence obtained (for example, appropriateness of assumptions used and management's oral and written representations).

Consider Point

The information gained from risk assessment procedures conducted before engagement acceptance or continuance should be used as part of the audit team's understanding of the entity. Simply ensure the information collected is readily available to the audit team after the engagement has been approved.

2.1.2 Sources of Information

Information about the entity and its environment can be obtained from both internal and external sources. In most cases, the auditor will start with internal sources of information; however, these should be checked for consistency with information obtained from external sources. The following exhibit shows some of the potential sources of information available.

Exhibit 2.1-5

	Internal Sources	**External Sources**
Financial Information	• Financial statements • Budgets • Reports • Financial performance measures/metrics • Minutes • Income tax returns • Decisions made on accounting policies • Judgments and estimates	• Industry information • Competitive intelligence • Credit rating agencies • Creditors • Government agencies • Franchisors • The media and other external parties
Non-financial Information	• Vision • Mission • Values • Objectives • Strategies • Organization structure • Minutes • Job descriptions • Operating performance • Business drivers • Capabilities • Policy & procedure manuals • Non-financial performance measures/metrics	• Trade association data • Industry forecasts • Government agency reports • Newspaper/magazine articles • Information on the Internet

Consider Point

A major source of information that is often overlooked is the auditor's working paper files from previous years' engagements. They often contain valuable information on matters such as:

- Considerations or issues to address in planning this year's audit;
- Evaluation and source of possible adjustments and uncorrected errors;
- Areas where there are recurring disagreements such as the assumptions used for accounting estimates;
- Areas which appear to be susceptible to error; and
- Matters raised in the auditor's communication with management and those charged with governance.

2.1.3 Scope of Understanding Required

In addition to the need to understand the relevant internal control, which is addressed in Chapter 2.10, the auditor needs to understand and document four key areas, as outlined below.

Exhibit 2.1-6

1. External Factors	Nature of industry? Regulatory environment? Financial reporting framework?
2. Nature of Entity	Operations, ownership & governance? People, investments & structure? Application of accounting policies?
3. Entity Objectives & Strategies	Related business risks? Financial consequences?
4. Measurement/Review of Financial Performance	What key measures are used? What pressures are on management to improve business performance?

Additional information on each of the four areas is provided as follows.

1. External Factors	Nature of industry? Regulatory environment? Financial reporting framework?

Factors to Consider

- Industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments.
- The regulatory environment, including the applicable financial reporting framework.
- Specific risks arising from the nature of the business or the degree of regulation.
- The legal and political environment and environmental requirements affecting the industry and the entity.
- Laws or regulations that, if violated, could reasonably be expected to result in a material misstatement in the financial statements.
- Other external factors, such as general economic conditions.

2. Nature of Entity

Operations, ownership & governance?
People, investments & structure?
Application of accounting policies?

Factors to Consider

- Entity's operations.
- Ownership and governance, including owners, family members, those charged with governance and relationships between owners and other people or entities.
- Types of investments (acquisitions, equipment, people, new products, locations, R&D, etc.) that the entity is making and plans to make.
- Entity structure (locations, subsidiaries, etc.) Complex structures may give rise to risks of material misstatement such as:
  - Allocation of goodwill and its impairment; and
  - Accounting for investments.
- How related party transactions are identified and accounted for.
- How the entity is financed.
- Are the accounting policies appropriate for the business?
- Are the accounting policies used in the relevant industry?
- Are the accounting policies consistent with the applicable financial reporting framework?
- What methods are used to account for significant and unusual transactions?
- Are there significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus? If so, consider the effect of using such policies.
- Are there any changes in the entity's accounting policies during the period? (This includes new financial reporting standards/regulations.) If so:
  - Document the reasons and consider appropriateness; and
  - Consider consistency with requirements of the applicable financial reporting framework.
- Is there adequate disclosure of material matters in the financial statements? Consider form, arrangement and content of the financial statements and footnotes, classification of items, amount of detail provided and basis of amounts set forth.

3. Entity Objectives & Strategies

Related business risks?
Financial consequences?

Factors to Consider

- Obtain a copy of any mission, vision or values statement produced by the entity (such as in promotional or web-based materials) and consider its consistency with the entity's strategy and objectives. In smaller entities, this information will not often be documented but could possibly be obtained through discussions with management and observation of how they respond to such matters.
- Identify and document the entity's strategies (that is, operational approaches by which management intends to achieve its objectives).
- Identify and document the entity's current objectives (that is, its overall plans for the entity both short term and long term). In smaller entities, this information will likely be obtained through inquiry of management and observation of how they respond to such matters.
- Based on the understanding obtained about mission, vision, business strategies and objectives, identify and document the related business risks.
- Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies or through the setting of inappropriate objectives and strategies.

4. Measurement/Review of Financial Performance

What key measures are used?
What pressures are on management to improve business performance?

Factors to Consider

- Identify the key measures used by management to assess the entity's performance and achievement of objectives.
- Are there external parties that measure and review the entity's financial performance (regulators, franchisors, lending institutions, and so forth)? If so, consider whether copies of such reports should be obtained from the entity (for example, credit rating agency reports).
- Did the performance measures motivate management to take action to:
  – Improve the business performance?
  – Heighten risk by taking aggressive actions to achieve objectives?
  – Meet personal goals such as achieving a bonus threshold?
- Do the performance measures:
  – Highlight any unexpected results or trends?
  – Indicate trends or results consistent with the industry as a whole?
- Are the performance measures based on reliable information and precise enough to be used as a basis for analytical procedures?

Each industry tends to have its own key performance indicators (financial and non-financial) which the auditor should identify and consider first. Some typical key performance indicators include:

- Comparisons of performance to budgets;
- Variance analysis;
- Gross margin by product;
- Unit sales;
- Repeat contracts;
- New and lost customers;
- Segment information;
- Divisional, departmental or other level performance reports; and
- Comparison of the entity's performance with that of its competitors.

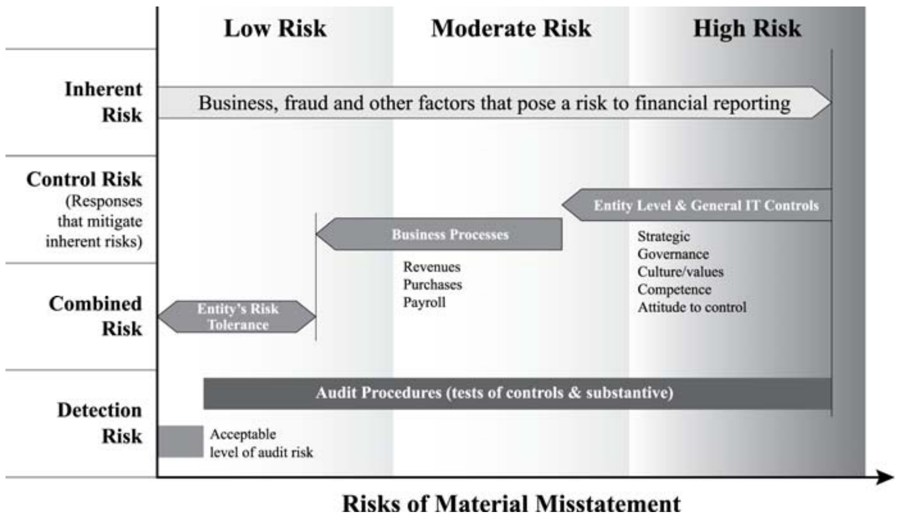
In smaller entities, management may rely on just one or two key indicators that may be reliable for evaluating financial performance and taking appropriate action.

The auditor should also consider information obtained from other sources, such as engagement acceptance and continuance procedures, that may be relevant to any of the four key areas that the auditor needs to understand and document.

2.1.4 Classifying the Information Obtained

The purpose of understanding the entity is to perform a risk assessment. This involves the identification and then the assessment of potential risks of material misstatement in the financial statements. The information obtained will consist of risk factors or sources of risk and the internal control system in place that will mitigate such risks, as illustrated in the exhibit below.

Exhibit 2.1-7



Note: The term "entity level controls" incorporates many elements of the control environment, risk assessment, and monitoring components of internal control. Refer to Chapter 1.2.

The sources of risk and the mitigation of risk can be further broken down as illustrated in the exhibit below.

Sources of Risk

Exhibit 2.1-8

Note: The term "entity level controls" incorporates many elements of the control environment, risk assessment and monitoring components of internal control. See Chapter 1.2.

Note: The term "business risk" is broader than the risks of material misstatement in the financial statements. Business risk may also arise from change, complexity, or the failure to recognize the need for change. Change may arise, for example, from:

- The development of new products that may fail;
- An inadequate market, even if successfully developed; or
- Flaws that may result in liabilities and risk to reputation.

The auditor's understanding of the business risks increases the likelihood of identifying the risks of material misstatement. However, there is no responsibility for auditors to identify or assess all business risks.

The sufficiency of information (depth of understanding) required by the auditor is a matter of professional judgment. It is less than that possessed by management in managing the entity.

Subsequent chapters in this Guide address the identification of business risk factors, fraud risk factors, internal control, and the combined risk assessment.

2.1.5 Documentation

The auditor should document key elements of the understanding obtained regarding each of the aspects of the entity and its environment, as outlined above. Professional judgment should be used regarding the manner in which these matters are documented. The more complex the entity and the audit procedures required, the more extensive the documentation will be.

Documentation will include:

- Discussions among the audit team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud and the significant decisions reached.
- Key elements of the understanding of the entity obtained regarding:
  - Each of the aspects of the entity and its environment outlined above;
  - Each of the internal control components, as outlined in Chapter 1.2;
  - Sources of information from which the understanding was obtained; and
  - The risk assessment procedures performed.
- The identified and assessed risks of material misstatement at the financial statement level and assertion level.
- Significant risks identified and evaluation of related controls.

In the documentation, it is important to obtain, in writing, management's acceptance of responsibility for the design and implementation of internal control.

Consider Point

It is not necessary to prepare new documentation each year. To the extent possible, simply update the previous year's documents with changes and fresh information but always be sure the changes can be identified as being made in the current audit period. Then, document the fact that the information was updated.

Case Study — Understanding the Entity

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Dephta Furniture Inc.

Some of the information obtained from performing the risk assessment procedures might include the following:

Industry factors
Dephta seems to be following the industry trends, as outlined below.

The furniture industry is expanding due to a growing economy (more people can afford good furniture), availability of skilled labour, government policies that encourage business development, and local lumber mills that can now produce raw materials at a competitive rate. Dephta has a five-year contract for the supply of lumber at fixed prices.

The growing industry is also attracting new players and there is some consolidation of smaller manufacturers by larger more profitable manufacturers. Dephta was approached by a larger company last year that wanted to buy the company. The offer was refused.

The trend seems to be towards manufacturing standard (lower priced) pieces of furniture for larger retailers as opposed to the traditional practice of custom furniture sold directly to consumers. Retailers are asking for bigger orders but only in exchange for lower prices. This is driving assembly-line style factories with a few standard product lines. Dephta has supplied two major retailers. There is risk here because the retailers can be very demanding. In the last year, three furniture companies went bankrupt by trying to produce and finance large quantities of goods and orders at razor-slim profit margins.

Related parties include…

Sales breakdown is as follows:

Standard furniture (from catalogue)	40%
Sales to furniture retailers	30%
Internet sales	12%
Made-to-order (custom-built) furniture	15%
Scrap sales from factory	3%

Laws and regulations to consider…

Key customers…

Key suppliers…

Nature of entity

The company does not have a formal governance structure, but Jeewan and Suraj prepare a business plan each year and then meet regularly (once a month) with successful local businessman, Ravi Jain, to review their progress against the plan. They pay Ravi to comment on the practicality of their new dreams and ideas for the business, review the operating results, and provide advice on how to deal with any specific issues that have arisen (see organizational chart on W/P Ref #).[1]

Suraj feels that the company pays too much in corporate taxes. By comparing actual results to the estimates made in previous years, we identified some instances of management bias. This matter has become a topic of discussion at the closing meeting in each of the last two years.

Ownership is as follows:

(See chart on W/P Ref #)[1]

Personnel

Dephta Furniture Inc. has a full-time staff of 19 employees. Over eight of these employees are related in some way to the family. However, during busy periods extra people are hired to fulfill larger orders where a deadline for order completion exists. During some weeks, there is no need for temporary workers at all; at other times, there can be anywhere from four to eight temporary workers employed. A few of the temporary workers return regularly, but because of the lack of job security, the turnover is quite high.

All hiring decisions are made by Dameer and Suraj. Like his father, Suraj is committed to hiring competent people and expects loyalty from his employees. Dephta has always strived to hire the best talent the company can find in the region and pays its full-time employees very competitive rates.

Individual responsibilities are as follows:

- Suraj Dephta is the managing director. He oversees all aspects of operations and finances with the help of his assistant, Kamera, who is his daughter-in-law.
- Arjan Sing is in charge of sales and he is assisted by two full-time salespeople.
- Dameer looks after production, which includes raw materials ordering and the inventory. There are eight full-time production staff members, which includes a production supervisor and one person in charge of quality internal control. Because the facility's space is limited, Suraj and Dameer are never too far away from the production process and so they share the task of supervising the staff.
- Jawad Kassab (a cousin of Suraj) is in charge of the finance function.
- John Rabeer is in charge of IT.
- Management is very involved in the operations. Suraj and Dameer monitor operations and deal with issues as they arise. Job descriptions have been developed and roles and responsibilities are reasonably well defined.

1 W/P = working papers. Ref # = reference number. Not included.

Key advisors
In addition to the bank manager and Ravi, Parvin (Ravi's daughter and a lawyer by training) usually accompanies her father to the meetings with Suraj and Jeewan. Parvin offers some legal advice, but also gets involved with strategy. It was Parvin's idea that Dephta Furniture should expand its boundaries and start some Internet sales. She also pushed for expansion outside their local region and even to neighbouring countries.

Financing
HGIQ Bank operating loan secured by receivables and inventory.

Vinjay – unsecured loan at 12% repayable over 10 years commencing January 1, 20x4. The debt is convertible to equity if there is ever a default in repaying either interest or the principal on the loan.

Bonus plans
Both Suraj and Dameer receive a management bonus based on the audited financial statements. Each member of the sales staff (including Arjan) receives a commission of 10% on each sale in addition to a minimum base salary. This commission can represent a significant part of their salaries.

Accounting policies
Revenue is recognized when the goods are shipped. The only exception is the non-refundable 15% deposit taken on large orders, which is recognized as revenue when the deposit is made. This amount has not been material in the last three years.

Of more concern are the sales contracts that have provisions for inventory to be returned to Dephta if it does not sell within a specified time period. This could result in a revenue recognition issue.

The other significant accounting policies are as follows…

Business objectives and strategies
The business plan calls for more expansion beyond local boundaries. This includes more sales to large retailers and marketing to attract Internet sales. Suraj sees this as a great new opportunity to grow the company and become more profitable.

The implications of growth are:

- An increased risk of bad debts;
- A need for sound inventory management to ensure investment levels and obsolescence are minimized;
- A potential squeeze on working capital;
- An increased risk of damage in transport;
- An increased cost of returned merchandise;
- A need for foreign currency exchange risk management;
- A need for additional fixed assets;
- A need for additional craftsmen; and
- Foreign exchange risk management.

Performance measures
See the extensive analytical procedures performed on W/P Ref. #[2]

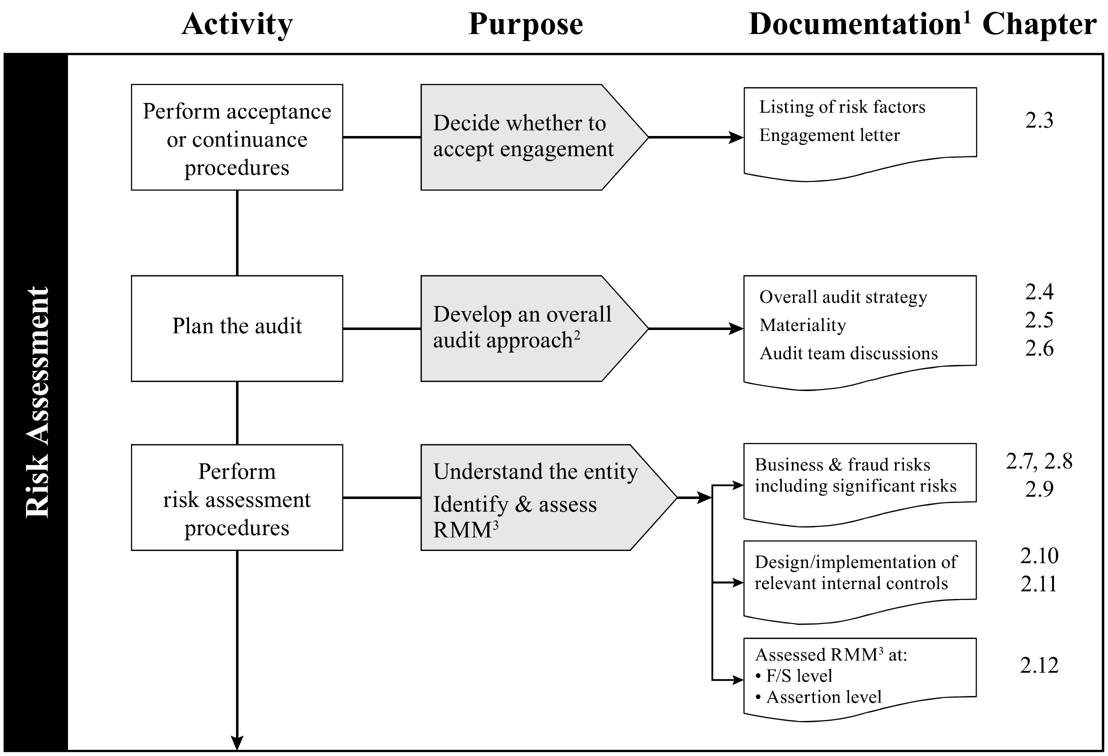
Suraj watches the gross margin levels very closely. However, because inventory management is not strong, some of the calculated margins may be higher than reality. This has been the subject of a communication to management in the past.

Based on our research of the industry, the current margin levels are reasonable.

[2] W/P = working papers. Ref # = reference number. Not included.

2.2 What are Risk Assessment Procedures?

Exhibit 2.2-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA References
To explain the purpose and nature of risk assessment procedures and how they relate to the development of the detailed audit plan and overall audit strategy.	**315, 520**

2.2.1 Overview

ISA 315 states:

7. **The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:**

   (a) Inquiries of management and others within the entity;

   (b) Analytical procedures; and

   (c) Observation and inspection.

12. When the auditor intends to use information about the entity and its environment obtained in prior periods, the auditor should determine whether changes have occurred that may affect the relevance of such information in the current audit.

ISA 520 states:

2. The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit.

Risk assessment procedures are designed for obtaining an understanding of the entity and its environment, including its internal control. This understanding should be a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit.

2.2.2 Nature of Evidence Obtained

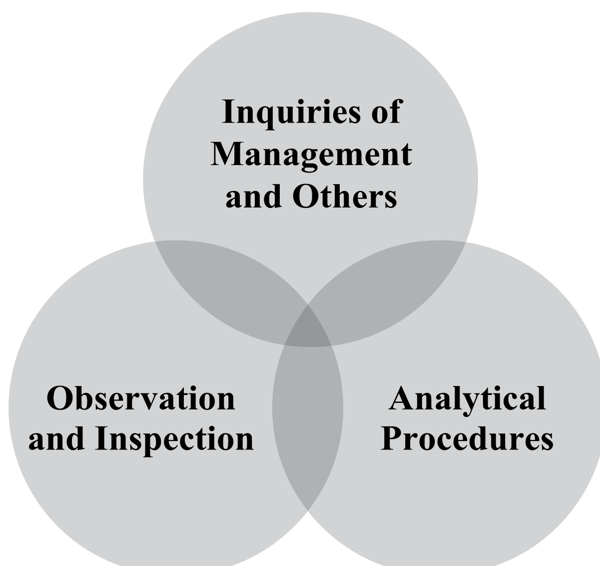
Risk assessment procedures provide the audit evidence necessary to support the assessment of risks at the financial statement and assertion levels. However, this evidence does not stand alone. At the risk response phase of the audit, the evidence obtained will be supplemented by further audit procedures (that respond to the risks identified) such as tests of controls and/or substantive procedures.

Where efficient, further procedures such as substantive procedures or tests of controls may be performed concurrently with the risk assessment procedures.

2.2.3 Required Procedures

There are three risk assessment procedures, as illustrated below.

Exhibit 2.2-2



Each of these procedures should be performed during the audit, but not necessarily for each aspect of the understanding required. In many situations, the results from performing one type of procedure may lead to another. For example, the findings from analytical procedures on preliminary operating results may trigger inquiries of management. The answers to the inquiries may then lead to requests to inspect certain documents or observe some activities.

The nature of the three procedures is outlined below.

2.2.4 Inquiries of Management and Others

The goal of this procedure is to understand the entity and to identify/assess the various sources of risk that exist. Some areas of inquiry would include those outlined in the following exhibit.

Exhibit 2.2-3

Inquire To…	Inquire About…
Management and Those Responsible for Financial Reporting / Those Charged with Governance	• The processes in place for identifying and responding to the risks of fraud and error in the financial statements. • How management communicates, if at all, to employees regarding its views on business practices, adherence to policies and procedures, and ethical behavior. • The role they play. • The entity's culture (values and ethics). • Management's operating style. • Management incentive plans. • Potential for management override. • Knowledge of fraud or suspected fraud. • The financial statement preparation and review process. Also consider attending a meeting of those charged with governance and reading the minutes of their meetings.
Key Employees (Purchasing, payroll, accounting, etc.)	• The initiating, processing or recording of complex or unusual transactions. • The extent of management override (have they ever been asked to override internal controls). • The appropriateness/application of the accounting policies used.
Marketing or Sales Personnel	• Marketing strategies and sales trends. • Sales performance incentives. • Contractual arrangements with customers. • The extent of management override (have they ever been asked to override internal controls or revenue recognition accounting policies?).

Consider Point

Do not confine your questions (especially in smaller audits) to the owner-manager and the accountant. Ask others in the entity (such as the sales manager, production manager or other employees) about trends, unusual events, major business risks, the functioning of internal control, and any instances of management override.

2.2.5 Analytical Procedures

Analytical procedures used as risk assessment procedures help to identify matters that have financial statement and audit implications. Some examples are unusual transactions or events, amounts, ratios, and trends.

There are two other major purposes for using analytical procedures:

- As the primary source of evidence for a financial statement assertion. This would be a substantive analytical procedure and is discussed in further detail in Chapter 3.3; and
- In performing an overall review of the financial statements at, or near, the end of the audit.

Most analytical procedures are not very detailed or complex. They often use data aggregated at a high level, which means the results can only provide a broad initial indication about whether a material misstatement may exist.

The steps involved in performing analytical procedures are outlined in the chart below.

Exhibit 2.2-4

What To Do	How To Do It
Identify Relationships Within the Data	Develop expectations about plausible relationships among the various types of information that could reasonably be expected to exist. Seek to use independent sources of information (that is, not internally generated) where possible. The financial and non-financial information could include: • Financial statements for comparable previous periods; • Budgets, forecasts, and extrapolations, including extrapolations from interim or annual data; and • Information regarding the industry in which the entity operates and current economic conditions.
Compare	Compare expectations with recorded amounts or ratios developed from recorded amounts.
Evaluate Results	Evaluate the results. Where unusual or unexpected relationships are found, consider potential risks of material misstatement.

The results of these analytical procedures should be considered along with other information gathered to:

- Identify the risks of material misstatement related to assertions embodied in significant financial statement items; and
- Assist in designing the nature, timing and extent of other auditing procedures.

2.2.6 Observation and Inspection

Observation and inspection:

- Support the inquiries made of management and others; and
- Provide information about the entity and its environment.

Observation and inspection procedures ordinarily include a procedure and an application, as outlined in the chart below.

Exhibit 2.2-5

Procedure	Application
Observation	Observe: • How the entity operates and is organized; • Management's operating style and attitude toward internal control; • Operation of various internal control procedures; and • Compliance with certain policies.
Inspection	Inspect documents such as: • Business plans and strategies; • Accounting policies and records; • Internal control manuals; • Reports prepared by management (such as interim financial statements); and • Other reports such as minutes from meetings of those charged with governance, reports from consultants, etc..

2.2.7 Other Risk Assessment Procedures

Other procedures not listed above may also be used for risk assessment purposes. Typical examples include:

- Information obtained from pre-engagement procedures;
- Experience gained from previous engagements and other engagements performed for the entity;
- Information about the entity and its environment obtained in prior periods such as:
  - Organizational structure, business processes, and internal control,
  - Past misstatements and whether they were corrected on a timely basis, and
  - Before such information can be used, the auditor should first determine (through inquiries, walkthroughs, etc.) whether changes have occurred that may affect its relevance to the current audit;
- Inquiries of the entity's external legal counsel or of valuation experts;
- Reviewing information obtained from external sources such as reports by banks or rating agencies, trade and economic journals, and regulatory and financial publications;
- Evidence obtained from evaluating the design of internal control and determining whether the control procedures have been implemented; and

- Results of discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatements.

Case Study — Risk Assessment Procedures

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Risk assessment procedures are used to understand the entity. There are five key areas (industry factors, nature of entity, accounting policies, business plans, and performance indicators) for which information should be obtained or updated each year.

The goal is to identify and assess risk factors and determine how management mitigates such risks. This information is then used for developing an appropriate audit response. Some information obtained as a result of these inquiries is contained in the business/fraud risk chapters, as well as the chapters about internal control.

Deptha Furniture Inc.
Some typical risk assessment procedures that would apply to Dephta include the following:

INQUIRIES

1. Management and those responsible for financial reporting (Suraj, Jawad)
    - Review business objectives, industry trends, current issues, and management's planned responses.
    - Are there any significant changes in the corporate structure, operations, key personnel, bonus plans, internal control, and/or financial statement items?
    - Ask about the monthly management meetings. Are there minutes and action steps arising?
    - Discuss the entity's culture/values and expected employee behaviors.
    - Address how company values are communicated to employees.
    - Ask how management assesses risks and what processes are in place for monitoring and responding to such risks, including fraud and error in the financial statements.
    - Are there any instances of alleged, suspected or actual fraud? If yes, provide details.
2. Key employees (Dameer, Arjan, production supervisors)
    - Ask about unusual or complex transactions and changes in accounting policies. Has management asked them to override internal control?
    - Ask about sales trends, contractual arrangements with customers, warranties, and return rates.
    - Ask about any changes in terms with key suppliers.
    - Ask about the adequacy of insurance coverage.
    - Ask about the effectiveness of internal control systems, any knowledge of fraud, and any knowledge of non-compliance with laws and regulations.

ANALYTICAL PROCEDURES

- Obtain a copy of the most recent operating results and identify plausible relationships among the various types of information available. Consider both financial and non-financial information.
- Compare expectations with recorded amounts or ratios developed from recorded amounts and last year's files.
- Identify unusual or unexpected relationships. Obtain an explanation from management and assess the resulting risks of material misstatement.

OBSERVATION AND INSPECTION

Identify, obtain, and read key documents such as:

- Business plans, budgets, and most recent financial statements;
- Any consultant reports;
- Reports/letters from regulators or government agencies;
- Magazine/newspaper articles about Dephta or the industry;
- Any correspondence with the bank regarding changes in overdraft facility or covenants;
- Details of any actual or threatened litigation;
- Significant contracts or agreements signed in period;
- Tax assessments; and
- Perform walkthroughs of major internal control systems to ensure there have been no major changes in the process and/or the people performing the internal control procedures.

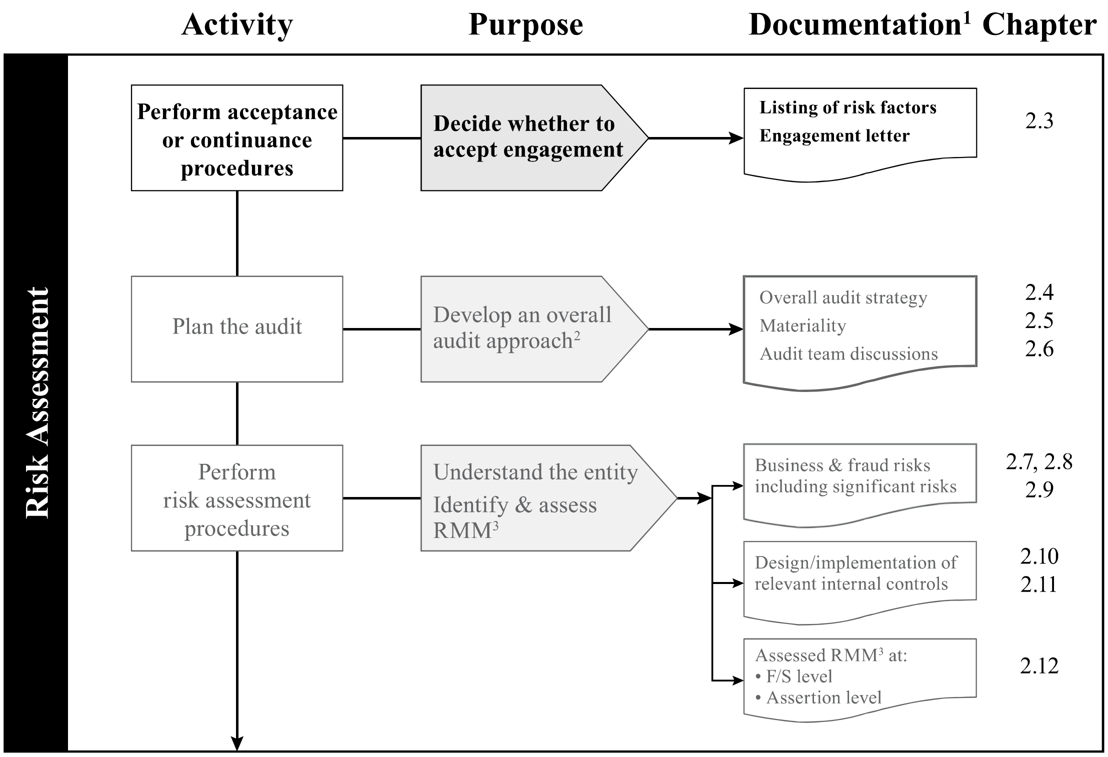
CONCLUSIONS

Document key findings on the appropriate working papers. This would include the listing of all risks identified, the control design matrix (see Chapter 2.11 of this Guide), and the overall and detailed audit plans. Matters to address would include:

- Concerns about management override, culture, and key employees' integrity and/or competence;
- Risk factors identified that should be addressed in the detailed audit plan;
- Internal control deficiencies identified plus their impact, if any, on the detailed audit plan; and
- Matters that should be discussed with management.

2.3 Client Acceptance and Continuance

Exhibit 2.3-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA References
To provide guidance on the procedures required to: • Identify and assess risk factors relevant to deciding whether to accept or decline the audit engagement; and • Agree upon and document the terms of the engagement.	**ISQC 1, 200, 210, 220, 300**

2.3.1 Overview

ISQC 1 states:

> **3. The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances.**

7. The firm's system of quality control should include policies and procedures addressing each of the following elements:

(a) Leadership responsibilities for quality within the firm.

(b) Ethical requirements.

(c) Acceptance and continuance of client relationships and specific engagements.

(d) Human resources.

(e) Engagement performance.

(f) Monitoring.

8. The quality control policies and procedures should be documented and communicated to the firm's personnel.

28. The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will only undertake or continue relationships and engagements where it:

(a) Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;

(b) Is competent to perform the engagement and has the capabilities, time and resources to do so; and

(c) Can comply with ethical requirements.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

34. Where the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:

(a) The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and

(b) The possibility of withdrawing from the engagement or from both the engagement and the client relationship.

ISA 200 states:

4. The auditor should comply with relevant ethical requirements relating to audit engagements.

One of the most important decisions that a practice can make is who to accept or retain as a client. A poor decision can lead to unbillable time, unpaid fees, additional stress on partners and staff, loss of reputation, or – worst of all – potential lawsuits. ISQC 1 and ISA 220 require firms to develop, implement, and document their quality control procedures in regard to client acceptance and retention policies. Ideally, these policies and procedures should address the level of risk (risk tolerance/appetite) or client characteristics (such as a specialized or publicly traded company) that would not be acceptable to the firm.

2.3.2 Acceptance and Continuance Procedures

ISA 220 states:

> **14. The engagement partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and specific audit engagements have been followed, and that conclusions reached in this regard are appropriate and have been documented.**
>
> **18. Where the engagement partner obtains information that would have caused the firm to decline the audit engagement if that information had been available earlier, the engagement partner should communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.**

For initial audit engagements, ISA 300 states:

> **28. The auditor should perform the following activities prior to starting an initial audit:**
>
> **(a) Perform procedures regarding the acceptance of the client relationship and the specific audit engagement.**
>
> **(b) Communicate with the previous auditor, where there has been a change of auditors, in compliance with relevant ethical requirements.**

Before a decision is made to accept or retain a client, the auditor is required to perform some client acceptance or continuance procedures. The procedures are similar in nature to the risk assessment procedures outlined in Chapter 2.4 and the results (if the engagement is accepted) can be used as part of the risk assessment. A yearly assessment of engagement risk will ensure the firm's continuing independence and ability to act and that the engagement risk is still within the firm's predetermined appetite for risk.

The purpose of these procedures is to identify and then assess the risk to the firm in accepting or continuing with an engagement. For example, if the auditor discovered that a prospective client is heading for financial difficulty or you found out that an existing client had made false representations in a previous engagement, the risk of accepting or continuing with that client may be deemed unacceptable.

In addition to risks posed by the client, there is also a need to review the auditing firm's ability to perform the engagement. This would include the availability of appropriately qualified staff when the work is required, the need for specialized assistance, any conflicts of interest, and independence from the client.

Other considerations relate to the business risk to the firm in accepting or continuing with the entity. This would include the risk of not being paid, or being associated with an entity that may harm the firm's reputation, etc.

The following exhibit outlines some possible lines of inquiry.

Exhibit 2.3-2

What is Required	• What is the nature and scope of the audit? • How will the audit report and financial statements be used? • What is the deadline for completing the audit?
Firm's Ability to Serve	• Can an engagement team be assembled by the firm that has: – The competence required to perform the audit; and – The necessary time and resources available? • Can the firm and the engagement team comply with ethical requirements? • Are there any scope limitations such as unrealistic deadlines or inability to obtain the required audit evidence? • For new engagements, has the firm communicated with the predecessor accountant to determine if there are any reasons for not accepting?
Any Potential Challenges to Address	Are there difficult or time-consuming issues to address (accounting policies, estimates, nature of industry, compliance with legislation, etc.)? • What changes have taken place this year that will impact the engagement (business initiatives, financial reporting, IT systems, mergers, regulations, etc.)? • Is there a high level of public scrutiny and media interest? • Is the entity in good financial health and does it have the ability to pay professional fees?
Nature of the Entity's Management	• Is there any reason to doubt the integrity of the principal owners, senior management, and those charged with governance of the entity? • How competent is the senior management and staff? • What is management's attitude toward internal control (consider corporate culture, organizational structure, risk appetite, complexity of transactions, etc.)? • Will the client provide help to the firm in obtaining information and preparing schedules, analysis of balances, providing data files, etc.?

Background Checks

To ensure the information obtained from the client is accurate, consider what third party information could be obtained to validate key aspects of the risk assessment. This simple step could avert problems later on. Examples include information from sources such as previous financial statements, income tax returns, credit reports, and discussions with key advisors such as bankers, lawyers, etc.

Consider Point

Before contacting third parties and collecting information on the client, the auditing firm should take steps to ensure all partners and staff are aware of:

- The firm's policies to protect confidential information maintained on clients;
- Requirements of any privacy legislation; and
- Requirements of the applicable code of ethics.

2.3.3 Terms of Engagement

Once the engagement risk assessment is complete and the firm decides to proceed, a letter that sets out the terms of engagement should be prepared, discussed, agreed upon, and signed by both parties. This process is in the interest of both client and auditor, as it will help to avoid misunderstandings.

ISA 210 states:

> **2. The auditor and the client should agree on the terms of the engagement.**
>
> **10. On recurring audits, the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.**
>
> **12. An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.**
>
> **17. Where the terms of the engagement are changed, the auditor and the client should agree on the new terms.**
>
> **18. The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.**
>
> **19. If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report to other parties, such as those charged with governance or shareholders, the circumstances necessitating the withdrawal.**

The engagement letter would generally set out:

- The objective of the audit of financial statements;
- Management's responsibility for the financial statements;
- The scope of the audit, including reference to applicable legislation, regulations or pronouncements of professional bodies to which the auditor adheres;
- The form of any reports or other communication of results of the engagement;
- The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered; and
- That there will be unrestricted access to any records, documentation and other information requested in connection with the audit.

The engagement letter may also contain the following:

- The arrangements regarding the planning and performance of the audit;
- The expectation of receiving written confirmation from management concerning representations made in connection with the audit;
- A request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter;
- Descriptions of any other letters or reports the auditor expects to issue to the client;
- The basis on which fees are computed and any billing arrangements;
- Any restriction of the auditor's liability where such possibility exists; and
- A reference to any further agreements between the auditor and the client.

For additional guidance, refer to paragraphs 6 to 8 of ISA 210.

To ensure understanding of the engagement letter, the auditor would discuss the contents with those charged with governance or the appropriate representative of senior management. In some cases, it may be prudent for the auditor or the entity to review certain terms of the engagement with legal counsel.

Even in countries where the objective, scope, and auditor's obligations are established by law, an engagement letter may still be useful to inform clients about specific roles and responsibilities.

A sample of an engagement letter based on the example contained in ISA 210 is provided in the case study materials that follow.

Note: Engagement letters need to be adapted according to individual requirements and circumstances.

To avoid any potential for misunderstanding, the engagement letter should be finalized and signed before engagement work commences.

Updating the Engagement Letter

The engagement letter should be updated at regular intervals, ideally each year but no later than, say, every third year. When no changes have occurred the terms could also be reconfirmed at the point of auditor reappointment without the need for a new letter each year.

The engagement letter should always be updated whenever a material change takes place such as:

- Any indication that the client misunderstands the objective and scope of the audit;
- Any revised or special terms of the engagement;
- A recent change of senior management, those charged with governance or ownership;
- A significant change in nature, structure or size of the client's business;
- Legal requirements; or
- A change in the financial reporting framework adopted by management in preparing the financial statements.

Case Study — Client Acceptance and Continuance

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Assuming this is an ongoing audit engagement, the partner or senior manager in the audit firm would make some inquiries to identify and assess any new or revised risk factors relevant to deciding to continue with the audit engagement. For Deptha, this could include the following inquiries.

Dephta Furniture Inc.	
Inquiry	**Response**
1. Any change in the terms of reference or requirements for the audit engagement?	*No. We are required to audit the financial statements as at year end.*
2. Any independence issues or conflicts of interest? This might include non-audit services provided, a financial interest with the client, business relationships other than the audit, or family/personal relationships with key client people by partners or staff.	*Only matter noted was that one of our staff bought a lot of bedroom furniture but he paid the catalogue price. This incident is not considered a threat to our independence.*
3. Any circumstances that would cast doubt on the integrity of the client's owners? This could include convictions, regulatory proceedings/sanctions, suspicion or confirmation of illegal acts or fraud, police investigations, and any negative publicity.	*No. However, Parvin (daughter of the client's business advisor) received some negative publicity in July. She was an advisor in a land deal where government officials were accused of receiving bribes from developers. This matter has also been noted on our listing of risk factors for the audit.*
4. Do the partners and staff planned for the engagement have sufficient knowledge of the accounting principles and practices of the client's industry to perform the engagement?	*Yes. We plan to use the same staff as last year to complete the engagement.*
5. Are there areas where specialized knowledge is necessary?	*We will use our computer specialist to review control over the Internet sales.*
6. Does the firm have the capacity in time, competencies and resources to complete the engagement in accordance with professional and the firm's standards?	*Yes.*

7. Are there any new circumstances that increase the engagement risk? For example: industry trends and performance, differences of opinion with management, poor attitude toward internal control, inadequate accounting records, incompetent personnel, significant related party transactions, unusual or unexplained transactions, insufficient time allowed to complete work, a fee that is not adequate, questionable changes in accounting policies, or threats made against the firm.	*No. Management has a good attitude toward internal control.* *The company is planning to grow significantly, which will require additional finances and new business risks with regard to inventory management and receivables collection.*
8. Can the client continue to pay our fees?	*Yes.*
Overall assessment of engagement risk = Low	

Terms of Engagement

The terms of engagement would be included in a letter such as the example below.

JAMEL, WOODWIND & WING LLP
55 Kingston St, Cabetown, United Territories 123-50004

October 1, 20XX

Mr. Suraj Dephta, Managing Director
Dephta Furniture
2255 West Street
North Cabetown
United Territories
123-50214

Dear Mr. Dephta

You have requested that we audit the balance sheet of Dephta Furniture as of December 31, 20XX and the related statements of income and cash flows for the year then ending. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter.

Objective
Our audit will be made with the objective of our expressing an opinion on the financial statements.

Our Responsibilities
We will conduct our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undiscovered.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems which come to our notice.

Management's Responsibility
We remind you that the responsibility for the preparation of financial statements, including adequate disclosure, is that of the management of the company. This includes the maintenance of adequate accounting records and internal control, the selection and application of accounting policies and the safeguarding of the assets of the company.

As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

Access to Records
We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with our audit.

Fees
Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

Yours truly,

____

Sang Jun Lee
Jamel, Woodwind & Wing LLP

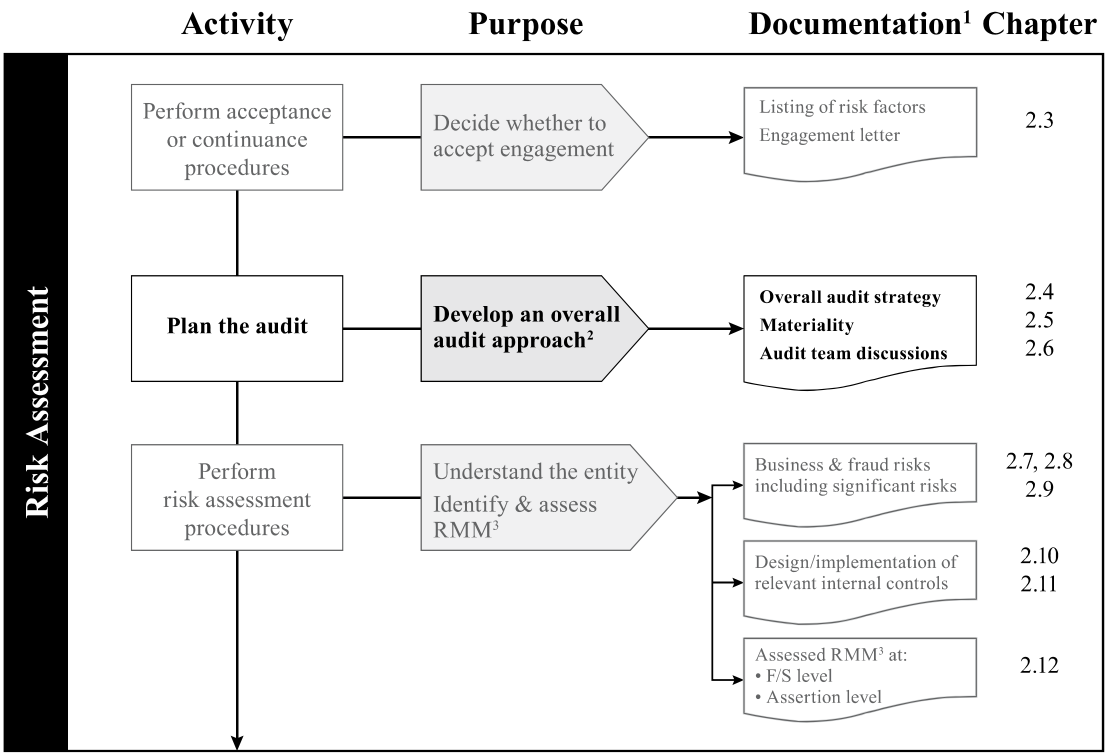
Acknowledged on behalf of Dephta Furniture by

____

Suraj Dephta
Managing Director
November 1, 20XX

2.4 Overall Audit Strategy

Exhibit 2.4-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA References
To describe the steps involved in developing the overall audit plan, including the overall audit strategy to address the identified risks of material misstatement.	**220, 300**

2.4.1 Overview

ISA 200 states:

> **15. The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.**

ISA 220 states:

19. The engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with professional standards and regulatory and legal requirements, and to enable an auditor's report that is appropriate in the circumstances to be issued.

30. The engagement partner should:

(a) Be responsible for the engagement team undertaking appropriate consultation on difficult or contentious matters;

(b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

(c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are documented and agreed with the party consulted; and

(d) Determine that conclusions resulting from consultations have been implemented.

34. Where differences of opinion arise within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team should follow the firm's policies and procedures for dealing with and resolving differences of opinion.

36. For audits of financial statements of listed entities, the engagement partner should:

(a) Determine that an engagement quality control reviewer has been appointed;

(b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and

(c) Not issue the auditor's report until the completion of the engagement quality control review.

ISA 300 states:

2. The auditor should plan the audit so that the engagement will be performed in an effective manner.

Planning is important to ensure that the engagement is performed in an efficient and effective manner and that audit risk has been reduced to an acceptably low level.

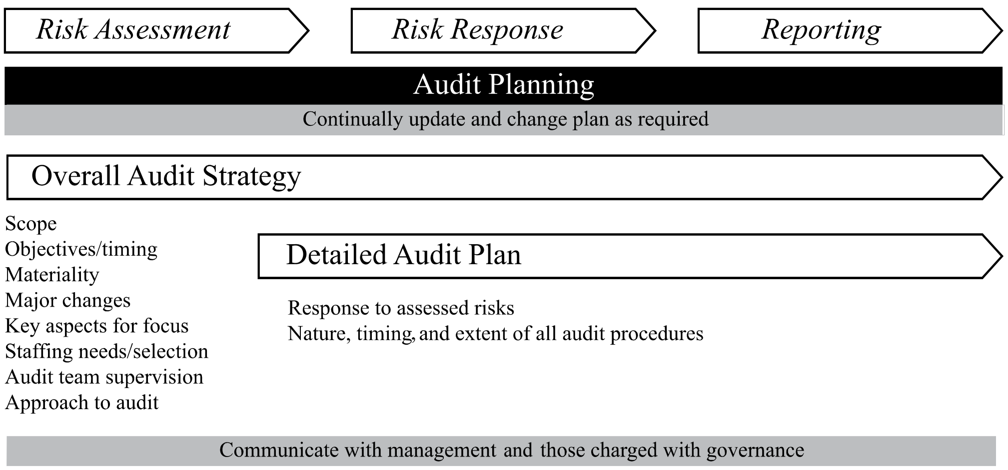
Audit planning is not a discrete phase of the audit. It is a continual and iterative process that starts shortly after completion of the previous audit and continues until the completion of the current audit.

ISA 300 states:

> **8. The auditor should establish the overall audit strategy for the audit.**
>
> **13. The auditor should develop an audit plan for the audit in order to reduce audit risk to an acceptably low level.**
>
> **16. The overall audit strategy and the audit plan should be updated and changed as necessary during the course of the audit.**

There are two levels of planning for the audit as illustrated in the exhibit below.

Exhibit 2.4-2



The overall strategy begins during the risk assessment phase of the audit. The detailed audit plan can begin when there is sufficient information about assessed risks to develop an appropriate audit response. This will most often take place at the risk response phase of the audit. The requirements for developing the detailed audit plan are addressed in Chapter 3.1.

The nature and extent of planning activities will vary according to several factors:

- The size and complexity of the entity;
- The composition and size of the audit team. Smaller audits will also have smaller teams, making planning, coordination, and communication easier;
- The auditor's previous experience with the entity; and
- Changes in circumstances that occur during the audit engagement.

The benefits of audit planning are outlined in the exhibit below.

Exhibit 2.4-3

Benefits of Audit Planning	• Team members learn from the experience/insight of the partner and other key personnel. • The engagement is properly organized, staffed, and managed. • Experience gained from previous years' engagements and other assignments is properly utilized. • Important areas of the audit receive the appropriate attention. • Potential problems are identified and resolved on a timely basis. • Audit file documentation is reviewed on a timely basis. • Work performed by others is coordinated (other auditors, experts, etc.).

2.4.2 Developing the Overall Audit Strategy

As mentioned, planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

The first step in planning is to gather information about the entity and determine the nature and extent of the required risk assessment procedures, and who will perform them. It also includes the scheduling of the audit team meeting to discuss the susceptibility of the entity to material misstatements (including fraud) in the financial statements. Then, as risks are identified and assessed, the appropriate audit response can be developed which will involve determining the nature, extent, and timing of the further audit procedures required. Other considerations involved in planning could involve the determination of materiality, involvement of experts, and any additional risk assessment procedures that may be required.

When the risks of material misstatement have been identified and assessed, the overall strategy (including timing, staffing, and supervision) can be finalized, and a detailed audit plan developed. The detailed plan will set out the further audit procedures required at the assertion level that will be responsive to the identified risks.

As work commences, changes may be required to the overall and detailed plans to respond to new circumstances, audit findings, and other information obtained.

Consider Point

Small entity audits are often conducted by very small audit teams. This makes coordination and communication among the team easier and the overall audit strategy can be straightforward. Documentation for small entities may be in the form of a brief memorandum that includes:

- Nature of engagement and timing;
- Issues identified in the audit just completed;
- What has changed in the current period;
- Any revisions required in the overall audit strategy or in the detailed audit plan; and
- The specific responsibilities of each member of the audit team.

Planning for the current year can start with a brief memo prepared at the end of the previous audit. This memo can be used as the basis for planning the current period when it has been changed and updated for the current period, based on discussions with the owner-manager. Refer to paragraph 12 of ISA 300 for additional guidance.

Learn from the Prior Year's Experience

Once the previous audit is complete, it is useful to obtain feedback from the audit team on what could be improved. This would include identifying:

- Any audit areas that might require additional or less attention in the future;
- Any planned changes that will affect future engagements such as an acquisition, new product or service, or the installation of a new accounting system; and
- Where additional assistance could be provided by the entity such as analysis of certain accounts.

2.4.3 The Four Planning Steps

The steps involved in developing an overall plan and strategy are illustrated below.

Exhibit 2.4-4

1 Gather Information

2 Assess RMM* at the Financial Statement Level

3 Develop Overall Responses

4 Develop Resource Management Plan

*RMM = Risks of material misstatement

Step 1 – Gather Information

The first step is to establish the scope of the engagement, reporting requirements and any significant changes that have taken place since the last engagement. Some factors to consider are outlined below.

The Scope of the Engagement
What characteristics will define the scope of engagement? Consider the following: • The financial reporting framework used; • Industry-specific reporting requirements; • Need for a statutory audit of stand-alone financial statements in addition to an audit for consolidation purposes; • The availability of client personnel and data at the times required; • Use of a service organization (such as for payroll, etc.) and availability of evidence about internal control; and • Entity components and locations (if any) audited by other firms.
Reporting Requirements, Timing, and Communications
What is required and when? Consider: • Timing of audit work and deadlines for issuing the audit report(s); • Communications and key dates for other auditors or third parties involved; and • Key dates for expected communications with management and those charged with governance to discuss: – Status of audit work throughout the engagement; – The nature, timing, and extent of the audit work; and – Expected deliverables resulting from the audit procedures.

Important Factors for Audit Team to Focus on
Key factors to consider include: • Lessons learned from prior experience and client acceptance and continuance procedures; • Determination of appropriate materiality levels; • Identification of areas where there may be higher risks of material misstatement; • Preliminary identification of material components and account balances; • Management's commitment to the design and operation of sound internal control, including documentation of such internal control; • Potential for management override; • Evaluation of relevant internal controls • Discussions of audit matters with other firm personnel with knowledge of the entity; and • Effect of information technology (availability of paper trails, etc.) on the audit.
Significant Changes that will Impact the Audit Approach
What changes will impact the audit approach in the current period? Consider the following: • Changes in the financial reporting framework, such as accounting standards; • Entity-specific, industry, financial reporting, or other relevant developments; • Business developments affecting the entity, including changes in information technology and business processes, changes in key management, and any acquisitions, mergers and divestments; and • Industry developments such as changes in industry regulations and new reporting requirements.

Consider Point

There may be some very small entities requiring an audit where the owner-manager runs the entity, has few (if any) formal documented controls in place, and can therefore override just about everything. In these situations, the auditor has to determine whether it is possible to perform an audit at all. If not, the auditor must exercise professional judgment in determining whether the engagement should be declined or a denial of opinion provided.

Factors to consider include:

- The entity's control environment. Is the owner trustworthy, competent and has a good attitude toward control? A competent owner-manager can often be control strength, as he or she will know the business, approve most transactions, and therefore be able to detect misstatements. However, the control weakness would create the potential for management override.
- Is it possible to develop further audit procedures that would respond appropriately to the assessed risk factors? The most difficult factor to determine is often what is not included (but should be) in the financial statements. For example, are all revenues and liabilities properly recorded in the accounting records?

Step 2 – Assess the RMM at the Financial Statement Level

The risks of material misstatement (RMM) at the overall financial statement level relate to the pervasive risks that affect the entity as a whole (such as nature of the industry, management's integrity, and their attitude toward control and competence). Risks at the assertion level generally relate to specific risks (such as high value of inventory or goods shipped but not invoiced) that occur at the business process level.

A preliminary assessment of the RMM at the overall financial statement level can be used to develop the preliminary overall audit strategy. The reason is that a low assessment of risk overall (appropriately documented) may be used to reduce substantive procedures required at the assertion level. Conversely, a high risk assessment would result in more work being required at the assertion level.

This preliminary assessment can be based on findings from the previous audit or as a result of performing risk assessment procedures in the current period.

The assessment of risk at the financial statement level can range from high to low. Some of the implications that flow from the risk assessment are outlined in the chart below.

	Impact on Overall Audit Responses
Risk Assessment is **LOW**	• Some ability to place increased reliance on management representations and audit evidence generated internally by the entity. • Greater potential for an audit approach that uses tests of internal controls as well as substantive procedures (combined approach). This should reduce the need for or extent of some substantive procedures. • Ability to perform more audit procedures at an interim date rather than at period end.
Risk **Assessment is** **HIGH**	• Emphasize to the audit team the need for an even higher level of professional skepticism in gathering and evaluating audit evidence. • Consider the effectiveness of actions (if any) taken by management to address identified internal control weaknesses. • Assign more experienced staff to the engagement team and consider the need to use experts. • Ensure continuity of staff on the engagement to maximize knowledge of the entity. • Provide more staff supervision. • Obtain more extensive audit evidence from substantive procedures. • Make changes to the analytical or other audit procedures applied as risk assessment procedures. • Modify the nature of audit procedures to obtain more persuasive audit evidence. • Consider changes in the nature, timing, or extent of other audit procedures. • Obtain additional corroborative evidence for management representations.

Consider Point

Consider communicating weaknesses in internal control to management (particularly in the control environment or entity level controls) before the year-end audit work commences. This communication provides management with an opportunity to take corrective action on a timely basis, which may improve the assessed level of audit risk. A recommendation to replace or redeploy an incompetent accountant/bookkeeper could help the entity improve control and result in less audit time being required at the period end.

Step 3 – Develop Overall Responses

The next step is to consider all the information obtained (in Steps 1 and 2 above) about the entity and the assessed risks to develop an overall audit strategy for conducting the engagement.

The overall audit strategy sets the scope, timing, and approach to the audit and guides the development of the more detailed audit plan (outlined in Chapter 3.1).

Factors to Consider
• Results from previous audit experience (including tests of controls that could be relied upon in the current period) and other assignments for the entity. • Response(s) by management to weaknesses identified in internal control. • The required staff resources and skills required for the audit. Consider need for experts to address complex, specific, and high-risk audit areas. • Audit timing, including inventory counts and other required procedures. • The most effective way to respond to the assessed risks of material misstatement at both the financial statement and assertion levels. • Effect of information technology (availability of paper trails, etc.) on the audit. • Management's commitment to the design and operation of sound internal control, including documentation of such internal control. • Potential for management override. • Need to introduce some unpredictability in performing audit procedures.

Step 4 – Develop a Resource Management Plan

ISA 300 states:

> **18. The auditor should plan the nature, timing and extent of direction and supervision of engagement team members and review of their work.**

The final step in completing the overall audit strategy is to ascertain the nature, timing, and extent of resources necessary to perform the engagement.

Selecting the Engagement Team
• Does the proposed audit team have the necessary skill levels and resources? • Have some team members been assigned supervisory responsibilities in the audit? • Is there some continuity of staff on the engagement? • Have audit tasks such as attending the inventory count and sending out confirmations before the year end been assigned to specific staff members? • Has an engagement quality control reviewer been assigned (where applicable)?
Time Allocations
• Has a time budget been allocated to each team member for his or her assignments? • Has time been set aside for areas where there may be higher risks of material misstatement? • How much time is budgeted overall to complete the assigned work?
Communications
• Have roles, responsibilities and expectations of each audit team member been communicated? • Have team members been reminded about the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence? • Have dates for audit team meetings been set to discuss: – Detailed audit plans and sharing information about the entity? – Identify possibility of fraud? (see paragraph 27 of ISA 240) – Engagement deadlines and timing of file reviews? • Have dates been established for fieldwork to commence (interim and year end) and other activities such as sending out confirmations, inventory count, and cut-off procedures? • Have key dates been established for other auditors, experts, and third parties involved in the audit?
Management, Direction, and Supervision
• Has a plan been developed for: – The day-to-day supervision of staff on the engagement? – Senior staff being available to answer questions, respond to potential problems, and generally keep informed about progress? – File reviews at either the entity's premises or in the office? – Team debriefing meetings (where appropriate)? • Is there a need for increased supervision and review as a result of a high level of assessed risk at the overall financial statement level?

Consider Point

In addition to the audit planning meeting at the start of the engagement (refer to Chapter 2.7) it is highly desirable for the audit team (however small) to meet (or arrange a conference phone call) and discuss audit findings after performing:

- Risk assessment procedures; and
- Further audit procedures.

These debriefing sessions do not need to be formal or long, and enable audit team members to report verbally on their findings, exceptions found, and concerns noted. They can also report on any matters (however small) that seemed odd or did not make sense. It is often the small matters that, when combined with information obtained by other team members, point to a possible risk factor (such as fraud) that may require further work to be performed. Even when the audit team is just two people, these meetings can yield significant results. At the planning meeting, a time and date for these debriefing sessions can be scheduled.

2.4.4 Communicating the Plan with Management and Those Charged with Governance

The overall audit strategy and the detailed audit plan are entirely the auditor's responsibility.

It is often useful to discuss elements of the detailed audit plan (such as timing) with management. These discussions often result in some minor changes to the plan to coordinate timing and facilitate performance of certain procedures. However, the exact nature, timing and scope of planned procedures should not be discussed in detail and should not be changed or scaled back to accommodate a management request. Such requests could compromise the effectiveness of the audit, make audit procedures too predictable, and could even constitute a scope limitation.

Where management reports to a separate group of people charged with governance, the overall audit strategy should be discussed with them or communicated in writing, including:

- Overall audit strategy;
- Timing of the audit; and
- Any additional requirements or limitations.

Refer to paragraph 11 of ISA 260 and paragraph 27 of ISA 300 for additional guidance.

2.4.5 Documentation

ISA 300 states:

> **22. The auditor should document the overall audit strategy and the audit plan, including any significant changes made during the audit engagement.**

The overall audit strategy and detailed audit plan, including details of any significant changes made during the audit engagement, should be documented.

The form and extent of documentation will depend on such matters as the size and complexity of the entity, materiality, the extent of other documentation, and the circumstances of the specific audit engagement. It may take the form of a memorandum or a standard planning checklist.

Areas that Documentation Should Address
• The key decisions (scope, timing, and conduct of the audit) considered necessary to properly plan the audit. • Information needed for communicating significant matters to the engagement team. • Planned nature, timing, and extent of risk assessment procedures and of further audit procedures at the assertion level for each material class of transaction, account balance, and disclosure in response to the assessed risks. • Reasons for significant changes to the original strategy, such as responding to new events and conditions or the results of performing audit procedures. Also include details of the revised/further procedures performed as a result. • Identification of a temporary materiality level and relevant sampling factors such as confidence levels planned and used.

Case Study — Overall Audit Strategy

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Once the decision is made to continue with the audit of Dephta Furniture, the next step is to develop and document an overall plan and strategy for conducting the engagement. This can be documented by a memo or by completing some form of planning checklist, as illustrated in the example below.

Dephta Furniture Inc.

Overall Planning Memo

Scope
The scope of the audit has not changed this year. We are required to audit the financial statements in accordance with [insert applicable accounting framework] as at year end.

Changes
The company is beginning to expand beyond the local area. As Dephta expands its sales to foreign countries and makes sales in foreign currencies, managing foreign exchange risk will become more important. Internet sales are also increasing, so Dephta's IT capabilities will be stretched.

Changes in the following applicable financial reporting framework will also need to be reflected in financial statement preparation: [insert].

Dephta is now selling to Franjawa Merchandising. This company is renowned for squeezing profit margins of suppliers in exchange for giving large orders. They also require suppliers to maintain additional inventories of some products for instant delivery as required.

Internal Control Environment
Our assessment of risk at the financial statements level is low (refer to W/P Ref. #)[1]. Management is not particularly sophisticated but there is a strong commitment to competence, they have introduced a code of ethics and, in general, they have a good attitude toward internal control.

Overall Strategy
Based on our assessment of the internal control environment we should proceed as follows:

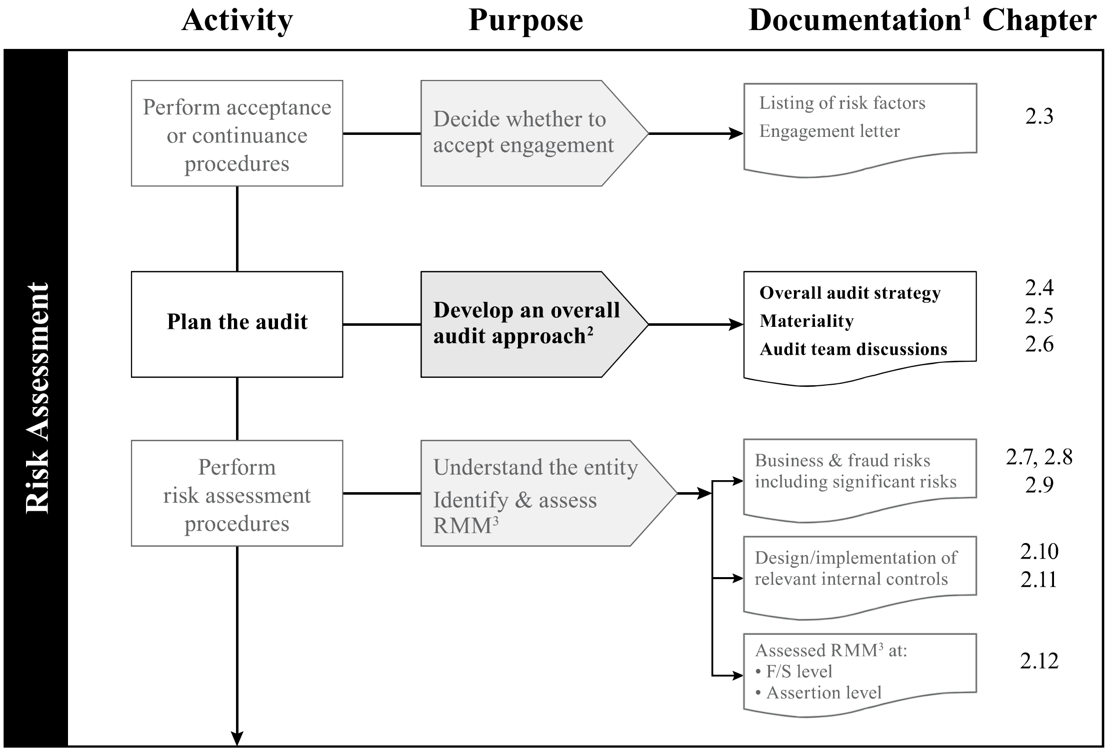
1. Materiality will be increased from 10,000€ to 15,000€ this year to reflect the growth in sales and profitability during the last year.
2. Use the same senior staff as last year and perform the work at the same time. This will provide continuity and audit efficiency. New junior staff will be used.

[1] W/P = working papers. Ref # = reference number. Not included.

3. At our team planning meeting to be held on November 15, we need to:
    i. Spend more time considering the susceptibility of the financial statements to fraud;
    ii. Emphasize the use of professional skepticism by our staff;
    iii. Consider the potential for employee fraud and management override. We have no specific reason for suspicion but profit margins have been fluctuating and no one seems to know why; and
    iv. Focus on the related-party transactions that have been growing.
4. Perform our risk assessment procedures at the end of July. There are no plans to change systems unless the volume of new sales demands it.
5. Attend both the mid-year and year-end inventory counts due to the lack of ongoing inventory internal control procedures.
6. We must keep in touch with senior management to ensure we are informed on a timely basis of any dramatic increase in sales and production. This would cause us to perform additional risk assessment procedures to identify/assess the new risks and management's response to mitigate those risks.
7. Test the operating effectiveness of internal control over sales and payroll (in September) so that the extent of our substantive procedures can be reduced. This work will be rolled forward to cover the October–December period.
8. Our IT specialist needs to spend some time at Dephta this year to thoroughly assess the internal control over Internet sales and the general IT controls. As the company grows, IT general controls are becoming more critical and must keep pace. Other than John, not many of the managers at Dephta are knowledgeable about IT.
9. We should expand our testing with regard to related-party transactions. This includes the process for identifying who is a related party and the terms and timing of such transactions.
10. Because of the recent changes in accounting standards and the growth potential in this company and associated risks, we should assign an engagement quality control reviewer to review the file this year.

2.5 Materiality

Exhibit 2.5-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA Reference
To provide guidance on what would constitute a material misstatement and how materiality is considered by auditors.	**320**

2.5.1 Overview

ISA 320 states:

4. **The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.**

8. **Materiality should be considered by the auditor when:**

   (a) Determining the nature, timing, and extent of audit procedures; and

   (b) Evaluating the effect of misstatements.

Materiality addresses the significance of financial statement information to economic decisions of users taken on the basis of the financial statements.

The concept of materiality recognizes that some matters, either individually or in the aggregate, are important to people making an economic decision based on the financial statements. This could include decisions such as whether to invest in, purchase, do business with, or lend money to an entity.

When a misstatement (or the aggregate of all misstatements) is significant enough to change or influence the decision of an informed person, a material misstatement has occurred. Below this threshold, the misstatement is regarded as not material. For example, if it is determined that the decision of a financial statement user group would be influenced by a misstatement of 10,000€ in the financial statements, the auditor would plan the engagement to detect any misstatements in excess of this amount or a combination of smaller misstatements that would exceed that amount in total.

Materiality is often explained in financial reporting frameworks as follows:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Materiality is determined by the auditor based on his or her perception of the needs of users. In applying his or her professional judgment, it is reasonable for the auditor to assume that users:

- Have a reasonable knowledge of business, economic activities, and accounting and have a willingness to study the information in the financial statements with reasonable diligence;
- Understand that financial statements are prepared and audited to levels of materiality;
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
- Make reasonable economic decisions on the basis of the information in the financial statements.

Misstatements may arise from a number of causes and can be based on the following.

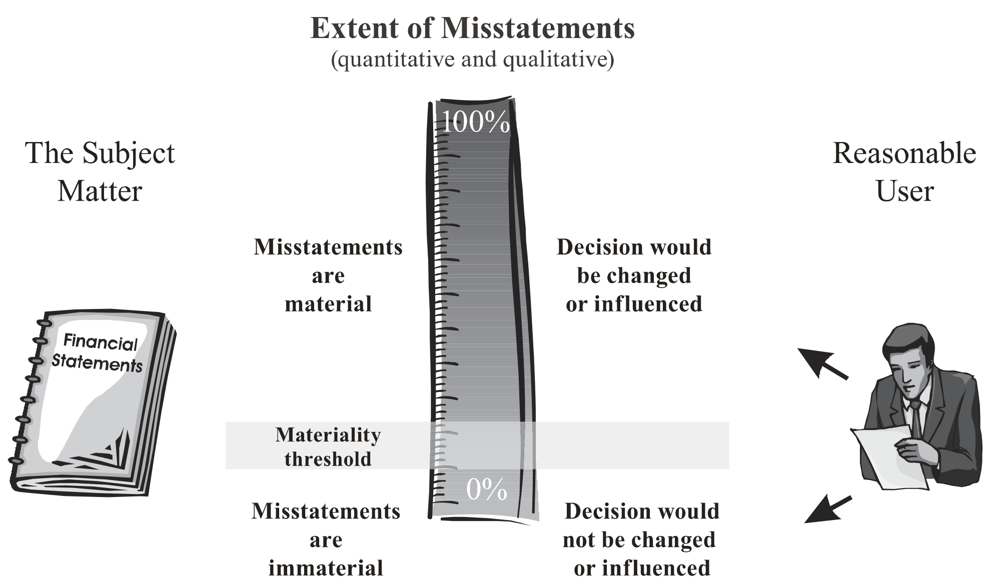
- Size — the monetary amount involved (quantitative);
- Nature of the item (qualitative); and
- Circumstances surrounding the occurrence.

Typical misstatements could include the following:

- Errors or fraud in the preparation of the financial statements;
- Departures from the accounting framework;
- Employee fraud;
- Management error;
- Management fraud;
- Preparation of inaccurate or inappropriate estimates; or
- Inappropriate or incomplete descriptions of accounting policies or note disclosures.

Materiality is not an absolute number. It represents a grey area between what is very likely not material and what is very likely material. Consequently, the assessment of what is material is always a matter of professional judgment. In some situations, a matter well below the quantitative materiality level may be determined as material based on the nature of the item or the circumstances related to the misstatement. For example, the information that there are a number of transactions with related parties may be very significant to a person making a decision based on the financial statements. Finally, a series of immaterial items may well become material when aggregated together.

Exhibit 2.5-2



2.5.2 Required Materiality Levels

At the start of the audit, judgments must be made about the size and nature of misstatements that would be considered material. This includes establishing a materiality level for:

- The financial statements as a whole (overall materiality); and
- Particular classes of transactions, account balances or disclosures where appropriate. This applies to any areas where lesser amounts than the overall materiality level could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

To allow for the possible existence of undetected and immaterial misstatements aggregating to a material amount, the auditor should establish a lower amount than the materiality level or levels for purposes of assessing risks and designing further audit procedures.

The overall materiality level (the financial statements as a whole) will be used by the auditor for:

- Determining the nature, timing, and extent of risk assessment procedures;
- Identifying and assessing the risks of material misstatement; and
- Determining the nature, timing, and extent of further audit procedures.

As the audit progresses, materiality should be updated for any new information gained during the engagement.

At the conclusion of the audit, both the overall materiality and the lower amounts established for particular transactions, account balances, or disclosures will be used for evaluating the effect of identified misstatements on the financial statements and the opinion in the auditor's report.

Because the determination of materiality levels is based on the auditor's professional judgment, it is important that the considerations involved be properly documented at the planning stage of the engagement. This will include:

- The materiality level for the financial statements as a whole;
- The materiality level for a particular class of transactions, account balance or disclosure, if applicable;
- The amount or amounts determined for purposes of assessing the risks of material misstatement and designing further audit procedures; and
- Any changes made to the above factors as the audit progresses.

2.5.3 Materiality and Audit Risk

ISA 320 states:

> **2. The auditor should consider materiality and its relationship with audit risk when conducting an audit.**

Materiality and audit risk are related. Audit risk is the possibility that an auditor expresses an inappropriate audit opinion on financial statements that are materially misstated.

Audit risk has two major components:

- Risks of material misstatement; and
- Detection risk.

These are discussed as follows.

Risks of Material Misstatement
This is the risk that the financial statements are materially misstated prior to the start of any audit work. The risks of material misstatement (RMM) relate to the entity's risks that exist quite independently of the audit of the financial statements. The risks of material misstatement are considered at the overall financial statement level (often pervasive risks, which affect many

assertions) and at the assertion level, which relates to classes of transactions, account balances, and disclosures.

The risks of material misstatement are a combination of inherent risk and control risk.

- **Inherent risk**
  This is the susceptibility of an assertion to a misstatement that could be material, (either individually or when aggregated with other misstatements), assuming that there are no related internal control systems in place to mitigate such risks. For example, if an entity has a high-value inventory that could be easily stolen, there would be an inherent risk relating to the existence assertion. This assessment of risk ignores the internal control in place to protect this inventory.

- **Control risk**
  This is the risk that a material misstatement could occur in an assertion, (either individually or when aggregated with other misstatements), that will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. This addresses the risk that entity controls (designed to mitigate a particular risk) fail to work properly resulting in a misstatement.

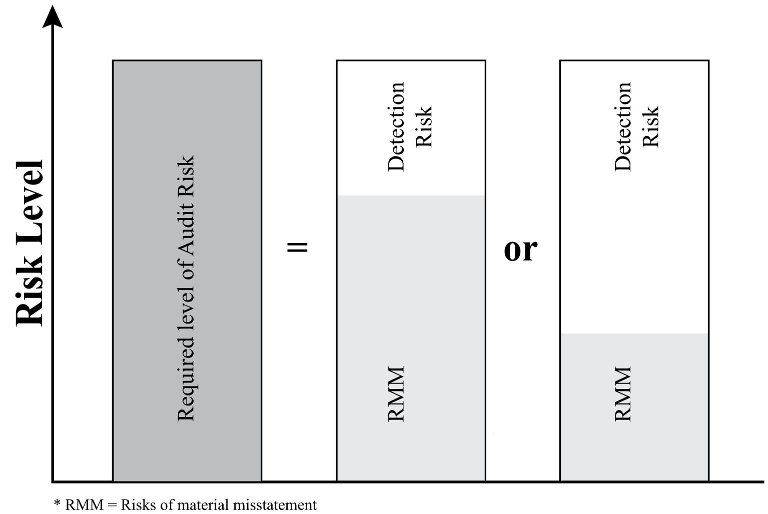
Detection Risk
This is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material. Detection risk relates to the appropriate applicability, effectiveness, and proper application of the audit procedures performed. Detection risk can never be reduced to zero because of the inherent limitations in the procedures carried out, the human judgments required, and the nature of the evidence examined. These risk factors are addressed through adequate planning, proper assignment of audit personnel, the application of professional skepticism, and supervision and review of the audit work performed.

For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risks of material misstatement at the assertion level. Therefore:

- The greater the RMM, the less the detection risk that can be accepted.
- The less the RMM, the greater the detection risk that can be accepted.

This relationship between the risks is illustrated in the exhibit below.

Exhibit 2.5-3



Note: The relationship between the risks can also be expressed mathematically in the following formula:

Audit Risk = RMM* (Inherent Risk x Control Risk) x Detection Risk

In summary, the auditor performs audit procedures to assess the risks of material misstatement and seeks to limit detection risk by performing further audit procedures based on that assessment. Risk assessment procedures are addressed in Chapters 2.2 to 2.12 and further audit procedures in Chapters 3.1 to 3.5 of this Guide.

2.5.4 Determining Materiality Levels

Qualitative and Quantitative Considerations

Materiality should address qualitative and quantitative considerations. In some cases, misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount or failure to comply with a regulatory requirement may be material if there is a reasonable possibility of such payment or failure leading to a material contingent liability, a material loss of assets, or a material loss of revenue.

The chart below outlines some possible qualitative factors.

Possible Qualitative Factors	• Perception of users' needs. What financial statement areas are of most interest? • Profitability trends. • Impact of misstatements resulting from non-compliance with loan covenants, contractual agreements, regulatory provisions and statutory/regulatory reporting requirements. • The basis for calculating management's compensation (bonuses, etc.). • Susceptibility of account items to loss due to errors or fraud. • Significant contingent liabilities. • Volume of activity, complexity, and homogeneity of the individual transactions processed through the account. • Related-party transactions. • Possible illegal acts, violations of contracts, and conflicts of interest. • Significance, nature, complexity, and composition of financial statement items. • Estimation, allocation, or uncertainty that may involve a high degree of subjectivity. • Management bias. Is there motivation to either maximize or minimize income? • Continued unwillingness by management to correct reported weaknesses in internal control over financial reporting. • Accounting and reporting complexities associated with the account. • Changes in account characteristics since the previous period (for example, new complexities, subjectivity, or types of transactions). • The existence of offsetting effects of individually significant, but different, misstatements.

Materiality Level for the Financial Statements as a Whole

Determining a materiality level for the financial statements as a whole requires the exercise of professional judgment.

A percentage numerical threshold (or benchmark) is often used as a first step in assessing materiality. Factors to consider in identifying an appropriate benchmark include:

- The elements of the financial statements (for example, assets, liabilities, equity, income, and expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (an example is when, for the purpose of evaluating financial performance, users may tend to focus on profit, revenue, or net assets);

- The nature of the entity, where the entity is in its life cycle and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets and claims on them than on the entity's earnings); and
- The relative volatility of the benchmark.

Income from continuing operations (that is, after-tax income before discontinued operations) is generally recognized as the quantitative measure of greatest significance to financial statement users. However, another basis, such as a percentage of income before tax or of total revenues or expense, may be more appropriate when the entity's net income is small or fluctuates widely from year to year.

For example, a percentage of income from continuing operations for profit-oriented enterprises could be used. Income from continuing operations should be adjusted for:

- Unusual or non-recurring revenue/expense items; and
- Items such as a management bonus, which may be based on profits before the bonus or simply paid out to reduce profits left in the company.

Other measures that could be used in special circumstances include current assets, net working capital, total assets, total revenues, gross profit, total equity, and cash flow from operations.

Materiality Levels for Particular Classes of Transactions, Account Balances, or Disclosures
Factors to consider include the following:

- Users' expectations regarding measurement or disclosure of certain items. Examples include related-party transactions, remuneration of management and those charged with governance and compliance with sensitive laws and regulations.
- Industry-specific disclosures. Examples include exploration costs in a mining company and research and development costs in a high technology or pharmaceutical company.
- Attention focused on a particular aspect of the entity's business that is separately disclosed in the financial statements. This could include disclosure of events such as an acquisition, divestiture, or a restructuring.

In considering factors such as those above, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

2.5.5 Materiality Levels and Audit Risk

The materiality level is based on the economic decisions made by a financial statement user. This differs from audit risk, which relates to an inappropriate audit opinion being issued on financial statements that are materially misstated.

If the audit was planned solely to detect individually material misstatements, there would be no margin of error to identify and account for immaterial misstatements that might exist. As a result, it would be possible for the aggregate of individually immaterial misstatements to cause the financial statements to be materially misstated.

To address this possibility, the auditor should determine lower materiality amounts for:

- Assessing the risks of material misstatement; and
- Designing further audit procedures to respond to assessed risks.

The purpose of setting the lower materiality levels is to reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements in the financial statements exceeds the materiality level or levels.

The determination of this lower amount or amounts is not a simple mechanical calculation. It requires the auditor to exercise professional judgment, and is affected by:

- The auditor’s understanding of the entity, which is updated during the execution of the risk assessment procedures; and
- The nature and extent of misstatements identified in previous audits.

Consider Point

Do not reduce the overall materiality level based on a high level of audit risk.

Avoid the mistake of reducing the overall (financial statement) materiality level because of a high audit risk. This has the effect of lowering the auditor’s tolerance level for finding misstatements, which can actually make the situation worse. It implies that because of the high audit risk, the decision of a financial statement user would be affected by a lower amount than if no audit risk was present.

First establish the materiality level by reference to financial statement users and then use a lower amount at the class of transaction or account balance level for designing further audit procedures.

2.5.6 Starting Points for Determining Materiality Levels

ISA 320 does not provide benchmarks as to what percentage of income or revenues should be used to calculate overall materiality, as the assessment of what is material is always considered to be a matter of professional judgment based on the circumstances.

As a generalization, overall materiality levels often fall into one of the following ranges as appropriate for the nature of the entity involved:

- Income from continuing operations 3 to 7%;
- Assets 1 to 3%;
- Equity 3 to 5%; and
- Revenues 1 to 3%.

In planning audit work, the auditor may intentionally set the acceptable materiality level at a lower level than is intended to be used to evaluate the results of the audit. This may reduce the likelihood of undiscovered misstatements and provide the auditor with a margin of safety when evaluating the effect of misstatements discovered during the audit.

2.5.7 Other Considerations

Other considerations include:

- Communicating to management and those charged with governance;
- Updating materiality; and
- Reducing materiality level from previous period.

Communicating to Management and Those Charged with Governance

Management and those charged with governance need to understand the limitations concerning the degree of precision that can be expected from an audit. They also need to be aware that it is not economically feasible to design audit procedures that will provide absolute assurance that the financial statements are not materially misstated. An audit can provide only reasonable assurance in this regard.

Updating Materiality

The preliminary assessment of materiality and audit risk may change from initial planning to the time of evaluating the results of the audit procedures. This could result from a change in circumstances or from a change in the auditor's knowledge as a result of performing audit procedures. For example, if audit procedures are performed prior to the period end, the auditor will anticipate the results of operations and the financial position. If the actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. For additional guidance, refer to paragraph 11 of ISA 320.

Consider Point

Ensure that experts employed by the entity or used by the audit team are instructed to use an appropriate materiality level.

If any experts are employed on the engagement, ensure that they are briefed on what you have determined to be audit materiality. Also ensure that they use a materiality level, as instructed by you, which is appropriate in relation to the work they perform.

Reducing Materiality Level from Previous Period

When circumstances change from one year to the next, the auditor should consider the effect of any misstatement on the opening equity. For example, where sales and income are substantially less than the previous year's, a lower materiality is required. Errors could exist in opening figures, as the audit was previously conducted using a higher materiality level. To reduce the risk of a material error occurring in the opening equity, the auditor may perform further audit procedures on the opening asset and liability balances.

Case Study — Materiality

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Materiality is often documented on a worksheet that includes a summary of operating results and provides space for other materiality considerations such as qualitative factors.

Dephta Furniture Inc.

Materiality assessment
We calculated income from continuing operations, as well as 1% and 2% of revenue as our starting point in determining materiality (see W/P Ref #)[1] .We decided to base our materiality on approximately 1% of sales for the year. Given Dephta's current and expected growth, revenue appeared to be a more consistent and reliable measure on which to base our materiality level.

The materiality number used last year was 10,000€. The main users of the financial statements are the bank and the shareholders. This year, the plan is to use 15,000€ as the overall materiality due to the growth in sales and profitability. This revised amount has been communicated orally to the client.

At the audit planning meeting, we should discuss the use of lower materiality amounts that would be applicable to the major classes of transactions and account balances such as receivables and inventory.

[1] W/P = working papers. Ref # = reference number. Not included.

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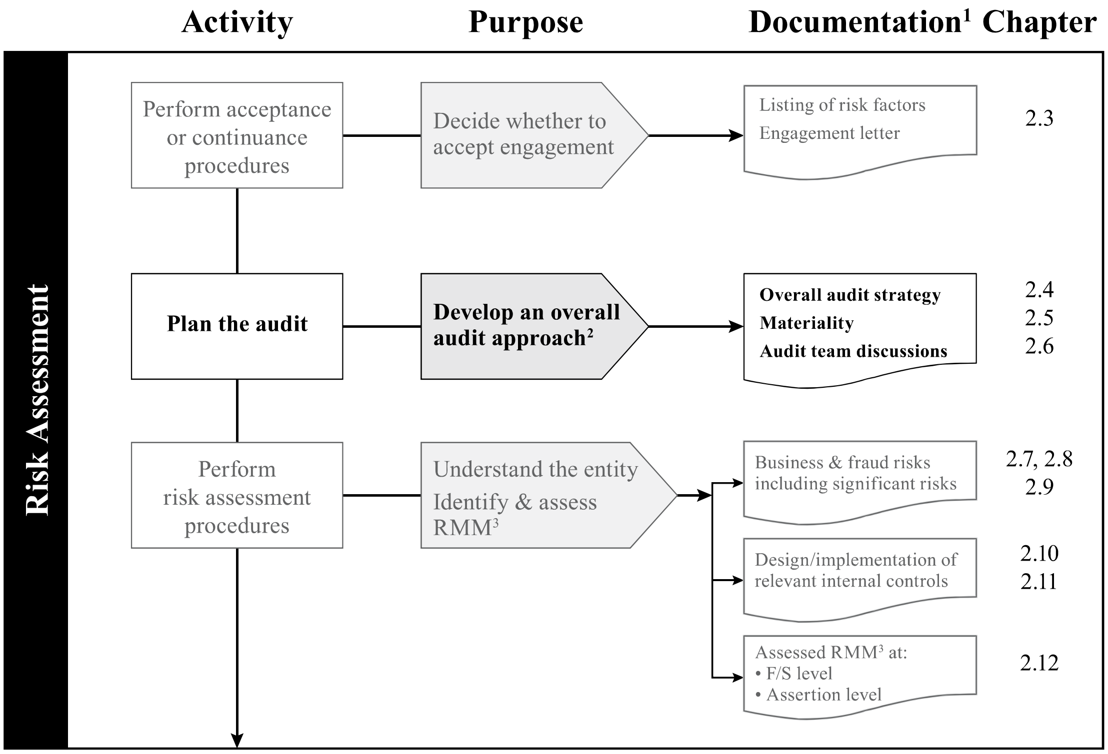
2.6 Audit Team Discussions

Exhibit 2.6-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA References
To outline the purpose and nature of the required discussions among the audit team about the susceptibility of the entity's financial statements to material misstatements.	**315, 240**

2.6.1 Overview

ISA 315 states:

> **14. The members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements.**

ISA 240 states:

> **27. Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatement due to fraud.**

29. The engagement partner should consider which matters are to be communicated to members of the engagement team not involved in the discussion.

Members of the engagement team have an ongoing responsibility to discuss:

- Their understanding of the entity to be audited;
- The business risks to which the entity is subject;
- Application of the applicable financial reporting framework; and
- The susceptibility of the financial statements to material misstatements, including fraud.

2.6.2 Communication Among Audit Team Members

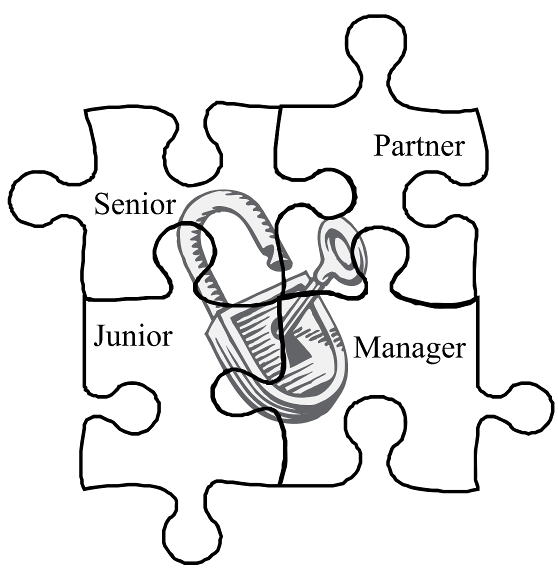
Communication between audit team members is necessary at all stages of the engagement to ensure all matters are appropriately considered. More experienced audit team members, such as the engagement partner, can share their insights and any previous experience working with the entity. This includes risk identification and assessment, responding to risks, and reporting.

Each member of the audit team will gather a slightly different perspective on the entity. Some of the information gathered by a particular team member may not even make sense unless it is combined with information obtained by other team members. This is particularly true in relation to fraud where it is the identification of small patterns, oddities, and exceptions that may lead to its ultimate detection.

A simple analogy is the jigsaw puzzle. Each part by itself does not enable a person to see the entire picture. It is only when all the pieces are put together that the big picture can be seen. The same is true in auditing. It is only when the individual knowledge/findings of each auditor are shared with the team that the bigger picture emerges.

Exhibit 2.6-2

Sharing Findings



Team sharing is often achieved by holding an audit planning meeting. Professional judgment is used to determine which members of the engagement team are included, but the agenda typically involves key members of the engagement team.

Note: It is not necessary for all team members to have a comprehensive knowledge of all aspects of the audit.

An engagement quality control reviewer as described in ISQC 1 may also attend the meeting (where applicable) but only as an observer/consultant, not as a decision-maker for the team or as a participant in the engagement.

The objective of audit team discussions is to:

- Share insights based on their knowledge of the entity;
- Exchange information about business risks;
- Gain a better understanding of the potential for material misstatements (especially for the audit areas assigned to them);
- Consider the susceptibility of the entity's financial statements to material misstatement due to fraud;
- Consider application of the applicable financial reporting framework to the entity's facts and circumstances; and
- Understand how the results of the audit procedures performed may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures.

Team discussions need not be confined to just the planning meeting. Audit team members should be encouraged to communicate and share information they obtain throughout the audit on any matters of relevance, particularly when it affects the assessment of risk and planned audit procedures.

2.6.3 Audit Team Planning Meeting

A planning meeting should be scheduled well in advance of the commencement of fieldwork. This will provide the time necessary to prepare or make changes in the detailed audit plan.

Team members should be encouraged to come to the meeting with a questioning mind and be prepared to participate and share information with an attitude of professional skepticism. They should set aside any strongly held beliefs that management is honest or above reproach. The extent of the discussion should be influenced by the roles, experience, and information needs of the engagement team members. The three key areas to address are outlined in the chart below.

Exhibit 2.6-3

<table>
<tr><th>Key Areas to Address</th><th>Purpose: To Understand the Entity and Have an Open Discussion</th></tr>
<tr><td>Share Knowledge</td><td>Discuss matters such as:
The nature of the entity, management, the attitude toward internal control, experience from previous audit engagements, and significant business risk factors.
Known external and internal fraud risk factors affecting the entity that may create incentives/pressures for management or others to:
Commit fraud;
Provide an opportunity for fraud to be perpetrated;
Take advantage of a corporate culture or environment that enables management or others to rationalize committing fraud; and
Misappropriate assets. Consider management’s involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
Unusual or unexplained changes in the behavior or lifestyle of management or employees.
Any allegations of fraud that have come to the auditor’s attention.
Identify:
Where the financial statements may be susceptible to material misstatement.
Any circumstances indicative of management bias to either overstate or understate income.</td></tr>
<tr><th></th><th>Purpose: To Brainstorm Ideas and Possible Audit Approaches</th></tr>
<tr><td>Exchange Ideas</td><td>Brainstorm ideas about:
How management could perpetrate and conceal fraudulent financial reporting such as management override of internal control. It may be helpful to develop a fraud scenario based on the assessment of fraud risk factors identified. For example, the sales manager could achieve a bonus threshold by overstating the sales figure. Then, most likely methods would be changes in the policy on revenue recognition or improper cut-off on invoices; and
How assets of the entity could be misappropriated or misused for personal purposes.
Consider:
Possible techniques to over/understate such as journal entries, management bias in estimates/provisions, changes in accounting policies, etc.
Possible audit procedures/approaches that might be selected to respond to the assessed risks.</td></tr>
</table>

	Purpose: To Provide Direction to the Audit Team
Provide Direction	In providing direction to the audit team: • Stress the importance of maintaining professional skepticism throughout the audit. Management should not be treated as being either totally honest or as criminals. • Outline the circumstances that, if encountered, might indicate the possibility of fraud. For example: – Recognize the warning signals (red flags) and follow the trail; and – An immaterial amount (such as an inflated expense claim) could be indicative of a larger issue, such as management's integrity. • Decide how an element of unpredictability will be incorporated into the nature, timing, and extent of the audit procedures to be performed. • Provide an overview of the audit sections each staff member will be performing, the approach required, special considerations, timing, documentation required, the extent of supervision provided, who is to be contacted when questions arise, file review, and any other expectations. • Emphasize the importance of being alert for indications of dishonesty, but also be careful not to jump to any conclusions, particularly when discussing findings with the entity's management or staff.

Note: If some members of the audit team are not able to attend the meeting, the engagement partner should consider which matters arising at the meeting should be communicated to them.

Case Study — Audit Team Discussions

For details of the case study, refer to the Introduction to the Case Study in this Guide.

The business risk and fraud risk registers should be reviewed at the audit team meeting and any additional risk factors added. Time should also be taken to reinforce the need for professional skepticism at all times and to immediately report any possible warning signals of fraud occurring.

The following example of the audit team discussion outlines other matters to address.

Area of Discussion	Possible Responses
1. Materiality and significant account balances.	*Increase to 15,000€ based on growth in profitability and sales.*
2. Timing, key dates, and availability of client personnel.	*Confirmed that last year's timing is appropriate and our requests for management help in preparing certain schedules are reasonable.*
3. What can we learn from past experience such as issues/events that caused delays and areas of over/under auditing?	*Inventory internal control was poor last year and resulted in additional work. Client has indicated that this will be addressed before this year end.*
4. Any new concerns about management's integrity, going concern, litigation, etc.?	*See newspaper clipping re: Parvin. This may be isolated but we need to be cautious.*
5. Changes this year in business operations and/or financial condition, industry regulations, accounting policies used, and people.	*Plans for significant growth are in place. This will put a strain on cash resources, internal control, and the operating systems.*
6. Susceptibility of the financial statements to fraud. In what possible ways could the entity be defrauded? Develop some possible scenarios and then plan procedures that would confirm or dispel any suspicions.	*Management bias and ability to override to avoid tax liability are quite possible. We should look at management's estimates, journal entries, and the use of related party transactions. Also, Arjan (the senior salesperson) lives an expensive lifestyle. We should look at the bonus calculations and the sales revenue.*

Area of Discussion	Possible Responses
7. Significant risks that require special attention.	*The possibility of defaulting on bank covenants is a real one given the growth and resulting shortages of cash. Suraj says he is going to renegotiate the bank terms this year to provide some flexibility.*
8. Appropriate audit responses to the risks identified.	*The detailed audit plan was reviewed in some detail with the staff member responsible.*
9. Consider the need for specialized skills or consultants, testing internal control versus substantive procedures, the need to introduce unpredictability in some audit tests, and work that could be completed by the client.	*IT specialist to look at Internet sales and IT controls in general. Scheduled visit for September this year.*
10. Audit team roles, scheduling, and file reviews.	*Overall and detailed audit plans have been updated.*

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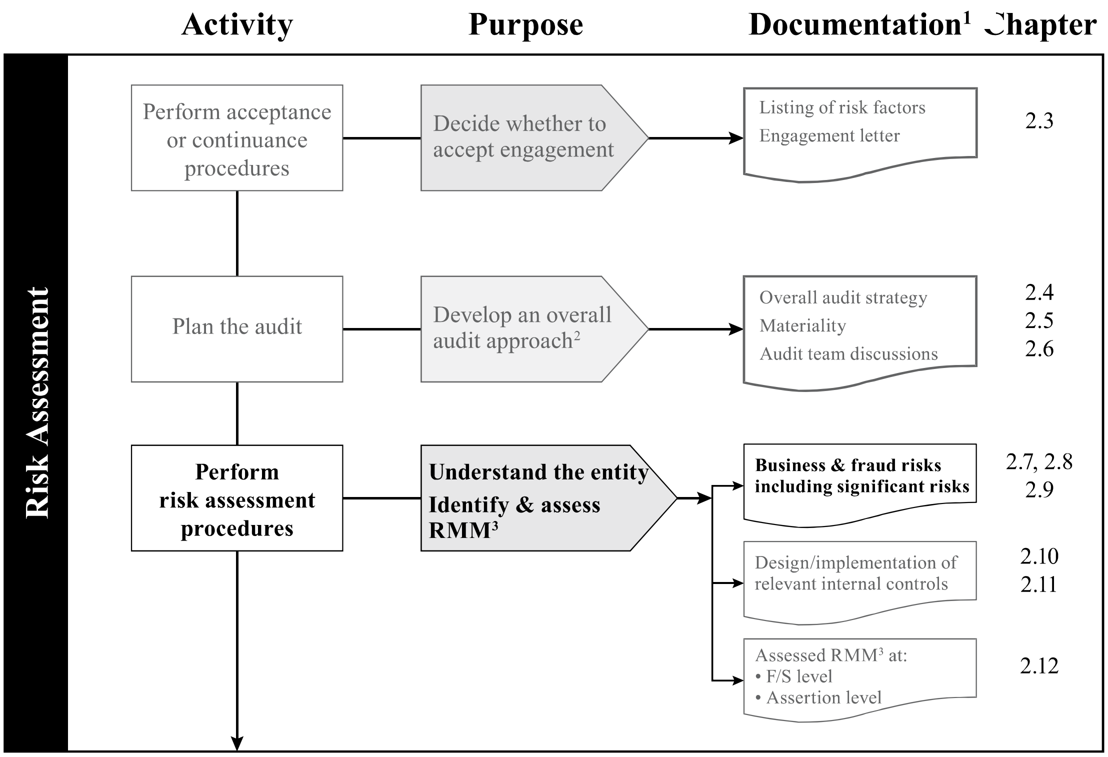
2.7 Business Risks

Exhibit 2.7-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA Reference
To provide guidance on the identification and assessment of business risks.	**315**

2.7.1 Overview

ISA 315 states:

> **100. The auditor should identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures.**
>
> **108. As part of the risk assessment as described in paragraph 100, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as "significant risks").**

The assessment of the risks of material misstatement is made at the:

- Financial statement level; and
- Assertion level for classes of transactions, account balances, and disclosures.

This chapter focuses on the identification and assessment of business risks resulting from the performance of risk assessment procedures.

2.7.2 Risk Factors

Exhibit 2.7-2

An understanding of business risks increases the likelihood of identifying the risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks.

Business risks result from conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies.

Consider Point

It is best to separate the identification of risks from their assessment. As business risks can be identified during any stage of the engagement, the audit team should be encouraged to document them in a single place (for ease of reference and review) before they are assessed. This will ensure that all risks are documented and considered, even if some of the risks identified are later assessed as being insignificant and requiring no further work.

The chart below outlines some examples of risk factors that may indicate the existence of risks of material misstatement.

Exhibit 2.7-3

Source of Risk Factors	
External Factors	• State of the economy and government regulation; • High degree of complex regulation; • Changes in the industry in which the entity operates; • Changes in the supply chain; • Declining demand for the entity's products or services; • Inability to obtain required materials or the personnel with skills required for production; • Deliberate sabotage of an entity's products or services; and • Constraints on the availability of capital and credit.
Business Strategies	• Operations in regions that are economically unstable; • Operations exposed to volatile markets; • Developing or offering new products or services, or moving into new lines of business; • Entering into business areas/transactions with which the entity has little experience; • Setting of inappropriate or unrealistic objectives and strategies; • Aggressive expansion into new locations; • Acquisitions and divestitures; • Complex alliances and joint ventures; • Use of complex financing arrangements; • Corporate restructurings; and • Significant transactions with related parties.
Entity's Organization	• Poor corporate culture and governance; • Incompetent personnel in key positions; • Changes in key personnel including departure of key executives; • Complexity in operations, organization structure and products; • Failure to recognize the need for change such as in skills required or the use of technology; • Response to rapid growth or decline in sales that can strain internal control systems and people's skills; • Lack of personnel with appropriate accounting and financial reporting skills; • Weaknesses in internal control, especially those not addressed by management; and • Inconsistencies between the entity's IT strategy and its business strategies.
Other	• Product or service flaws that may result in liabilities and reputation risk; • Relationships with external funders, such as banks; • Going-concern and liquidity issues including loss of significant customers; and • Installation of significant new IT systems related to financial reporting.

2.7.3 The Entity's Risk Assessment Process

Risk assessment is one of the five components of internal control that the entity should be using for:

- Identifying business risks relevant to financial reporting objectives; and
- Forming the basis for how management will determine what risks to manage.

In smaller entities, the risk assessment process is likely to be informal and less structured. Risk in these entities is often recognized implicitly rather than explicitly. Management may be aware of risks related to financial reporting through direct personal involvement with employees and outside parties. As a result, the auditor will make inquiries of management as to how they identify and manage risk, what risks have been identified and managed, and then document the results.

Consider Point

When risk factors are documented and assessed by the auditor, it is important that the results are discussed with management of the entity. This will help to ensure that a significant risk factor has not been overlooked and that the assessment of risks (likelihood and impact) is reasonable.

As management understands the benefits of a more formalized risk assessment process, they may decide to develop, implement, and document their own processes. When this occurs the auditor is required to evaluate its design and implementation. This involves determining how management:

- Identifies business risks relevant to financial reporting;
- Estimates the significance of the risks;
- Assesses the likelihood of their occurrence; and
- Decides upon actions to manage them.

In addition to considering the entity's process, the auditor should also inquire about:

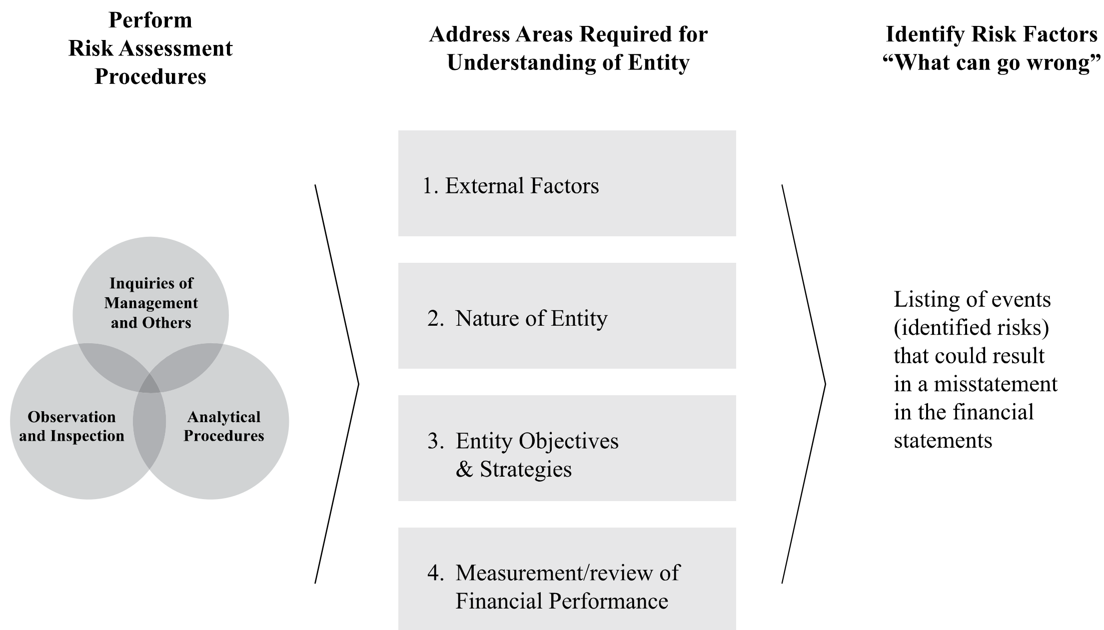
- Business risks that management has identified and whether they may result in material misstatement; and
- Business risks that management may have failed to identify under the entity's process. If additional risks are found, consideration should be given as to whether there is a material weakness in the entity's risk assessment process, which should be communicated to those charged with governance.

Identification of Risks

Risk identification is derived from information gathered in performing the three risk assessment procedures. First, identify risks without consideration of any internal control that might mitigate such risks. (Internal control is addressed in Chapter 2.10.) Separately assessing risks before considering the internal control system will help to identify any significant risks (refer to Chapter 2.9) and provide the necessary basis for assessing the design and implementation of management's internal control.

The risk identification process is illustrated in the exhibit below.

Exhibit 2.7-4



For each risk identified, the auditor would carefully consider:

- **What are the implications?**
  What type of misstatement could occur in the financial statements as a result of the risk? For example, if the entity handles diamonds there is a high level of inherent risk (that is, before consideration of any internal control) that it could be stolen. The implication of this risk is the possibility that the diamonds inventory in the financial statements might not exist (existence assertion) or the value may be misstated (valuation assertion). This question becomes even more difficult for pervasive risks where the possibilities for misstatement could be numerous. For example, if those charged with governance were ineffective, all sorts of misstatements (deliberate or otherwise) could potentially go unnoticed.

- **What financial statement areas and assertions are affected?**
  To what specific classes of transactions, account balances, and disclosures and related assertions does the risk relate? Note that a number of the risks identified will be pervasive across the entity, as they cannot be related to specific areas or assertions. For example, the failure of the entity to set objectives and operating budgets could result in various types of errors being missed. Another example would be an incompetent bookkeeper/accountant. These risks cannot easily be allocated to specific financial statement areas or disclosures.

Pervasive risks often derive from a weak internal control environment and potentially affect many financial statement areas, disclosures, and assertions. These risks will likely affect the assessment of risk at the financial statement level and require an overall response (such as more audit work, assigning more experienced staff members, etc.) by the auditor.

Avoid the temptation to only list risk factors that are likely to be significant or important. A key part of risk or event identification is to develop as complete a listing of risk factors as possible. Inconsequential risk factors can always be removed later after each risk is appropriately assessed. This will help to ensure that all material risks are indeed identified.

As the audit progresses, additional risks may be identified. These should be added to the list of identified risks and appropriately assessed before making a decision as to any further audit procedures required.

2.7.4 Assessment of Risks

After the auditor has identified the risk factors and the types of misstatement in the financial statements that could result, the next step is to assess or rank their significance. Again, it is preferable to assess these risks before consideration of any internal control that mitigates the risks.

For each identified risk consider:

- Likelihood of risk occurrence; and
- Monetary impact of risk occurrence.

Likelihood of Risk Occurrence
What is the probability that the risk will occur? The auditor can evaluate this probability simply as high, medium, or low or by assigning a numerical score, such as 1 to 5. The higher the score, the more likely the risk could occur.

Monetary Impact of Risk Occurrence
If the risk occurred, what would be the monetary impact? This judgment needs to be assessed against a specified monetary amount. If not, different people (with different amounts in mind) could come to entirely different conclusions. For audit purposes, the specified amount would relate to what constitutes a material misstatement of the financial statements. This can also be evaluated simply as high, medium, or low or by assigning a numerical score, such as 1 to 5.

Numeric scores for the likelihood and impact can be multiplied to give a combined or overall score. This can be helpful in sorting the risks in order of importance.

Using a simple format within an electronic worksheet can be an efficient way of conducting this step. The risks can then be sorted so that the most significant identified risks are at the top of the list.

The “risk register” below provides a sample format for identifying and assessing risks.

Exhibit 2.7-5

Risk Register

Entity ABC Co.
Risk Tolerance for Materiality 2500€

	Risk Factor	Assertions addressed	Risk Assessment Likelihood	Impact €	Comb[1]
			1–5	1–5	Li x Im
1	New technology is significantly reducing production costs on some products	Inventory or older products could become obsolete and therefore overvalued.	3	4	12
2	New environmental law is being introduced	New liabilities and contingent liabilities will be created for environmental clean-up costs.	2	4	8
3	New accounting system is being introduced	Errors could occure during the changeover that would not be prevented or detected.	4	2	8
4	Senior production manager is retiring	Not finding a suitable replacement could result in many types of mistakes being made.	3	2	6
5	Significant management bonuses based on sales	Pressure could exist to inflate sales to ensure bonus threshold is achieved.	2	2	4

[1] Comb = combined risk score

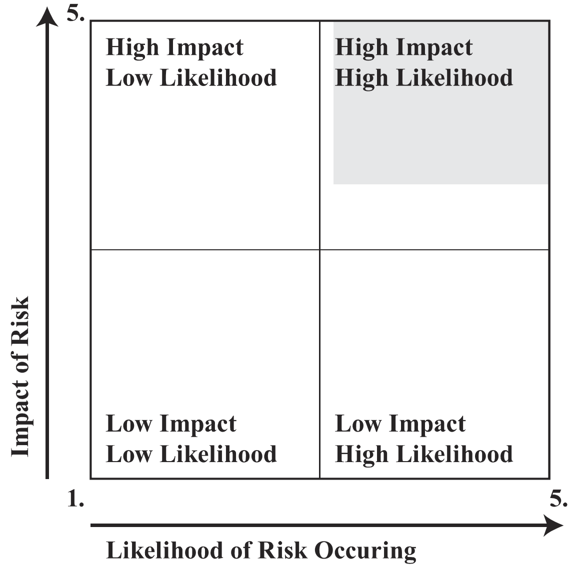
Note: An additional column can also be added to the above format to identify or cross-reference the internal control or steps taken by management to mitigate the risk.

Consider Point

The most important, but also the most difficult, column to complete on the above form is “What can go wrong in the financial statements (F/S) as a result”. It is in this column that the auditor sets out the implication of the identified risk. Declining sales is a risk factor but if recorded accurately by the entity, this would not result in risks of material misstatement. However, declining sales could result in inventories being obsolete or overvalued and receivables may become difficult to collect. It is the implication of each risk factor that the auditor needs to identify so that an appropriate audit response (such as further audit procedures) can be developed.

The results of the risk assessment process can also be set out in a chart, as illustrated below.

Exhibit 2.7-6



Risks falling in the "high impact, high likelihood" area of the chart clearly require management action to mitigate. In addition, these will likely be determined as being significant risks, which require special audit consideration (refer to Chapter 2.9).

2.7.5 Documentation of Risks

The auditor should document the key elements of the understanding obtained regarding each of the aspects of the entity and its environment, as outlined above. Documentation may be memoranda or forms may be used to ensure information is captured in a structured format. Often the auditor will use a mixture of both formats – memoranda and forms.

Consider Point

A key point to consider is how the documentation will be updated in subsequent years. If information is captured in a structured way, it may take longer to prepare initially but may be much easier to update at a later time.

Using a "risk register" such as the example above helps to ensure all risks are documented in a central place and are assessed in a consistent and systematic manner. When such a list is recorded on an electronic worksheet, the risks can also be sorted based on likelihood, impact, or by the combined risk score.

A structured format helps to ensure:

- Consistent basis for risk assessment and identifying significant risks;
- Ease of review;
- Ability to sort risks using various criteria; and
- Ability for the auditor to share the list with the client for their input or request that the client prepare it for the auditor's review.

The more complex the entity and the audit procedures required, the more extensive the documentation required.

Note: The auditor should use his or her professional judgment regarding the manner in which these matters are documented.

Case Study — Business Risks

For details of the case study, refer to the Introduction to the Case Study in this Guide.

One way of documenting risks (both business and fraud) is to list them in a structured format such as the risk register used in the example below. A form such as this could be used to record and assess all the risk factors identified during the audit.

An extract from the list of risks for Dephta is provided below. In the column "Financial statement impact", CEAV relates to the assertions of Completeness, Existence, Accuracy and Valuation.

Risk Register — Business/Operating

Materiality 15,000€

Assess each risk in terms of likelikhood and impact on a scale of 1–5 (1=low, 5=low).
Discuss this worksheet (risk register) with management to ensure completeness and the appropriateness of the risk assessment.

		FSA Impact — CAEV			Risk Assessment			
Risks Identified	**What Could go Wrong as a Result**	**Assets**	**Liabili-ties**	**Inc.**[1]	**Likeli-hood to Occur**	**€ Impact**	**Com-bined Risk**	**Signif-icant Risk?**
Inventory returns not estimated at time of sale. Deposits treated as revenue.	Inaccurate revenue recognition			EA	3	3	9	N
Contingent payment of fines to large retailers for late shipments	Fines for late deliveries not accrued		CA	C	2	2	4	N
Inventory returns may not be saleable at normal margins	Inventory write-downs may be required	V			3	3	9	N
Large custom sales made to customers on extended credit	Possible bad debts	V			3	4	12	N
Bank covenants could be breached due to rapid expansion and poor inventory control	If the bank called their loan company would be unable to continue resulting in major asset write downs	V			4	5	20	Y
IT general controls are weak in a number of areas	Data integrity may be compromised or data may even be lost	all	all	all	3	4	12	N

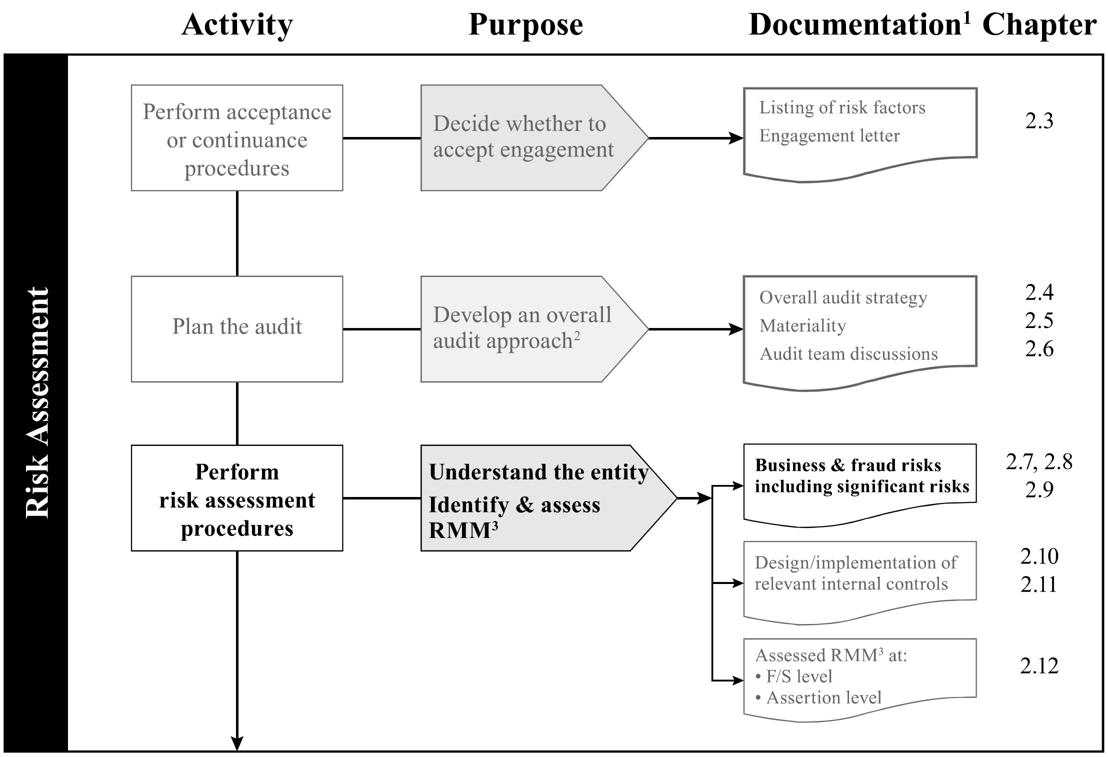
[1] Inc. = Income statement

C = Completeness, E = Existence, A = Accuracy, and V = Valuation

Note: Possible violation of the bank covenants has a combined risk score of 20 and is therefore being considered a significant risk. Significant risks will require special audit consideration.

2.8 Fraud Risks

Exhibit 2-8.1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA References
To outline the auditors' role in assessing risk factors that could result in financial statement fraud and misappropriation of assets.	**240, 315**

2.8.1 Overview

ISA 315 states:

100. **The auditor should identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures.**

108. **As part of the risk assessment as described in paragraph 100, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as "significant risks").**

ISA 240 states:

3. In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.

24. The auditor should maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.

27. Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatement due to fraud.

29. The engagement partner should consider which matters are to be communicated to members of the engagement team not involved in the discussion.

34. When obtaining an understanding of the entity and its environment, including its internal control, the auditor should make inquiries of management regarding:

(a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud;

(b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or account balances, classes of transactions or disclosures for which a risk of fraud is likely to exist;

(c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and

(d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

38. The auditor should make inquiries of management, internal audit, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

43. The auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.

46. The auditor should make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

48. When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether the information obtained indicates that one or more fraud risk factors are present.

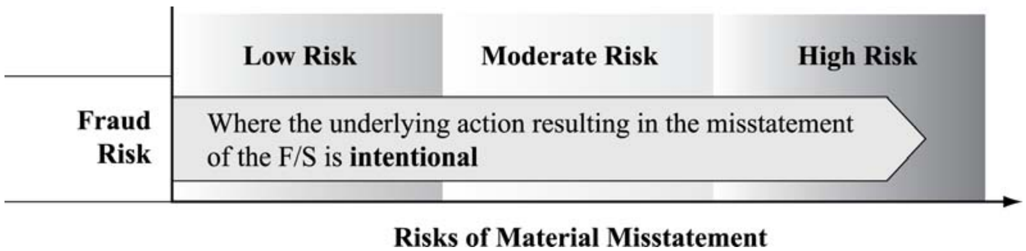
53. When performing analytical procedures to obtain an understanding of the entity and its environment, including its internal control, the auditor should

consider unusual or unexpected relationships that may indicate risks of material misstatement due to fraud.

55. **When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether other information obtained indicates risks of material misstatement due to fraud.**

The risk assessment described in this chapter focuses on the auditor's responsibility to consider fraud that causes a material misstatement in the financial statements. This is described in ISA 240 but still forms part of the overall risk assessment performed in accordance with ISA 315.

Exhibit 2-8.2



2.8.2 Fraud

The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Fraud involving one or more members of management or those charged with governance is referred to as "management fraud". Fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion within the entity or with third parties outside of the entity.

The exhibit below outlines the types and characteristics of fraud.

Exhibit 2-8.3

Types and Characteristics of Fraud

	Misappropriation of Assets (converting assets to personal use)		Manipulation of F/S (reporting a higher/lower level of earnings than actually occurred)	
Who?	Management	Employees	Management	Employees
Pressures	Personal benefit	Personal benefit	Personal benefit such as saving taxes, selling business at an inflated price or justifying a bonus	Personal benefit such as meeting a performance-based threshold for a bonus
Opportunities	Override of functioning internal control (IC) Exploit weakness in internal control	Exploit weakness in internal control	Override of functioning internal controls Exploit weakness in internal control (IC)	Exploit weakness in internal control (IC)
Amounts Involved	Tend to be large due to position in entitiy and knowledge of IC	Often small but could potentially be large	Tend to be large due to position in entity and knowledge of IC	Size would be relative to benefit (bonus) paid

Although fraud can occur at any level in the organization, it tends to be more serious (and involve higher monetary amounts) when senior management is involved.

Some of the major conditions that create an environment for fraud include:

- Ineffective corporate governance;
- Lack of leadership and "tone at the top" by management;
- High incentives provided for financial performance;
- Complexity in entity rules, regulations, and policies;
- Unrealistic budget targets for staff to attain; and
- Inadequate internal control, especially in the presence of organizational change.

As can be determined from the above, the most effective anti-fraud internal control would be a strong commitment by those in governance and senior management to doing the right thing. This is evidenced through articulated entity values and a commitment to ethics that are modelled on a day-to-day basis. This is true for any size of organization.

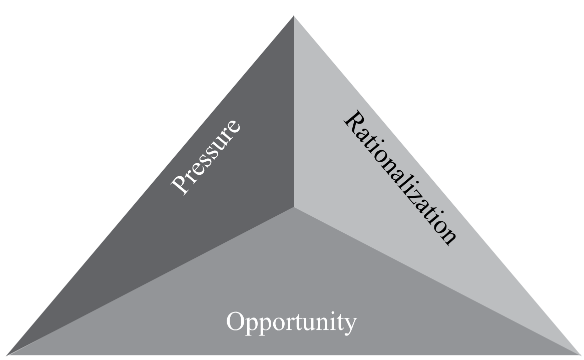
The Fraud Triangle

Appendix B – Nature of Fraud in the Appendices outlines three conditions that often provide clues to the existence of fraud. Forensic accountants often refer to this as the "fraud triangle" because when all three conditions are present, it is highly likely that fraud may be occurring.

The conditions are:

- **Opportunity**
  A poor corporate culture and a lack of adequate internal control procedures can often create the confidence that a fraud could go undetected.
- **Pressure**
  This is often generated by immediate needs (such as having significant personal debts or meeting an analyst's or bank's expectations for profit) that are difficult to share with others.
- **Rationalization**
  Rationalization is the belief that a fraud has not really been committed. For example, the perpetrator rationalizes "this is not a big deal" or "I am only taking what I deserve".

Exhibit 2-8.4



In conducting risk assessment procedures, the audit team members may identify a fraud risk factor that relates to one of the triangle elements. However, it is less likely that any one auditor will identify all three conditions (opportunity, pressure, rationalization) together. For this reason, it is very important for the audit team to continually discuss their findings throughout the engagement.

For example, an owner-manager in the construction business may offer to build a significant addition to a friend's house for a good price, as long as it is a cash-only transaction with no paperwork involved. Because of the owner-manager's position, the opportunity exists for him or her to override the internal controls over revenue recognition and not record the revenue from the sale. The pressure might be to reduce taxes that would otherwise be payable and the rationalization would be that he or she is paying far too much in taxes already. In conducting risk assessment procedures, the auditor may discover several findings.

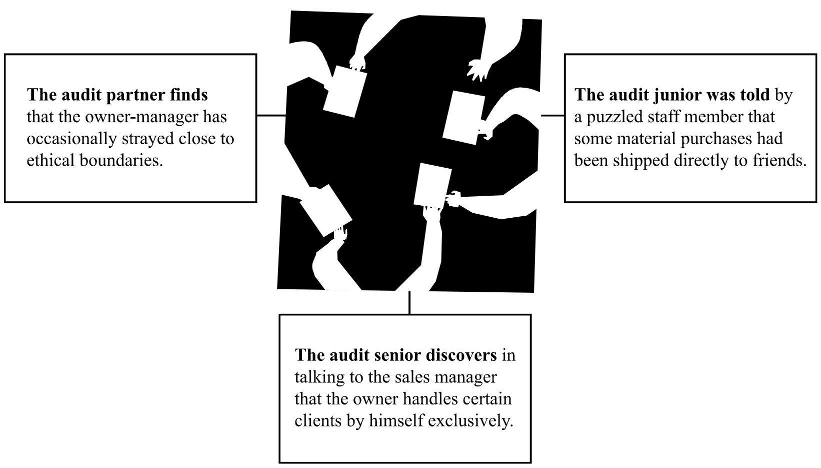
2.8.3 Audit Team Discussions

An important part of gathering information about fraud risk factors and effectively utilizing the firm's knowledge of the entity is sharing that information with the other members of the audit team. Encourage team members to come to the meeting with a questioning mind, setting aside any beliefs (possibly built over a number of years) that management is honest and has unquestioned integrity. Refer to Chapter 2.6 for more information on audit team meetings.

The benefits of audit team discussions are outlined in the exhibit below.

Exhibit 2-8.5

Benefits of Audit Team Discussions



In the absence of communication, it would be difficult for any member of the above audit team to see the big picture. However, the audit team discussion allows them to pull the different pieces of information together so that the bigger picture can indeed be seen. Fraud is always intentional and involves concealment of information. Its detection is often discovered by looking for patterns, oddities, and exceptions in what might be very small monetary amounts.

Professional Skepticism

It is the responsibility of auditors to maintain an attitude of professional skepticism at all times during the engagement. An attitude of professional skepticism involves:

- Making critical assessments, with a questioning mind, of the validity of audit evidence obtained;

- Being alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance; and
- Recognizing that management is always in a position to override otherwise good internal control.

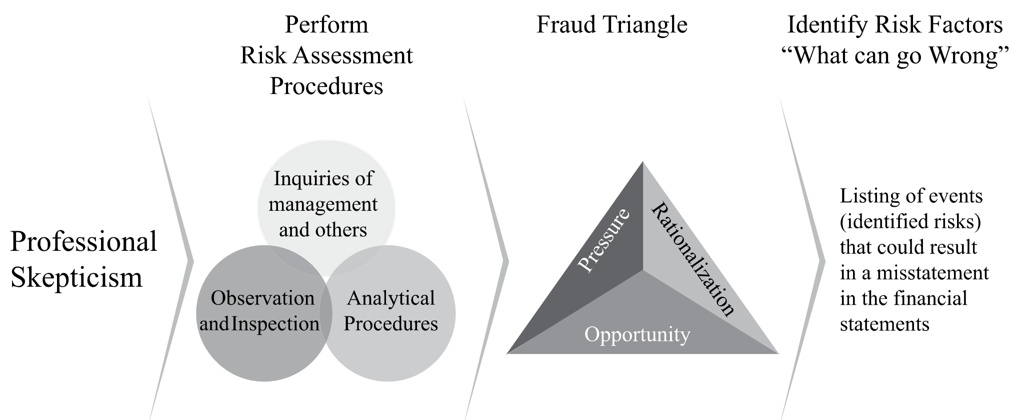
In conducting their work, auditors need to be careful to avoid:

- Overlooking unusual circumstances;
- Over-generalizing when drawing conclusions from audit observations;
- Using faulty assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof;
- Accepting less than persuasive audit evidence on a belief that management and those charged with governance are honest and have integrity; and
- Accepting representations from management as a substitute for obtaining sufficient appropriate audit evidence.

2.8.4 Identification of Fraud Risk Factors

Because fraud is concealed and management override is always a possibility, auditors need to carefully consider all the information obtained from performing the three risk assessment procedures and have regular discussions among the audit team, as illustrated below.

Exhibit 2-8.6



These procedures will include gaining an understanding and consideration of the "tone at the top" or management's attitudes toward the internal control environment. For example:

- How do those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud?
- How does management address the design and implementation of internal control to mitigate these risks? In smaller entities, management may consciously choose to accept the risk associated with a lack of segregation of duties due to high levels of day-to-day supervision of operations.

- Is there actual, suspected or alleged fraud affecting the entity and has management discovered any material errors?
- What perspective do persons other than the owner or senior management have on the culture, management operating style, management override, and existence of fraud risk factors?
- Are there specific areas of vulnerability such as management estimates, revenue recognition, use of journal entries, transactions with related parties, etc.?

This understanding of the entity should also include the internal control over financial reporting. Refer to the discussion on internal control in Chapters 1.2 and 2.10.

Examples of Fraud Risk Factors
The fraud risk factors identified in Appendix 1 of ISA 240 (summarized in the following chart for smaller entities) are examples of such factors typically faced by auditors in a broad range of situations.

Exhibit 2-8.7

<table>
<tr><th colspan="2">Fraudulent Financial Reporting</th></tr>
<tr><td rowspan="2">Tone at the Top

Pertains to management's abilities, pressures, style and attitude relating to internal control and the financial reporting process.</td><td>1. Pressures
• Bonuses
A significant portion of management or staff's compensation is represented by bonuses (or other incentives), the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow.

• Forecasts
Management commits to financial institutions, creditors and other third parties to achieving what appear to be unduly aggressive or clearly unrealistic forecasts.

• Tax reduction
Management has an interest in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.</td></tr>
<tr><td>2. Opportunities
• Management's attitudes
Failure by management to display/communicate an appropriate attitude regarding internal control and the financial reporting process such as:
– Management does not effectively communicate and support the entity's values or ethics or management communicates inappropriate values or ethics;
– Management is dominated by a single person or a small group without the compensating internal control such as effective oversight by those charged with governance;
– Management does not monitor significant internal control procedures adequately;</td></tr>
</table>

Fraudulent Financial Reporting	
	– Management fails to correct known material weaknesses in internal control on a timely basis; – Management sets unduly aggressive financial targets and expectations for operating personnel; – Management displays a significant disregard for regulatory authorities; and – Management continues to employ ineffective accounting and/or information technology staff. • Turnover There is a high turnover of management, legal counsel or board members. • Management/auditor relationships There is a strained relationship between management and the current/predecessor auditor such as: – Frequent disputes on accounting, auditing, or reporting matters; – Unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report; – Formal or informal restrictions on the auditor that inappropriately limit the auditor's access to people or information or limit the auditor's ability to communicate effectively with those charged with governance; and – Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work. • Corporate governance structure The corporate governance structure is weak or ineffective as evidenced by inexperience or lacking members, members who are not independent of management or where little attention is being paid to financial reporting matters and accounting and internal control systems.

Fraudulent Financial Reporting	
Industry Conditions Pertains to the economic and regulatory environment in which the entity operates.	• New compliance requirements New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity. • Operational challenges A high degree of competition or market saturation, accompanied by declining margins. • Industry trends – A declining industry with increasing business failures and significant declines in customer demand; and – Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.
Operating Characteristics and Financial Stability Pertains to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.	• Cash flows – Inability to generate cash flows from operations while reporting earnings and earnings growth; and – Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity (including a need for funds to finance major research and development or capital expenditures). • Estimates – Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties; and – Estimates subject to significant change in the near term that may have a financially disruptive effect on the entity (such as collectibility of accounts receivable, valuation of inventory, timing of revenue recognition. or a significant deferral of costs). • Related parties – Significant related-party transactions which are not in the ordinary course of business; and – Significant related-party transactions which are not audited or are audited by another firm. • Complexity – Significant, unusual or highly complex transactions (especially those close to year end) that pose difficult questions concerning substance over form; – Significant bank accounts or subsidiary operations in tax-haven jurisdictions for which there appears to be no clear business justification;

Fraudulent Financial Reporting	
	– An overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority; or contractual arrangements without apparent business purpose; and – Difficulty in determining the organization or person (or persons) controlling the entity. • Growth/profitability Unusually rapid growth or profitability, especially compared with that of other companies in the same industry. • Dependencies/vulnerabilities – Especially vulnerable to changes in interest rates; – Unusually high dependence on debt, a marginal ability to meet debt repayment requirements, or debt covenants that are difficult to maintain; – Unrealistically aggressive sales or profitability incentive programs; – A threat of imminent bankruptcy, foreclosure; or hostile takeover; – Adverse consequences on significant pending transactions (such as a business combination or contract award) if poor financial results are reported; and – A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Exhibit 2-8.8

Misappropriation of Assets	
Susceptibility of Assets to Theft	• Large amounts of cash on hand or processed; • Inventory characteristics, such as small size combined with high value and high demand; • Easily convertible assets, such as bearer bonds, diamonds, or computer chips; and • Fixed asset characteristics, such as small size combined with marketability and lack of ownership identification.
Absence of Internal Control	• Lack of appropriate management oversight (for example, inadequate supervision or inadequate monitoring of remote locations); • Lack of procedures to screen job applicants for positions where employees have access to assets susceptible to misappropriation; • Inadequate record keeping for assets susceptible to misappropriation; • Lack of an appropriate segregation of duties or independent checks; • Lack of an appropriate system of authorization and approval of transactions (for example, in purchasing); • Poor physical safeguards over cash, investments, inventory or fixed assets; • Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns); and • Lack of mandatory vacations for employees performing key internal control functions.

2.8.5 Assessment of Fraud Risk

Once the fraud risk factors have been identified (from performing risk assessment procedures), the next step is to assess the likelihood of the risk occurring and whether it could result in a material misstatement in the financial statements. The same risk assessment procedures should be followed as for business risks outlined in Chapter 2.7.

Documentation

The auditor should document the fraud risk factors identified and their assessment. When deciding what form of documentation is required, consider how it will be updated in subsequent years. If information is captured in a structured way, it may take longer to prepare initially but may be much easier to update at a later time.

Consider Point

Separate the listing of fraud risk factors from business risks. Some business risks, such as complex financing arrangements, could result in simple errors being made but could also be used to conceal fraud. It is preferable to document assessed business and fraud risks separately.

The same 'risk register' as illustrated in Chapter 2.7 for business risks can be used to document fraud risk factors. A simple example is provided below.

Exhibit 2-8.9
Risk register — Fraud

Materiality 15,000€

Assess each risk in terms of likelihood and impact on a scale of 1-5 (1=low, 5=high).
Discuss this worksheet (risk register) with management to ensure completeness and the appropriateness of the risk assessment.

Risks identified	What Could go Wrong in the F/S as a Result	FSA Impact — CEAV Assets	Liabilities	Inc.[1]	Risk Assessment Likelihood to occur	€ Impact	Combined Risk	Significant risk? Y/N
Cash flow is tight due to late delivery on a major contract. Problems will take some time to rectify.	*Owner-manager may try to cover up losses on contract to avoid more tough questions from the bank.*	EV	C	A	3	3	9	No
Sales targets for bonuses may be narrowly missed this year by a number of salespersons.	*Sales persons may be tempted to inflate their sales revenue to ensure targets are met.*	EV		C	3	2	6	No
Inconsistency in revenue recognition.	*Revenues could be inflated or recorded in the wrong period.*	ECA		ECA	4	5	20	Yes

[1] Inc. = Income statement

Note: Revenue recognition is considered a significant risk that will require special attention.

When such a list is recorded on an electronic worksheet, the risks can also be sorted based on likelihood, impact, or by the combined risk score. Professional judgment should be used regarding the manner in which these matters are documented.

Consider Point

Maintain separate lists for business risk factors and fraud risk factors. Note that some business risk factors will also be fraud risk factors. For example, revenue recognition is included on the business/operating "risk register" in Chapter 2.7 and on the fraud risk register above.

This separation is also helpful in:

- Identifying possible pressures, opportunities, and rationalizations for fraud;
- Identifying the susceptibility of particular account balances and transactions to fraud; and
- Designing an appropriate audit response.

Case Study — Fraud Risks

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Fraud risks can be documented using the same structure as that for business risks. One possible approach is to document risks under the headings of opportunities, pressures, and rationalizations.

An extract from the Dephta list of risks is provided below. CEAV relates to the assertions of Completeness, Existence, Accurgacy and Valuation.

Risk Register — Fraud

Materiality 15,000€

Assess each risk in terms of likelikhood and impact on a scale of 1–5 (1=low, 5=low).
Discuss this worksheet (risk register) with management to ensure completeness and the appropriateness of the risk assessment.

		FSA Impact — CAEV			Risk Assessment			
Risks Identified	**What Could go Wrong as a Result**	**Assets**	**Liabili-ties**	**Inc.**[1]	**Likeli-hood to Occur**	**€ Impact**	**Com-bined Risk**	**Signif-icant Risk?**
Pressures								
Minimize tax burden	Management bias in estimates	CA	C		4	4	16	N
	Unauthorized journal entries	all	all		4	5	20	Y
Rapid growth putting pressure on financing	F/S manipulation to avoid bank covenant being violated	all	all		4	5	20	Y
Saleperson's bonus based on sales above certain thresholds	Inflated sales to meet thresholds	CV		E	3	3	9	N
Paying bribes to obtain contacts	Illegal acts	C	CE	A	2	3	6	N
Opportunities								
Poor control over inventory	Goods stolen	E			4	3	12	N
Poor control over cash sales	Goods stolen/cash stolen	E			4	3	12	N
Transactions with related parties	Sales/purchases could be undervalued/overvalued	V		V	3	3	9	N
Significant expansion in the use of related-party transactions	Sales/purchases could be undervalued/overvalued	V	V	V	4	5	20	Y
Rationalization								
Low morale among temporary workers	Goods stolen	E			3	2	6	N

[1] Inc. = Income Statement

C = Completeness, E = Existence, A = Accuracy, and V = Valuation

Note: The possible management bias in estimates, unauthorized journal entries, the pressures to finance the rapid growth, and related-party transactions have been identified as significant risks. Significant risks will require special audit consideration.

The audit response column can be used to cross-reference the risk factors to the audit procedures that address the risk identified.

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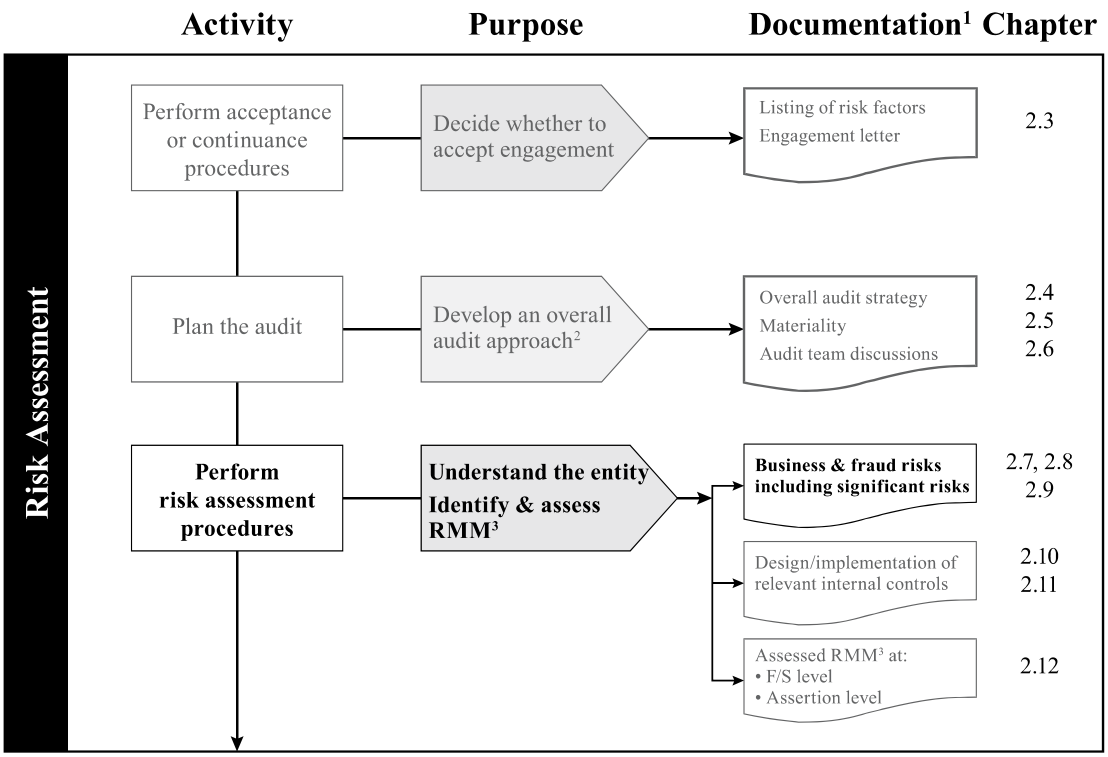
2.9 Significant Risks

Exhibit 2.9-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA References
To provide guidance on the nature and determination of significant risks and the consequences for the audit.	**240, 315**

2.9.1 Overview

ISA 315 states:

> **108. As part of the risk assessment as described in paragraph 100, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as "significant risks").**
>
> **113. For significant risks, to the extent the auditor has not already done so, the auditor should evaluate the design of the entity's related controls, including**

relevant control activities, and determine whether they have been implemented.

ISA 240 states:

57. **When identifying and assessing the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures, the auditor should identify and assess the risks of material misstatement due to fraud. Those assessed risks that could result in a material misstatement due to fraud are significant risks and accordingly, to the extent not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented.**

ISA 330 states:

44. **When, in accordance with paragraph 108 of ISA 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk and the auditor plans to rely on the operating effectiveness of controls intended to mitigate that significant risk, the auditor should obtain the audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period.**

51. **When, in accordance with paragraph 108 of ISA 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk.**

2.9.2 Determination of Significant Risks

A key part of the risk assessment process is to determine which of the business and fraud risks identified are, in the auditor's judgment, significant.

Significant risks will:

- Arise on most audits; and
- Require special audit consideration.

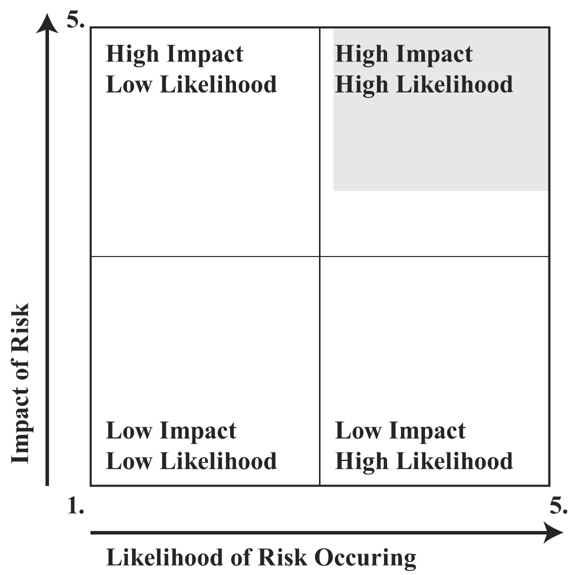
Determination of which risks are significant is based on:

- The nature of the risk;
- Consideration of the effect of any identified internal control related to the risk;
- The likely magnitude (size) of the potential misstatement (or multiple misstatements); and
- The likelihood (probability) of the risk occurring.

Note that the determination of significant risk is based on the inherent risk (before considering related internal control) and not the combined risk (considering both inherent and internal control risks). For example, a company with a large inventory of diamonds would have a high inherent risk of theft. Management's response is to maintain secure facilities and keep the diamonds locked in a safe that is guarded at all times. The combined risks of material misstatement are therefore minimal. However, because the risk of loss (before considering internal control) is highly likely and its size would have a material impact on the financial statements, the risk would be determined as "significant".

Chapter 2.7 contains a chart that maps the assessment of risks based on likelihood and impact. Risks that fall within the shaded area of the chart below (high impact, high likelihood) would certainly be considered as being significant risks.

Exhibit 2.9-2



2.9.3 Areas to Consider

When considering whether significant risks exist, the auditor would consider the following matters (Refer to paragraph 109 of ISA 315):

- Whether the risk is a risk of fraud;
- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
- The complexity of transactions;
- Whether the risk involves significant transactions with related parties;
- The degree of subjectivity in the measurement of financial information related to the risk, especially those involving a wide range of measurement uncertainty; 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.

In smaller entities, significant risks often relate to the matters outlined in the chart below.

Subject Matter/ Information	Characteristics
Significant Non-routine Transactions	• High inherent risk (likelihood and impact). • Occur infrequently. • Not subject to systematic processing. • Unusual due to their size or nature (such as the acquisition of another entity). • Require management intervention: – To specify accounting treatment; and – For data collection and processing. • Involve complex calculations or accounting principles. • Nature of transactions makes it difficult for entity to implement effective internal controls over the risks.
Significant Judgmental Matters	• High inherent risk. • Involve significant measurement uncertainty (such as the development of accounting estimates). • Accounting principles involved may be subject to differing interpretation (such as preparation of accounting estimates or application of revenue recognition). • Required judgment may be subjective, complex, or require assumptions about the effects of future events (such as judgments about fair value, valuation of inventory subject to rapid obsolescence, etc.).

The auditor should also consider the following factors when identifying significant risks:

- Is there a potential for fraud to occur?
- Is the risk related to recent significant economic or accounting changes or other developments?
- Are complex transactions involved?
- Are there significant transactions with related parties?
- Is there a high degree of subjectivity in the measurement of financial information, especially those areas involving a wide range of measurement uncertainty?
- Are there significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual?

2.9.4 Responding to Significant Risks

When a risk is classified as being “significant”, the auditor should respond as outlined below.

Internal Control Design and Implementation Should be Evaluated

The auditor should evaluate the design of the entity’s related internal control system, including relevant internal control activities, and determine whether they have been implemented. This is necessary to provide the auditor with adequate information to develop an effective audit approach.

Internal control activities could include:

- A review of assumptions (used in estimates) by senior management or experts;
- A formal process for preparing estimations; and
- Approval of the response by those charged with governance.

Where significant non-routine or judgmental matters are not subject to routine internal control (such as a one-off or an annual event), the auditor should evaluate management’s awareness of the risks and the appropriateness of their response. For example, if the entity purchased the assets of another business, the entity’s response might include hiring an independent valuator for the acquired assets, the application of appropriate accounting principles, and proper disclosure of the transaction in the financial statements.

Where the auditor judges that management has not appropriately responded (by implementing internal control over significant risks) and a material weakness exists in the entity’s internal control:

- The matter should be communicated (as soon as possible) to those charged with governance; and
- Consideration should be given to the implications for the auditor’s risk assessment (determining the further audit procedures may be required to address the assessed risk).

Reliance on Evidence Attained in Previous Audits Not Allowed

Where a test of operating effectiveness is planned for a control that mitigates a significant risk, the auditor may not rely on audit evidence about the operating effectiveness of internal control obtained in prior audits. (Refer to paragraph 41 of ISA 330.)

Substantive Procedures Should Specifically Respond to the Identified Risk

Substantive procedures related to significant risks should address the specific risk identified. They should also be designed to obtain audit evidence with high reliability.

In many cases, the audit procedures for significant risks will be an extension of procedures that would be planned in any case. For example, if the significant risk related to potential management bias lies in the preparation of an estimate, the substantive procedures would address the validity of the assumptions used, identifying the sources and considering the reliability of the information used (both external and internal), the existence of any bias in the prior year’s estimates as compared to actual facts, and the methods used in the estimate calculation.

Substantive Analytical Procedures Alone are not a Sufficient Response

The use of substantive analytical procedures by themselves is not considered an appropriate response to address a significant risk. When the approach to significant risks consists only of substantive procedures, the audit procedures can consist of:

- Tests of details only; or
- A combination of tests of details and substantive analytical procedures.

For additional guidance on designing the nature, timing, and extent of substantive procedures, refer to Chapter 3.3.

Case Study — Significant Risks

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Significant risks can be identified from the listing of risk factors and their assessment. Refer to the "Risk Register" examples contained in the case study discussion for Chapters 2.6 and 2.7. Such a form can also be used to cross-reference each significant risk to the related detailed audit plan.

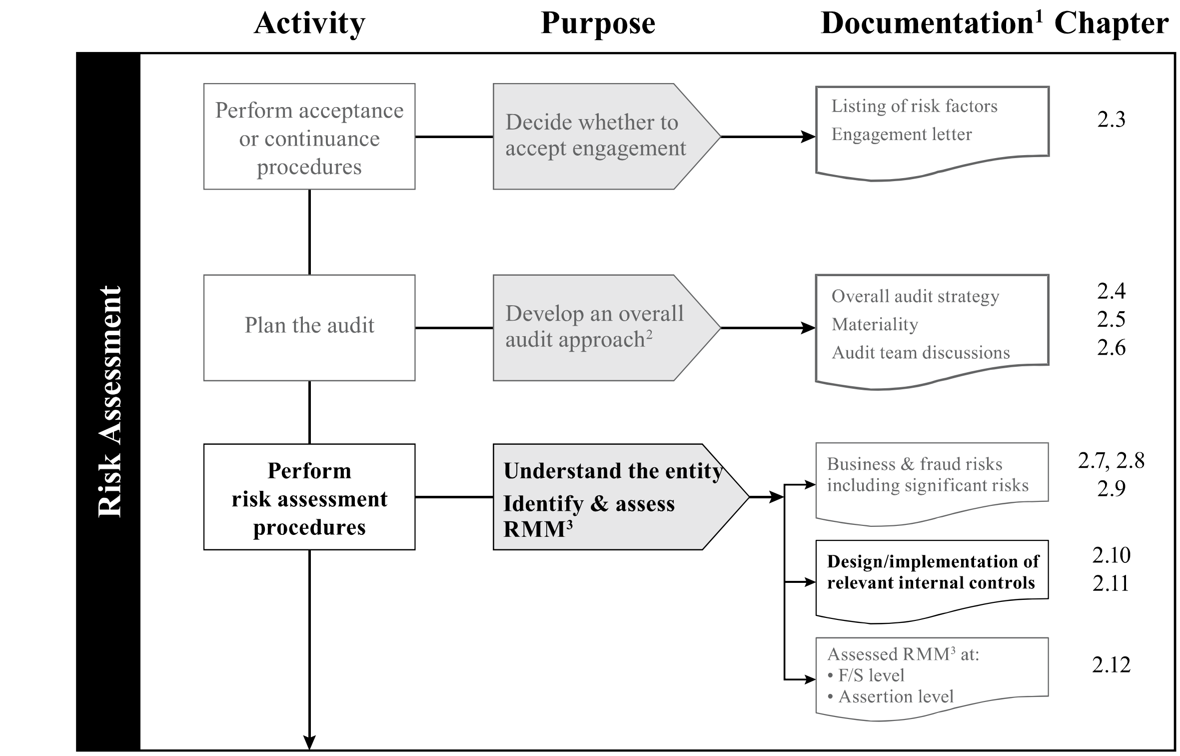
For each significant risk identified, management's response should be documented and appropriate audit procedures developed that respond to the specific risk.

Significant Risk	Management's Response	Audit Response	W/P Ref
Has the company violated the terms of its bank financing? *If so, the bank could call its loan. If this happened, the company would be unable to operate normally, which could result in major asset write-downs.*	*Preparation and monitoring of cash flow forecasts.* *Renegotiate amount and terms of financing.*	*Look at the company's growth plans and whether the forecasted cash flows are realistic.* *Review and compare actual results and cash flows.* *Ensure the valuations of receivables and inventory (the security for the loans) are reasonable.* *Review the company's refinancing submission to the bank.*	*(Not included)*
Financial statement manipulation could occur to avoid the bank covenants being violated.	*None. Management does not see this as a risk at all.*	*Carefully review the assumptions used in the cash flow forecasts and the basis on which actual cash flow reports are prepared. Also ensure the basis for the valuations of receivables and inventory is valid and correct.*	
Inconsistent revenue recognition.	*Sales contracts over 500€ are reviewed by the sales manager.*	*Review of major contracts (and a sample of smaller contracts) and discussion with sales manager to ensure revenue was appropriately recognized in the year.*	

Significant Risk	Management's Response	Audit Response	W/P Ref
Unauthorized journal entries.	*Management has agreed to put policy in place requiring approval of all journal entries but it has not yet been implemented.*	*Identify and review all journal entries over 1,500€ and all entries in the month before and after the year end.*	
Significant expansion in the use of related-party transactions.	*Policy is that all related-party transactions are identified as such and conducted at the normal terms of sale. This includes any corporate assets or services provided for personal use by management or employees.*	*Review employees' understanding of the policy through inquiry and inspection.* *Seek to ensure all related-party transactions have been identified and that the transactions, terms of sale, nature of transaction, and the dates are indeed appropriate.*	

2.10 Internal Control

Exhibit 2.10-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA Reference
To provide guidance on: • Relevant internal control; • Required scope of understanding; and • The levels of control and the five internal control components.	**315**

2.10.1 Overview

ISA 315 states:

41. The auditor should obtain an understanding of internal control relevant to the audit.

67. The auditor should obtain an understanding of the control environment.

76. The auditor should obtain an understanding of the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.

81. The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

- **The classes of transactions in the entity's operations that are significant to the financial statements.**
- **The procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed and reported in the financial statements.**
- **The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions.**
- **How the information system captures events and conditions, other than classes of transactions, that are significant to the financial statements.**
- **The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.**

89. The auditor should understand how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting.

90. The auditor should obtain a sufficient understanding of control activities to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks.

93. The auditor should obtain an understanding of how the entity has responded to risks arising from IT.

96. The auditor should obtain an understanding of the major types of activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates corrective actions to its controls.

Previous chapters of this Guide addressed the nature of internal control (refer to Chapter 1.2) and how to identify and assess inherent business risks and fraud risk factors (refer to Chapters 2.6 and 2.7).

This chapter addresses the next step of the risk assessment, which is to understand internal control relevant to the audit. This involves evaluating how the design and implementation of controls would prevent material misstatements from occurring or detect and correct misstatements after they have occurred. This step may also identify material weaknesses in the entity's internal control which would be communicated to management and those charged with governance.

ISA 315 requires auditors to obtain an understanding of internal control on all audit engagements. This applies to all audits, including where the auditor decides that an entirely substantive approach is the appropriate response to the risks identified.

2.10.2 Internal Control in Smaller Entities

In smaller entities, there are often few employees, which can limit the extent to which segregation of duties is practicable and the paper trail of documentation available. But internal control still exists. In such entities, the control environment (management's commitment to ethical values, competence, attitude toward control, and their day-to-day actions) will be very important to evaluate. This will involve assessing the behavior, attitudes, and actions of management.

The presence of a highly involved owner-manager can be both an internal control strength and an internal control weakness. The strength is that the person (assuming his or her competence) will be knowledgeable about all aspects of operations and that it is highly unlikely material errors will be missed. The weakness is that the person is also in a good position to override internal controls.

Management Override

Management override can often be mitigated or slowed down by establishing documented policies and procedures. For example, a written policy that says all non-routine journal entries require approval would empower the bookkeeper to ask for their approval. If no such procedures or other anti-fraud controls are in place, the risk of management override will need to be addressed through the performance of further audit procedures.

Consider Point

In the audit of small entities, there is often a temptation to jump to the conclusion that internal control is non-existent and, therefore, is not worth evaluating. However, any entity that wants to continue operating will have some form of internal control. What business would not want to monitor that cash received is deposited or that goods shipped are invoiced?

Control environment controls in small entities (such as the integrity and competence of the owner-manager) tend to be much more subjective than traditional control activities ("segregation of duties" type of controls), but they are nevertheless very important.

Auditability

In most entities, there is almost always some form of internal control. It may be informal and unsophisticated, but it is still internal control. An entity that does not mitigate the risks it faces and the resulting misstatements in the financial statements will not stay in business for long. If, however, there is no internal control at all (such as a lack of competent personnel and/or documented policies and procedures), it raises basic questions about the auditability of an entity's financial statements.

The following matters, in particular, should raise serious questions:

- Concerns about management's integrity or a poor attitude toward internal control. This raises the risk of management misrepresentation and fraud; and
- Concerns about the condition and reliability of an entity's records that make it unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion.

If these concerns are present, the auditor should consider the need to issue a qualification, disclaimer of opinion, or withdrawing from the engagement altogether.

If withdrawal is chosen, the auditor should consider his or her professional and legal responsibilities, including any requirement to report to the persons who made the audit appointment and to regulatory authorities. The auditor should also discuss the withdrawal and the reasons with the appropriate level of management and those charged with governance.

2.10.3 Required Understanding of Internal Control

Auditors are required to obtain a sufficient understanding of internal control (relevant to the audit) to:

- Identify specific controls that will prevent material misstatements from occurring or detect and correct misstatements after they have occurred);
- Assess the risks of material misstatement at the financial statement and assertion levels; and
- Enable the design of further audit procedures that are responsive to the assessed risks.

Assessing internal control involves identifying the risks of material misstatement (business and fraud risks) and then ascertaining what the entity is doing to address them. This may be achieved through discussions with senior management followed by observation and inspection of any internal control identified.

Inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented.

The auditor's understanding of internal control includes:

- Evaluating internal control design. Are the internal control procedures, individually or in combination with other internal control procedures, capable of effectively preventing, or detecting and correcting, material misstatements?
- Determining internal control implementation. Does the internal control exist and is the entity using it?

Risk Assessment Procedures

Risk assessment procedures are used to perform this work which may include:

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

If an internal control is improperly designed, determining its implementation is not necessary.

Instead, the auditor should consider if it represents a material weakness in the entity's internal control. If so, it should be communicated to management and those charged with governance.

Limitations of Internal Control

Internal control (regardless of how well it is designed and implemented) can only provide reasonable assurance about achieving financial reporting objectives. The major limitations include:

- The human judgments required in any system and simple human failures such as errors or mistakes;
- Circumvention of internal control by the collusion of two or more people; and

- Inappropriate management override of internal control, such as revising the terms of a sales contract or overriding a customer's credit limit.

Testing Operational Effectiveness

There is no requirement in the ISAs to test the operating effectiveness of controls unless there is no alternative way (such as in a highly automated and paperless system) to gain the necessary audit evidence. The decision to test the operating effectiveness of controls is therefore a matter of professional judgment. This topic is addressed further in Chapter 3.2.

The understanding of internal control is confined to design and implementation. This is established through risk assessment procedures such as inquiries of entity personnel, observing the application of specific controls, inspecting documents and reports, and tracing just one or two transactions through the information system. Because this understanding is limited to a specific point in time (the date of the risk assessment procedure), it does not provide evidence about the operating effectiveness of internal control over a period such as the fiscal year.

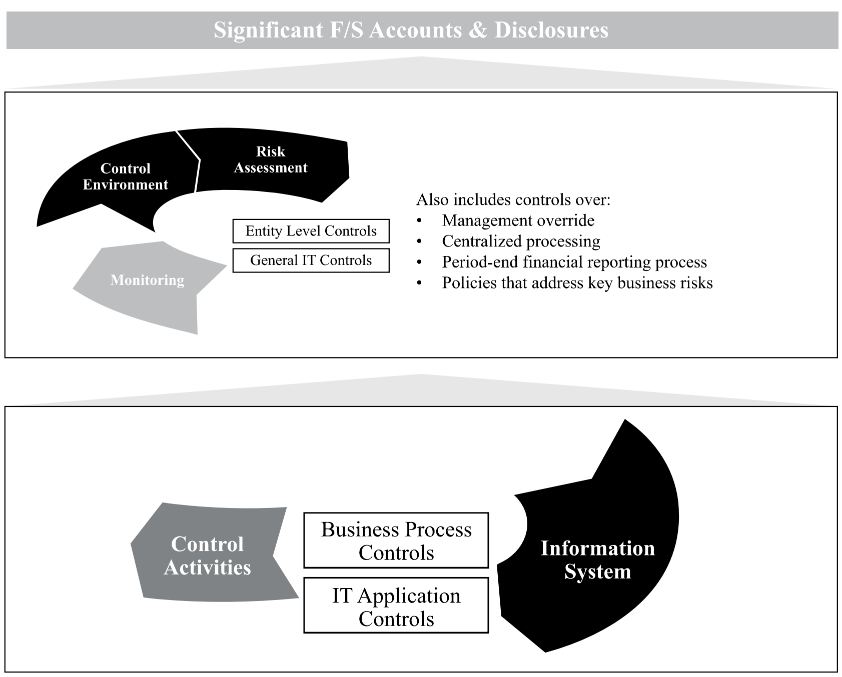
Management Representations about Internal Control

The auditor should obtain written representations from management acknowledging their responsibility for the design and implementation of internal control to prevent, detect, and correct errors.

2.10.4 Relevant Internal Control

Chapter 1.2 outlined the relationship between the five internal control components and the levels of control that exist in an entity. Entity level controls (which include controls over management override) and IT general controls tend to be pervasive across all business activities. Business process controls focus on internal control over transactions such as payroll, sales, and purchases. The interrelationships are illustrated (in general terms) in the exhibit below.

Exhibit 2.10-2



Entity level controls have a significant influence over the rigor with which internal control is designed and operates within all business processes. A poor entity level control can render even the best business process control ineffective. For example, an entity may have an effective purchasing system but if the bookkeeper/accountant is incompetent, a wide variety of errors could still occur and some could possibly result in a material misstatement in the financial statements. In addition, management override and poor "tone at the top" (which usually occurs at the entity level) are common themes in bad corporate behavior.

Consider Point

The auditor's approach to understanding internal control should be from the top down. A solid understanding of entity level controls provides an important basis for assessing relevant controls over financial reporting at the business process level. For example, if there are poor controls over data integrity at the entity level, this will impact the reliability of all information produced by systems such as sales, purchases, and payroll.

Entity level controls are usually more subjective to evaluate than business process controls. For example, asking "are purchase orders matched to goods received before payment is authorized?" is very easily answered with "yes" or "no". However, asking "is management competent?" requires some subjective analysis before it can be answered.

Relevant Controls

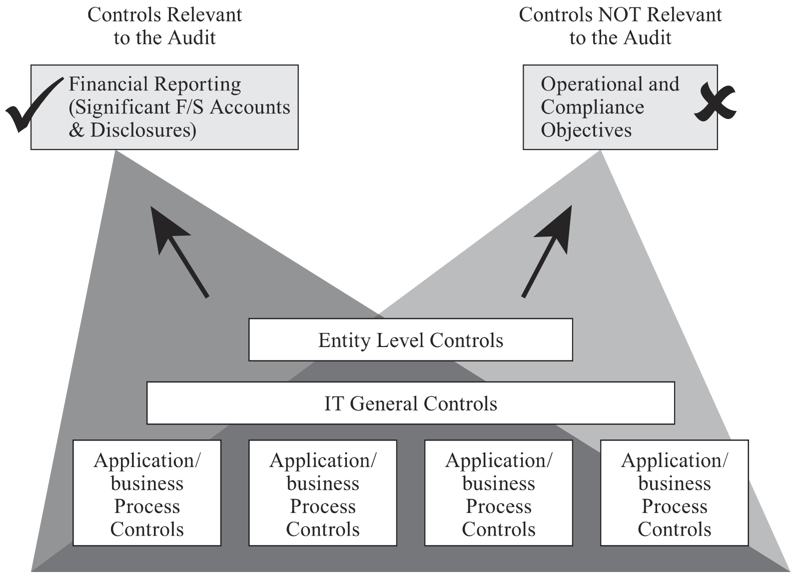
Not all controls are relevant to the audit. Internal control relevant to an audit relates to:

- The entity's objective of preparing financial statements for external purposes; and
- Management of risks that could result in a material misstatement in those financial statements.

This means that certain types of controls may normally be scoped out of further audit consideration. These are controls that:

- Do not drive financial reporting (such as operational controls and controls that address compliance with regulations); and
- Are unlikely to result in a material misstatement in the financial statements.

Exhibit 2.10-3



In some cases, there may be some overlap between financial controls and controls relating to operations and compliance objectives. Examples include controls that pertain to data the auditor evaluates or uses in applying other audit procedures such as:

- Data required for analytical procedures, for example, production statistics;
- Controls that detect non-compliance with laws and regulations;
- Safeguarding of asset controls that pertain to financial reporting; and
- Controls over the completeness and accuracy of information produced that may form the basis for calculating key performance measures.

Professional judgment is required to determine whether an internal control, individually or in combination with others, is, in fact, relevant.

Determining the relevance of controls should be based on factors such as:

- Materiality;
- Understanding the entity and its environment. This includes entity size, nature of business, organization, ownership, diversity, complexity of operations, and applicable legal and regulatory requirements;
- Previous experience with the entity; and
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.

Consider Point

A top down and risk-based approach to understanding internal control involves:

- Identifying the business processes involved (including accounting) for each significant account balance;
- Determining for each process identified whether a material misstatement in the financial statements could possibly occur or whether other factors exist that would make it relevant; and
- Scoping out of the audit those processes and controls that are not relevant.

For example, a biscuit production company may have the following processes that drive the sales revenue figure:

- The main sales order system captures details and progress of each order received by phone. This accounts for 70% of sales.
- "Window sales" are where customers can buy broken biscuits from a small shop at the back of the production facility. This accounts for 5% of sales.
- Internet sales where orders are placed on-line and paid by credit card. This accounts for 25% of sales.
- The accounting system that captures details of all types of sales.

In this situation, the window sales are unlikely to result in a material misstatement in the financial statements and may therefore be scoped out of the audit. However, before this decision is made, it would still be prudent to at least inquire about the existence of controls over the window sales to ensure all such sales are recorded and that there is no deliberate breaking of biscuits for sale at reduced prices to related parties.

2.10.5 Required Scope of Understanding

The objective of understanding internal control is to consider whether the entity has responded adequately to business and fraud risks by establishing effective controls. This would include the following items:

- Controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements;
- Controls over the selection and application of accounting policies;
- Anti-fraud programs and controls;
- Controls on which other controls are dependent, including information technology general internal controls;
- Controls over significant non-routine and non-systematic transactions, such as accounts involving judgments and estimates;
- Controls over the year-end financial reporting process;
- Controls over procedures used to enter transaction totals into the general ledger;
- Controls to initiate, authorize, record, and process journal entries in the general ledger; and
- Controls to record recurring and nonrecurring adjustments to the financial statements.

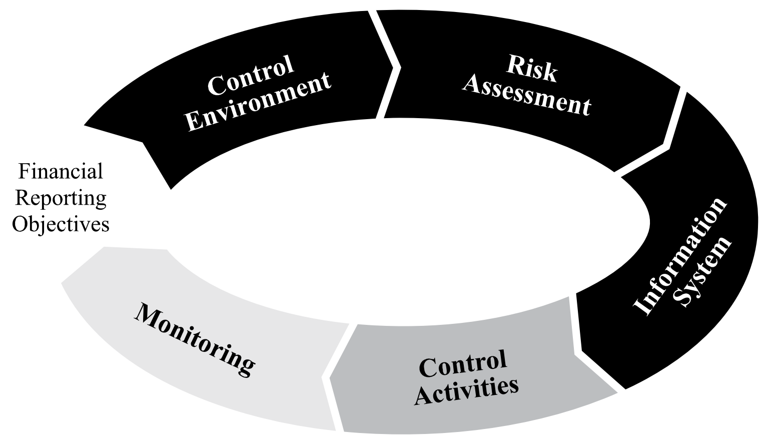
The auditor's emphasis is on identifying and obtaining an understanding of internal control activities where material misstatements are most likely to occur. When multiple internal control activities achieve the same objective, it is unnecessary to obtain an understanding of each of the internal control activities related to the objective.

The Five Internal Control Elements

The division of internal control into five components, for purposes of the ISAs, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. Each of the five components should be addressed by the auditor as part of understanding the internal control over financial reporting.

The five components are summarized in the illustration below.

Exhibit 2.10-4



How an entity actually designs and implements internal control will vary with an entity's size and complexity. In smaller entities, the owner-manager may perform functions that address several of the components of internal control. Consequently, these internal control components should only be used as a guide as to what should be considered in any sound system of internal control.

Refer to Chapter 1.2 for a detailed description of each component and Chapter 3.2 for a description of tests of control.

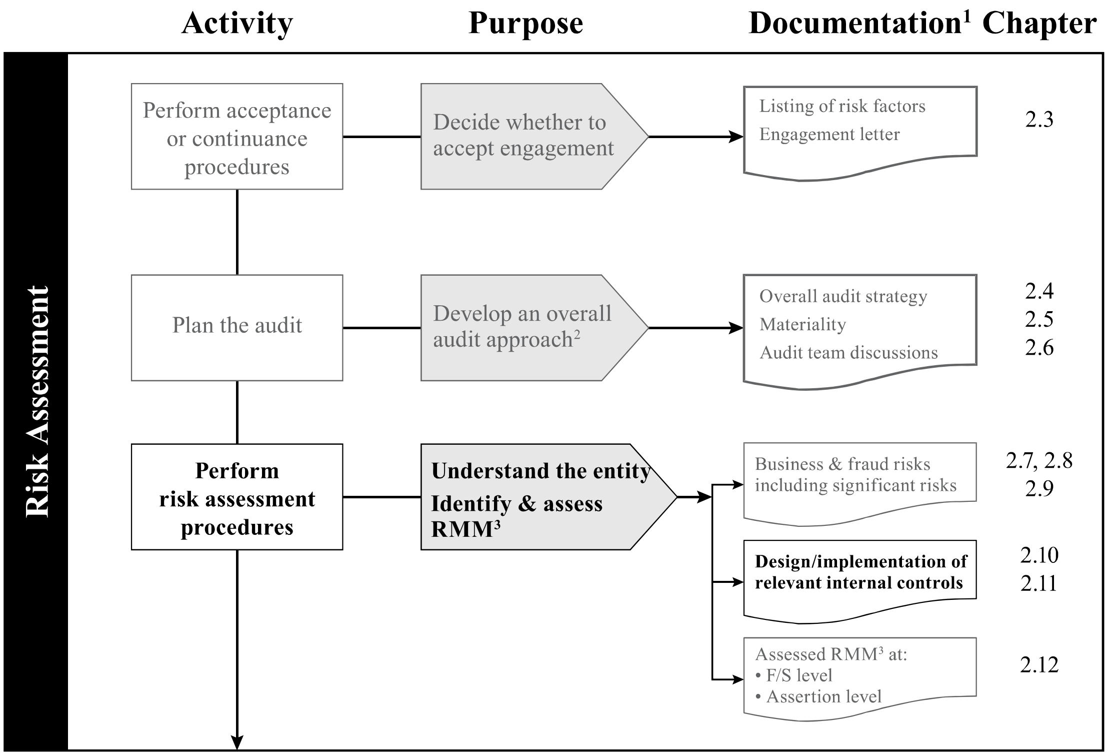
Case Study — Internal Control

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Refer to Chapter 2.11 for an extract of the internal control documentation for Dephta Furniture.

2.11 Assessing Internal Control Design and Implementation

Exhibit 2.11-1



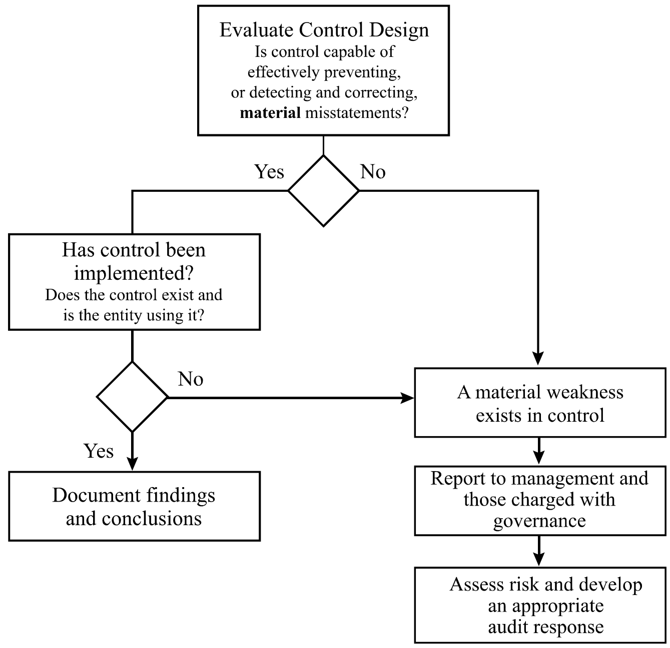
Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA Reference
To provide guidance on: • Documenting information about internal control; • Assessing internal control design and implementation; and • Identifying material weaknesses in internal control.	**315**

2.11.1 Overview

As discussed in Chapter 2.10, obtaining an understanding of internal control involves evaluating the design of internal control and determining whether the controls have been implemented. The key steps in this process are illustrated in the exhibit below.

Exhibit 2.11-2



2.11.2 Control Design

Internal control is designed and implemented to address identified business risks that threaten the achievement of objectives such as the reliability of financial reporting. At its most basic level, internal control design consists of a listing of risk factors matched to internal controls. Refer to paragraph 42 of ISA 315.

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

Evaluating control design involves:

- Identifying the relevant risk factors (those that could result in a material misstatement);
- Mapping the risk factors to the internal control that prevents misstatements from occurring or would detect and correct misstatements after they have occurred; and
- Determining whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements.

Risk/Control Mapping

A common approach to this risk/control mapping is what is often referred to as a "control design matrix," "matrix mapping" or a "many-to-many" matrix. These matrices enable the auditor to see at a glance:

- The many-to-many relationships that exist between risks and controls;
- Where internal control is strong;
- Where internal control is weak; and

- The key controls that address many risks/assertions and could be tested for operating effectiveness.

An example of a simple control design matrix is illustrated below.

Exhibit 2.11-3

Process xyz					
		Risk A	**Risk B**	**Risk C**	**Risk D**
	Assertion	**C**	**E A**	**A**	**C A**
Control	**IC Com**				
Procedure 1	CE	P			P
Procedure 2	IS		D		
Procedure 3	CA	P	P		P
Procedure 4	M	D			
Procedure 5	CA		P		
Procedure 6	CA				D
Procedure 7	IS	D	D		

IC Com = Internal Control Component
CE = Control Environment
IS = Information Systems
CA = Control Activities
M = Monitoring

P = Prevent control
D= Detect and correct control

Note: The following information that is contained in this matrix includes:

- The assertions addressed by the risk factors;
- The internal control component addressed by the internal control procedure; and
- Where the internal control procedure addresses (intersects) the risk on the matrix, it is recorded as either preventing (P) a misstatement or detecting (D) a misstatement after it has occurred.

Some matrices might also capture additional information such as:

- Internal control frequency;
- Whether it is a manual or automated internal control; and
- The likely reliability of the internal control over a period of time.

The matrix illustrated above can be used to:

- **Identify Internal Control Weaknesses**
  Look at each risk column to see what internal control procedures exist to mitigate it. Where there are no internal control procedures identified to mitigate a risk, a significant internal control deficiency exists. Refer to the matrix column for risk C in the example above. In this case, the auditor should first inquire if there are any undocumented internal control procedures or compensating internal control procedures that exist. If there are none or the controls that exist are inadequate:
  - Consider what further audit procedures may be necessary; and

  - Communicate the weakness to management and those charged with governance as soon as possible so that corrective action may be taken.

- **Identify Internal Control Strengths**
  Look at the internal control procedure rows to identify internal control procedures that would prevent or detect and correct a number of misstatements from occurring or effectively address certain assertions. Refer to Procedure 3 in the example above. These are key controls that, if considered reliable, could be considered for testing their operational effectiveness. This would occur when the evidence obtained from the tests of controls would reduce the need or extent for other substantive audit procedures.

Control Implementation
Inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented. Refer to paragraph 55 of ISA 315.

As a result, risk assessment procedures are required to obtain audit evidence about the design and implementation of the relevant internal control. This will include:

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

2.11.3 A Four Step Process

There are four important steps involved in obtaining an understanding of internal control and then evaluating internal control design and implementation. Apart from the first step, the order in which these steps may be performed may vary based on the circumstances and size of the entity.

The four steps are illustrated in the exhibit below.

Exhibit 2.11-4

1	Identify what risks require mitigation	**A Risk Assessment Procedure** What risks have been identified that should be addressed by controls
2	Document relevant internal controls	**Understand Internal Controls** From inception to financial reporting Address each of the 5 IC components
3	Assess internal control implementation	**A Risk Assessment Procedure** Ensure controls are actually operating as designed
4	Assess internal control design	**Match Risks with Controls** Identify key controls for testing Identify material control weaknesses

Step 1 — Identify What Risks Require Mitigation

The first step is to identify what risks need to be mitigated to prevent a material misstatement in the financial statements. Risk factors are often described as "what can go wrong" if a specific internal control objective is not achieved.

The following exhibit summarizes the types of risk factors that need to be addressed.

Exhibit 2.11-5

What can go wrong?	Sources of risk	Mitigating controls
Unreliable financial reports *(pervasive risks)*	External industry factors Nature of entity Accounting policies Objectives and goals Performance measures Fraud	Entity level controls IT general controls Business process controls
Misstatements arising from financial statement preparation	Accounting estimates Provisions Accounting policies Use of spreadsheet Non-routine transactions Journal entries, reconciliations Information neccessary for disclosures in F/S	Entity level controls IT general controls Business process controls
Transactions not processed or recorded accurately	Identification/recording of all valid transactions Transaction classification Measurement and cut-off	Business process controls

It is important that the auditor takes the time to understand, identify, and assess the significant and other risk factors present before evaluating internal control design. Otherwise the internal control evaluation will take place without any entity-specific context or knowledge of what risks the entity faces that need to be mitigated. If this step is skipped, audit time may well be spent assessing internal controls that may be irrelevant, unnecessary or that, even if well designed, would not mitigate entity-specific risks that do exist.

The risks relating to financial reporting in general are usually pervasive in nature (cover all assertions) and will be identified through performance of the risk assessment procedures. Misstatements arising from the financial statement preparation process may include a mixture of pervasive risks and those that relate specifically to assertions.

Transactional risk factors for major business processes (such as goods shipped but not invoiced in a sales process) tend to be similar in nature for most types of entity, but management's response to them may vary considerably.

The most common way of organizing the evaluation of internal control is by business process. However, many business processes will hand over transaction data (such as sales) to the accounting system for recording in the general ledger and ultimately the financial statements. Therefore risk factors need to be considered from the inception of transactions right through to financial reporting.

When a listing of list factors (by business process) has been prepared, the final step is to:

- Eliminate any risk factors that would not result in a material misstatement even if not mitigated. These controls are not relevant;
- Customize the wording of the risk factors for the particular entity;
- Ensure all relevant assertions have been addressed; and
- Consider whether other transactional risks exist that could result in a material misstatement if not mitigated.

Consider Point

Some internal control frameworks provide a listing of the typical internal control objectives for transaction streams such as sales, purchasing, and payroll. Before using such a tool as a starting point for control evaluation:

- Remove the risk factors that are unlikely to result in a material misstatement even if no internal control existed;
- Add any other risk factors that could result in a material misstatement if not mitigated; and
- Identify the assertions that are affected by the risk factors.

Step 2 — Document Relevant Internal Control

Steps 2 and 3 can often be completed at the same time. The purpose of the step is to identify the existence of internal control that mitigates the risk factors listed in Step 1 above. Remember though that there is no requirement to document and evaluate internal controls that are not relevant to the audit. Refer to the discussion of internal control in Chapter 2.10 of this Guide.

In addition, when enough controls have been identified to effectively mitigate a risk, there is no need to continue listing other controls that mitigate the same risk. This can save a lot of time when documenting business processes. If in doubt, consider which risks of material misstatement are being addressed by the specific control. If there are none, the control may not be relevant.

When documenting internal controls, the auditor should ensure that each of the five internal control components has been considered. If they are not applicable to a certain activity, document the reasons in an attached memo to file. For example, the control environment, risk assessment, and monitoring components most often relate to the entity level controls and not to individual business processes such as sales, payroll, and so forth.

Consider Point

Avoid the temptation to use generic lists of internal control activities that are appropriate to the so-called "typical" entity. Listings of "standard" or "typical" controls take a lot of time to read and understand and may often be irrelevant, especially for smaller entities. Instead, use them as a reference source only when needed. It is much better to document the nature of the control using the client's own description.

Documenting Pervasive Controls

When documenting controls, always start with the controls that have a pervasive effect over all other controls. These are the entity level (control environment, risk assessment, and monitoring) and IT general levels. An understanding of these pervasive controls will provide a context for assessing the design and operation of the business process controls. These controls may often be identified by inquiries of senior management using a checklist or questionnaire that addresses matters such as:

- Who has been charged with governance, their qualifications, independence, and how they perform their function;
- Anti-fraud controls in place (if any) that address management override;
- Internal control over journal entries;
- Selection of accounting policies;
- Management's attitude towards internal control and how that is evidenced in day-to-day operations;
- Incentive plans that might motivate employees to manipulate financial results;
- The values held of the entity and how effectively they have been communicated to employees. Junior employees could be asked if they are aware of the entity's values and any code of conduct that may exist;
- The competence of key personnel and the suitability of their job descriptions;
- Exceptions (if any) management has made to policies and procedures;
- How problems or system crashes during the year were handled;
- Whether any employees have been asked to override any controls by management; and
- Awareness of any illegal activities or potential fraud.

Consider Point

The documentation of entity level or pervasive controls can often be combined with the inspection/observation of documents to support implementation. For example, if there was a policy that no non-routine journal entries can be made without authorization, ask to see some journal entries and evidence of approval.

This documentation should be updated each year. Changes in the entity level controls can have a significant effect on effectiveness of other controls and may affect the relevance of information obtained in prior audits. For example, management's decision to hire a qualified professional to prepare the financial statements may considerably reduce the risk of errors in the financial information. Alternatively, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing unauthorized transactions to be processed.

Consider Point

Instead of identifying entity level controls, it is quite possible that the inquiries may identify additional risk factors. For example, if it is discovered that the accountant is not competent for the job he or she performs, it may impact the nature and extent of the further audit procedures required. Additional risk factors identified should be documented (such as on a "risk register") and assessed in a similar way to other risk factors.

Forms of Documentation

The manner in which internal controls are documented can vary considerably. It may include paper, electronic files, or other media and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, documents, and forms.

The extent of documentation required will vary depending on the size, nature, and complexity of the entity and is a matter of professional judgment.

The completed documentation should provide information on the following:

- The design of internal control over all relevant assertions related to significant accounts and disclosures in the financial statements;
- How significant transactions are initiated, authorized, recorded, processed, and reported;
- The flow of transactions in sufficient detail to identify the points at which material misstatements due to error or fraud could occur; and
- Internal control over the period-end financial reporting process, including significant accounting estimates and disclosures.

The most common forms of documentation prepared by management or the auditor are:

- Narrative descriptions or memoranda;
- Flowcharts;
- A combination of flow charts and narrative descriptions; and
- Questionnaires and checklists.

Refer to Appendix A in the Appendices to this Guide for additional information on these documentation methods.

Step 3 — Assess Control Implementation

As noted earlier, inquiry alone is not sufficient to evaluate the design of internal control or to determine whether it has been implemented. This is because documentation (however good) of controls that do not exist or do not operate is of no value to the audit. Refer to paragraph 55 of ISA 315.

Other reasons for observing internal control in action are:

- Processes change over time resulting from revised/new products or services, efficiencies in operation, changes in personnel, and implementation of new supporting IT applications;
- Entity personnel may explain to the auditor how a system should operate rather than how it actually does operate in practice; and
- Some aspects of the system may have been inadvertently overlooked in obtaining the understanding of internal control.

Only when it has been established that the internal control relevant to the audit has been properly designed and implemented is it worth considering:

- What tests of the operating effectiveness of controls (if any) will reduce the need for other substantive testing; and
- What controls require testing because they cannot be tested substantively.

The implementation of controls can be addressed by conducting a walkthrough. In a walkthrough, the auditor traces a transaction from each major class of transactions from origination, through the entity's accounting and information systems and financial report preparation processes, to its being reported in the financial statements. A walkthrough typically involves inquiries of personnel, observing the application of specific controls, and inspecting documents and reports.

Note: A walkthrough is not a test of the operating effectiveness of a control. This is because it only addresses the existence of a control at a specific point in time. A test of operating effectiveness gathers evidence about control operation over a period of time such as a year.

Consider Point

The difference between control design, control implementation, and tests of controls, can be summarized as follows:

- Control design
  Have controls been designed that will mitigate the identified risks of material misstatement?
- Control implementation
  Are the designed controls actually in operation? Control system walkthroughs should be performed each year to identify any system changes.
- Tests of controls
  Did the controls operate effectively over a specified period of time? There is no requirement to test controls but they should be considered as an effective way of achieving audit objectives.

Refer to Appendix B in the Appendices in this Guide for information on how to perform a walk-through procedure.

Major System Changes

Where there have been significant changes in the process flow of transactions, such as the introduction of a new computer application, the understanding of internal control will need to be updated and a walkthrough performed on the new system.

Where a change occurs that affects internal control relevant to the audit, there may be a need to walk through transactions that were processed both before and after the change.

Prior Year's Documentation

The auditor may use documentation prepared or obtained in a prior audit period when planning the audit of a subsequent period. This requires updating the prior period's documentation to reflect changes in internal control.

ISA 315 states:

> **12. When the auditor intends to use information about the entity and its environment obtained in prior periods, the auditor should determine whether changes have occurred that may affect the relevance of such information in the current audit.**

Any working papers to be carried forward should first be copied. Keep the prior year's file intact because it is the evidence of work carried out.

Consider Point

This step can be carried out in conjunction with the system documentation, after the control documentation has been completed or even after the evaluation of the internal control design. In practice, it is often preferable to assess control implementation before design. This is because time can be wasted evaluating the design of controls that do not exist or operate quite differently from what someone felt should be happening.

Step 4 — Assess Internal Control Design

The final step is to bring together all the information obtained and map the controls identified (and implemented) to the risk factors. An example of this mapping is provided in the case study that follows. It is then a matter of professional judgment to determine whether the controls identified, individually or in combination with other controls, are capable of effectively preventing, or detecting and correcting, material misstatements.

Consider Point

For a very small entity that includes only a few people, time will be saved by changing the order of the four step process outlined above.

Step 1 — This step remains the same. Risk factors need to be identified first.

Step 2 — Simply ask the responsible person what internal control procedures exist in the entity to mitigate each particular risk factor and document the results. If the matrix is used:

- Record the internal control procedures identified directly onto the matrix and indicate whether they prevent or detect and correct risk factors; and
- Address each risk factor separately. It is quite possible that some internal control procedures will prevent or detect a number of the risk factors.

Not only is this an efficient way to document relevant internal control procedures for small entities but it will immediately alert the client to risk factors that have not been mitigated.

Step 3 — This step is then to document the control procedures in the context of the business process involved.

Step 4 — This step, which may be completed at the same time as Step 3, is to conduct the walkthrough to ensure the internal control procedures identified are actually in existence. If yes, the evaluation of control design and implementation can then be completed.

2.11.4 Material Weaknesses in Control

On completion of the four steps above, the auditor should address any material weaknesses in internal control.

ISA 315 states:

> **120. The auditor should make those charged with governance or management aware, as soon as practicable, and at an appropriate level of responsibility, of material weaknesses in the design or implementation of internal control which have come to the auditor's attention.**

Risk factors identified that have not been addressed by internal control should be documented (such as on the risk register) and then assessed. This will help in the design of further audit procedures that will be responsive to the assessed risks. At this point, it would be good practice to prepare the communication for management that outlines the significant weaknesses in internal control identified.

Case Study — Assessing Internal Control Design and Implementation

For details of the case study, refer to the Introduction to the Case Study in this Guide.

The following extracts from internal control documentation for Dephta Furniture provide an example of the information obtained using the four step process described in this chapter.

Step 1 — Identify What Risks Require Mitigation

For entity level and IT general controls, the risks to be mitigated may have been identified on the risk register or will be identified and addressed through a questionnaire such as the one illustrated in partial form in Step 2 below.

For business process controls, the first step is to identify transactional risks that would result in a material misstatement if not mitigated. This provides a starting point or context for identifying the internal control procedures that would mitigate these risks. If the control design matrix is used, the "what can go wrong" columns of the matrix need to be completed, as illustrated below.

Control Design Matrix — Receivables, receipts

Entity: Dephta Furniture **Process:** Receivable/Receipts

Assertions
C = Completeness
E = Existence
A = Accuracy
V = Valuation

Internal control (IC) component
CE = Control environment
CA = Control activities
IS = Information systems
MO = Monitoring

Type of control
P = Prevent
D = Detect and correct

Risk factors: what can go wrong

		Internal Control Component	Receipts are partially or not deposited or recorded.	Cash sales are partially recorded or not recorded.	Recorded receipts are credited to the wrong customer or account (fraud or error).	Receipts are recorded in wrong period.	Overdue receivables are not followed up on a timely basis.							Control tested (Y/N)	W/P ref.
	Assertion addressed by risk factor		CAE	CAE	CAE	CAE	AV								
1	Karla perpares the deposit slips but Jawad makes the cash deposit to ensure functions are segregated.	CA	P												
2	When opening the mail, cheques are stamped "for deposit only" with the Dephta's account number. Bank is instructed not to cash cheques	CA	P												
3	Cheques received are listed, totaled and reviewed before deposit.	CA	P												
4	Accounts over 90 days are investigated by Suraj and Jawad and actions taken documented.	CA					D								
5	Cut-off procedures exist to ensure receipts are recorded in the correct period.	CA				P									
6	An aged accounts receivable listing is prepared regularly and distributed monthly to Suraj and Jawad.	IS					D								
7	Regular review of aged accounts receivable and follow-up of overdue accounts by Suraj. Accounts in default put on COD terks;	MO					P								
8															
9	Do the control procedures mitigate the risk factor? Y = risk mitigated, S= some mitigation, No = material weakness exists														

	Weakness identified:														
	1. Since statements are not sent to customers, a control weakness exists that a wrong customer's account could be credited.														
	2. Since most showrooms sales are for cash and receipts are given when requested, a risk exists that not all cash sales are recorded.														

Step 2 — Document Relevant Internal Control

Extract from Entity Level Internal Control Documentation

Usually, the gathering of information on entity level and IT general controls will be combined with the walkthrough. As information is gathered, the auditor would ask for the supporting documentation.

Area of Inquiry	Results
Describe how management communicates the need for integrity and ethical values. Consider what constitutes acceptable/ unacceptable workplace behavior.	*Suraj accepted our recommendation last year and prepared a code of conduct for all employees. When a person joins the company, a session is held to ensure he or she understands the requirements along with other matters, such as health and safety.*
Describe the policies and procedures in place to minimize the potential for management override. Consider documentation required for senior management-initiated journal entries, estimates, accounting policy changes, and exceptions made to established internal control procedures.	*This remains a weakness. We have recommended that all journal entries be approved by Suraj and a narrative explanation provided. Management estimates also tend to be biased toward minimizing taxes. This weakness is addressed in the detailed audit plan.*
What procedures are followed by management when they become aware of internal control deficiencies, overly aggressive accounting policies, or fraud?	*Management is very responsive to recommendations that are not costly or disruptive to implement. When fraud is discovered, employees are always fired immediately.*
Describe management's policies for determining the organizational structure and lines of reporting. Consider whether internal control and financial reporting risks are adequately addressed.	*Suraj reads many management books and likes to think the organization structure at Dephta is state-of-the-art. The current structure makes good sense, works well and ensures ongoing communication between production and sales.*
Describe HR policies such as hiring, compensation, performance evaluations, terminations, and discipline to ensure that only the honest and best people available are hired.	*HR is well managed as outlined in the attached HR policy manual. Reference checks are made for new employees and they are put on probation for a period of three months.*

Extract From IT General Internal Control Documentation

Area of Inquiry	**Results**
Describe the approach taken to planning and managing IT operations. Consider how needs are assessed (including the use of new technology), IT budget development, and the strategic importance of IT to the entity as a whole.	*John Rabeer prepares an IT budget each year. Suraj then reviews the budget, makes some changes, and approves it. The move to Internet sales put a strain on the system last year and resulted in a number of system crashes of a temporary nature. This year's plan calls for hiring a second full-time IT person.*
Describe the policies and procedures that define the role and responsibilities of the IT department.	*John is in the process of preparing a policy and procedures manual for IT operations, but he has just been too busy to complete it. New employees are adequately trained on the use of Dephta applications.*
Describe how the risks associated with IT operations are identified and assessed.	*The operating system used is Windows XP and John is very familiar with the company applications and the Internet tools used.* *We have recommended that an IT risk assessment be prepared on an annual basis.*
Describe the system(s) used for producing financial information and the extent (if any) the program has been customized for entity use. For example: • A mainstream accounting software package with no modification. • An older or custom-built system.	*Sales system was bought from the industry association for furniture manufacturers.* *The accounting system used is Sound Accounting by Onion. No modifications have been made to either the sales or accounting software.*

Area of Inquiry	**Results**
Describe the policies and procedures that address data management and security.	*Last year, a number of PCs were stolen from the office area. Steps have now been taken to make the office more secure.* *The server area is locked at all times and back-up copies of data are stored in the safe.* *New users receive a password that provides access to their applications only. When someone leaves, HR notifies John who then removes the person's access.* *There is no remote access to the system at present other than for email. There is back-up power in the event of power failure, which happens quite regularly.*
Describe the policies and procedures that address IT system disaster recovery. Consider the development, updating, and maintenance of a plan that addresses business continuity and data security. Address whether the plan is periodically tested (including off-site storage/facilities) and updated as required.	*There is no disaster recovery plan at present. Also the back-up tapes are stored in the safe which is not fireproof. Our IT specialist will review IT general controls this year and make specific recommendations for improvement.*

Extract From Business Process Documentation (Using a Narrative Approach)

Business Process — Revenue/Receivables/Receipts System

Sales Contracts
Sales contracts for the retail and specialized orders are prepared by Arjan as they involve extensive work. The contracts are all based on a template that contains the estimated quantities, types of furniture, special requests as well as standard delivery and payment terms and conditions. Payment terms and conditions can vary by customer. A 15% deposit is required on all custom orders and is recorded as revenue at the time of sale.

All contracts are reviewed and signed for approval by Suraj prior to being given to the customer for signature. When the contract is signed by the customer for approval, the order is entered into the accounting system which assigns the order a sequential number automatically. When the order is ready for shipment, a shipping document is prepared, entered into the system, and matched with the order. Karla then prepares an invoice from the accounting system which assigns a sequential number automatically. It is a strict rule that no shipments can be made without the shipping document number being entered into the system. The system can then track which orders have been filled and which ones are still pending by delivery date.

Regular Sales Orders
Sales orders are prepared for each order received and entered into the accounting system. Sales orders are prepared and entered into the accounting system which assigns the order a sequential number automatically. The only exception is furniture or other small items on hand that are sold directly from the shop.

All orders over 500€, or where the sales price is below the minimum sales price, must be approved by Arjan.

When items are assembled and ready for shipment, Karla prepares an invoice which is sent along with the order to the customer.

Arjan does not do a credit check on customers unless he does not know them or the order is large. He relies mostly on his previous experience with the customer when granting credit.

Shop Sales
For all sales out of the shop, invoices are prepared at the time of sale and entered into the accounting system. The system automatically generates an invoice number for each sale. Invoices are usually given to customers.

The majority of the shop sales are for cash, so there is little credit risk.

Internet Sales
A summary of the day's Internet sales is downloaded from the website by Karla. She prepares sales orders, which are given to the production department. An invoice is prepared at the same time and recorded as prepaid revenue since the item has been paid for. The invoice is marked "paid in full" and accompanies all Internet orders shipped.

Accounts Receivable
Karla opens all of the mail and segregates the payments received for deposit. Jawad usually goes to the bank on his way home and makes the deposit. Karla then enters the payments into the accounting system and applies the payment to the invoices indicated.

Jawad prepares an aged accounts receivable listing and gives the listing to Suraj. Suraj then reviews it.

Accounts over 90 days are followed up each month and comments are made on the listing as to when the customer has agreed to pay the balance.

For customers who are over 90 days and have not made alternative payment arrangements, future sales are made on a cash-on-delivery basis.

Step 3 — Assess Control Implementation
A walkthrough confirms the auditor's understanding of the process by tracing a single transaction from origin through the information processing system to the financial statements. A walkthrough consists of inquiries of entity personnel, which are corroborated by obtaining evidence. Document details of discussions with personnel and copies of the evidence obtained.

Extract from the Revenue/Receivables Walkthrough

Make inquiries of the personnel processing the transaction:

Persons interviewed:

Karla	Date November 15, 20X7
Dameer	Date November 17, 20X7
Maria Ho	Date December 3, 20X7

Area of Inquiry	**Results**
Describe the procedures performed related to the transaction: Address initiation, authorization, recording in the accounting records, and reporting in the financial statements.	*System works as described in the systems documentation. See W/P Ref #[1] for copies of documents that demonstrate the internal controls in action. However, we noted Maria Ho is a new employee and knows little about the system at present.*
Describe the process for any information transfers from one person (process owner) to the next.	*There is a hand-over from sales to accounting. Based on the walkthrough, the transfer worked well.*

[1] W/P = working papers. Ref # = reference number. Not included.

Area of Inquiry	Results
Note the frequency and timing of the internal control procedures performed.	*Noted on the control design matrix.*
Identify any IT general controls required to protect the transaction data files and ensure the proper functioning of application internal controls.	*IT general controls are minimal due to the small size of the entity.*
Document the procedures in place to cover illnesses and vacations of personnel. If vacations have not been taken in last 12 months, document why.	*There was a sales clerk vacancy for four months during the period before Maria was hired. This meant less segregation of duties during that time.*
Ask about the extent and nature of errors found in the past year.	*Most errors were due to mistakes in pricing, which is mostly a manual process at present.*
Ask whether person has been required to deviate from documented procedures.	*One request made by the sales manager to substantially reduce the price on a bedroom set for a friend was denied.*

Step 4 — Assess Internal Control Design

Entity Level and IT General Controls

For entity level and IT general controls, the answers to the questionnaire (refer to Step 2 above) and the supporting documentation obtained would be carefully reviewed and assessed. The goal is to identify the controls that would prevent or detect material misstatements from occurring.

Note: Entity level controls vary in precision. Some operate at the business process level and may be sufficient by themselves to prevent or detect a material misstatement from occurring.

In the case study, Dephta's strong human resource (HR) policies reduce the risk that incompetent people will be hired to perform the internal control procedures over transactions. The code of conduct that the company introduced last year (which provides employees with clear guidance on ethical behavior) could, if well implemented, prevent some forms of fraud from occurring. Other entity level controls, such as Suraj's monthly review of receivables, are more general in nature. This works with other established business process controls (such as in sales, receivables, and receipts) to identify breakdowns in internal control. This type of internal control still requires business process controls to be in place to work effectively. When evaluating internal control design and implementation, both entity level and IT general controls need to be mapped to the underlying or dependent business process controls.

Business Process Controls

Assessing design and implementation involves matching identified internal control procedures to the risks of material misstatement. This can be achieved by using a control design matrix.

For each "what can go wrong" or risk factor identified on the control design matrix (refer to Step 1 above), record details of the entity's internal control procedures that prevent or detect the potential misstatement from occurring. Where the internal control intersects with the risk on the matrix, indicate whether it prevents (P) or detects (D) a potential misstatement from occurring. Repeat this step for each of the other "what can go wrong" or risk factors. Some internal control procedures may prevent or detect a number of the risk factors.

Control Design Matrix — Receivables, receipts

Entity: *Dephta Furniture* **Process:** *Receivable/Receipts*

Assertions
C = Completeness
E = Existence
A = Accuracy
V = Valuation

Internal control (IC) component
CE = Control environment
CA = Control activities
IS = Information systems
MO = Monitoring

Type of control
P = Prevent
D = Detect and correct

		Internal Control Component	Receipts are partially or not deposited or recorded.	Cash sales are partially recorded or not recorded.	Recorded receipts are credited to the wrong customer or account (fraud or error).	Receipts are recorded in wrong period.	Overdue receivables are not followed up on a timely basis.							Control tested (Y/N)	W/P ref.
	Assertion addressed by risk factor		**CAE**	**CAE**	**CAE**	**CAE**	**AV**								
1	Karla perpares the deposit slips but Jawad makes the cash deposit to ensure functions are segregated.	CA	P												
2	When opening the mail, cheques are stamped "for deposit only" with the Dephta's account number. Bank is instructed not to cash cheques	CA	P												
3	Cheques received are listed, totaled and reviewed before deposit.	CA	P												
4	Accounts over 90 days are investigated by Suraj and Jawad and actions taken documented.	CA					D								
5	Cut-off procedures exist to ensure receipts are recorded in the correct period.	CA				P									
6	An aged accounts receivable listing is prepared regularly and distributed monthly to Suraj and Jawad.	IS					D								
7	Regular review of aged accounts receivable and follow-up of overdue accounts by Suraj. Accounts in default put on COD terks;	MO					P								
8															
9	Do the control procedures mitigate the risk factor? Y = risk mitigated, S= some mitigation, No = material weakness exists														
	Weakness identified:														
	1. Since statements are not sent to customers, a control weakness exists that a wrong customer's account could be credited.														
	2. Since most showrooms sales are for cash and receipts are given when requested, a risk exists that not all cash sales are recorded.														

Where there are no internal control procedures identified to mitigate a "what can go wrong" risk factor, a significant internal control deficiency would appear to exist. In the above example, there are two risk factors where no internal control procedures appear to exist. See the description under "weaknesses identified". Communicate these weaknesses to management so that corrective action may be taken.

The auditor would also consider the impact on other planned audit procedures. Where an internal control procedure prevents or detects a number of potential misstatements and assertions, it is likely to be a key internal control. A key internal control could be considered for testing (operational effectiveness) if the evidence obtained would reduce the need or extent for other substantive audit procedures.

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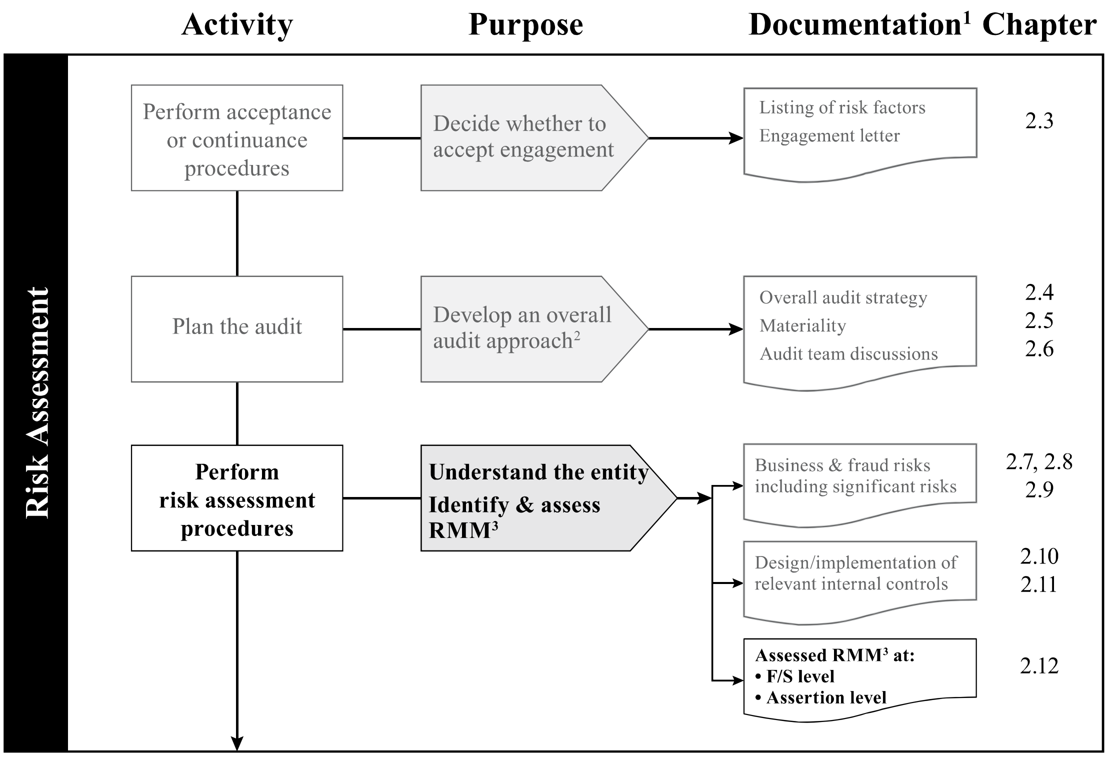
2.12 Assessing the Risks of Material Misstatement

Exhibit 2.12-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Chapter Purpose	Primary ISA Reference
To outline the steps involved in assessing and documenting the combined risks of material misstatement in the financial statements.	**315**

2.12.1 Overview

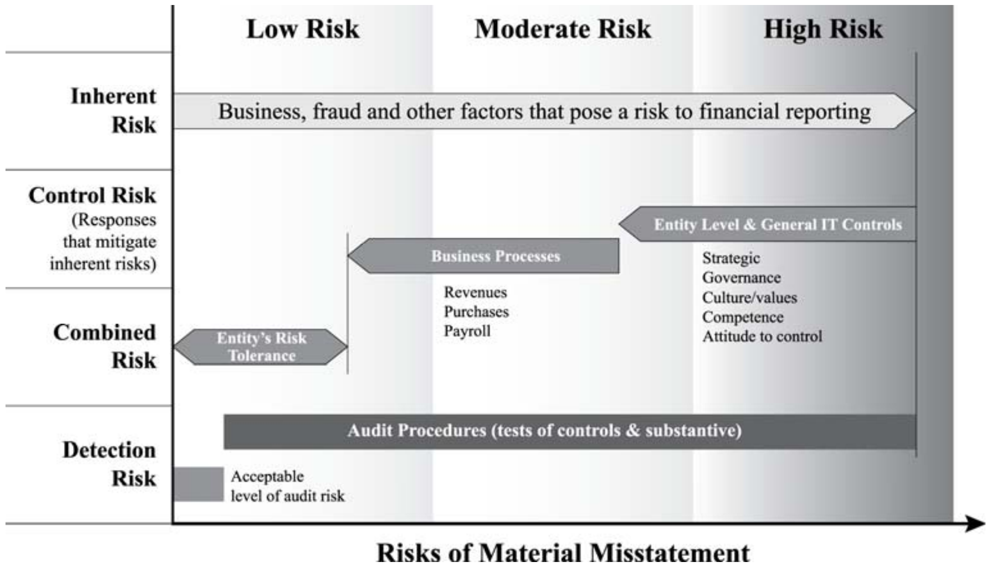
Assessing the risks of material misstatement is the final step in the risk assessment phase of the audit. The information obtained (from performing risk assessment procedures) about risk factors and mitigating control risks is all brought together to assess the risks of material misstatements at:

- The financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

This assessment will form the basis for determining the nature, extent, and timing of further audit procedures to be performed that respond to the risks identified.

The information elements that have been obtained to date are illustrated in the following exhibit.

Exhibit 2.12-2



2.12.2 Documentation

The documentation of assessed risks may take many forms. One possible approach (which uses the four assertions used in this Guide, as defined in Chapter 1.3) is illustrated below.

Exhibit 2.12-3

Assessed Levels of Risk

	As	IR	CR	Comb. RMM	Document the key risks and other contributing factors to risk assessment
Financial statement level	All	H	L	M	The industry is in decline and new technologies could accelerate the trend. Management's attitude to internal control is good. Competent people fill the key positions. Management override possible but new policies in place should deter the most common practices. The governance board does not have any non-family members.
Assertion Level FSA or financial statement disclosure					
1 Sales	C	H	L	M	Owner wants to save taxes. Revenue recognition has been inconsistent.
	E	L	L	L	Entity has a good sales system. Tests of internal control a possibility.
	A	L	L	L	Entity has a good sales system.
	V	NA	L	NA	
2 Receivables	C	L	L	L	No significant risks identified.
	E	H	M	M	Salesperson's bonuses are based on recorded sales.
	A	L	L	L	
	V	H	M	M	Recovery of receivables could be an issue in declining industry.

3 Inventory	C	L	L	L	
	E	H	L	M	Inventory theft and poor physical internal control in warehouse.
	A	L	L	L	
	V	H	H	H	New technology will make some parts and even whole products obsolete.

H=High M= Moderate L = Low
As = Assertion NA = not applicable
IR = Inherent risk CR = Internal control risk
Comb. RMM = Combined risks of material misstatement
FSA = Financial statement area

Documentation of the risk assessment process should include:

- Results of engagement team discussions and the significant decisions reached;
- Key elements of the understanding obtained;
- The sources of information from which the understanding was obtained;
- The nature and results of performing risk assessment procedures;
- The identified and assessed risks of material misstatement at the financial statement and assertion level;
- Details of significant risks that require special attention; and
- Risks for which substantive procedures alone will not provide sufficient appropriate audit evidence.

Pervasive Risks
Risks arising from a poor attitude toward internal control, a weak internal control environment, or management's lack of competence will have a more pervasive effect on the financial statements and may require an overall response by the auditor. In some cases, the weaknesses may be so serious that they require a qualification, disclaimer of opinion, or withdrawal from the engagement altogether.

2.12.3 Factors to Consider in Assessing Risks

Some of the risk factors to be considered and documented in the combined risk assessment are outlined in the exhibit below.

Exhibit 2.12-4

1. What Risks have been Identified?	
Financial Statement Level	• Risks resulting from poor entity level internal controls or general IT internal controls. • Significant risks. • Risk factors relating to management override and fraud. • Risks that management has chosen to accept, such as a lack of segregation of duties in a smaller entity.
Assertion Level	• Specific risks relating to the completeness, accuracy, existence or valuation of: – Revenues, expenditures, and other transactions; – Account balances; and – Financial statement disclosures. • Risks that may give rise to multiple misstatements.

Related Internal Control Procedures	• Significant risks. • The appropriately designed and implemented internal control procedures that help to prevent, detect or mitigate the risks identified. • Risks that can only be addressed by performing tests of controls.
2. What Magnitude Of Misstatement (Monetary Impact) Could Possibly Occur?	
Financial Statement Level	• What events, if they occurred, would result in a material misstatement in the financial statements? Consider management override, fraud, unexpected events, and past experience.
Assertion level	Consider: • The inherent nature of the transactions, account balance or disclosure; • Routine and non-routine events; and • Past experience.
3. How Likely is the Event (Risk) to Occur?	
Financial Statement Level	Consider: • "Tone at the top"; • Management's approach to risk management; • Policies and procedures in place; and • Past experience.
Assertion level	Consider: • Relevant internal control activities; and • Past experience.
Related Internal Control Procedures	Identify the elements of management's risk response that are crucial in reducing the likelihood of an event from occurring

Assumptions

Some risk assessments will be based on an expectation that internal control is operating effectively to prevent, or detect and correct, a material misstatement at the assertion level. These assumptions are important considerations in designing tests of the operating effectiveness of internal control and other substantive procedures required.

Internal Control Weaknesses

Examples of significant weaknesses in internal control include:

- Weak control environment (entity level) controls, such as ineffective oversight, poor attitude toward internal control, or instances found of management override or fraud.
- Weaknesses in IT general controls.
- Significant business risks that have not been addressed by policies, procedures or internal controls.
- Inadequate policies and procedures in place for:
  - Appropriately assessing and applying accounting principles;

  - Determining accounting estimates and assessing their reasonableness;
  - Preparing the financial statements and the disclosures required; and
  - Safeguarding assets.

- Significant internal control activities or application controls not operating as designed, not applied consistently by appropriate individuals, or not monitored by appropriate individuals.
- Significant deficiencies previously communicated to management or those charged with governance that remain uncorrected after some reasonable period of time.

2.12.4 Communicating Internal Control Weaknesses

ISA 315 states:

> **120. The auditor should make those charged with governance or management aware, as soon as practicable, and at an appropriate level of responsibility, of material weaknesses in the design or implementation of internal control which have come to the auditor's attention.**

As soon as practicable, the auditor should communicate significant weaknesses in internal control to management or those charged with governance. It is also helpful to discuss the implications, or the "so what", of each weakness. It is then the responsibility of management to respond by implementing the necessary internal control procedures on a timely basis or explaining why such action is not necessary. Failure to respond appropriately may indicate a poor attitude toward internal control, which may have implications for the auditor's risk assessment.

The responsibility to communicate significant weaknesses applies equally to the audit of owner-managed and smaller entities. It is only by communicating such significant weaknesses that the auditor can be certain that management has been informed of the problem. It is management's decision – not the auditor's – to determine whether the cost of addressing a weakness outweighs the benefit obtained.

Consider Point

The reporting of internal control weaknesses must be documented. The most common form is in a letter. However, depending on the circumstances, a file note containing minutes of a meeting with the client (to discuss the internal control weaknesses) is acceptable.

2.12.5 Revision of Risk Assessment

Risk assessment does not end at a point in time. New information may be gained as the audit progresses and the performance of audit procedures may identify additional risks or that internal control is not operating as intended. When this occurs, the original risk assessment should be revised and the impact on the nature and extent of further audit procedures considered.

Case Study — Assessing the Risks of Material Misstatement

For details of the case study, refer to the Introduction to the Case Study in this Guide.

The final step in the risk assessment process is to assess the combined risks of material misstatement at the financial statement and assertion levels.

This assessment can be summarized using a form such as the one illustrated below.

Assessed Levels of Risk

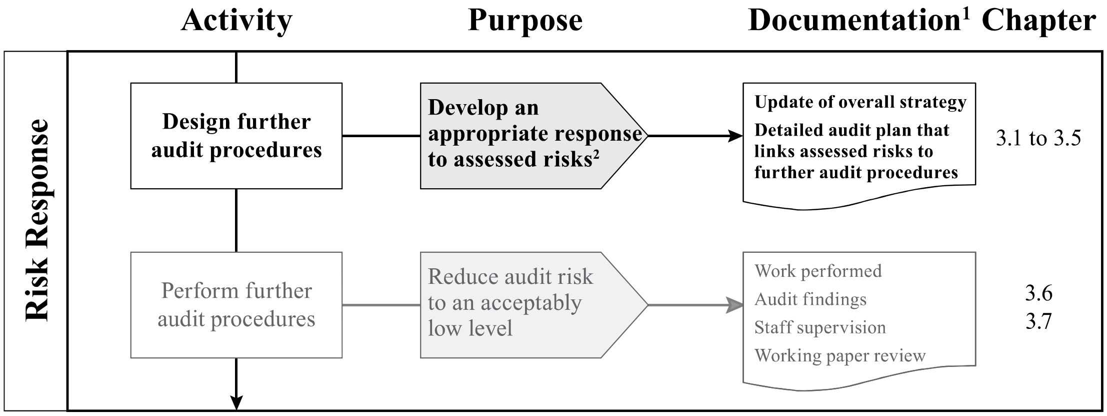
	As	IR	CR	Comb. RMM	Document the key risks and other contributing factors to risk assessment
Financial statement level				L	*Management's attitude to internal control is good and competent people fill the key positions.* *The monthly meeting to review performance provides some accountability to management.* *Management's attitude to internal control is good and competent people fill the key positions.*
Assertion Level FSA or financial statement disclosure					
1 Sales	C	H	L	M	*Revenue recognition policies are inconsistent.*
	E	L	L	L	*Sales system operates well. Tests of controls possible.*
	A	L	L	L	*Sales system operates well. Tests of controls possible.*
	V	NA	L	NA	
2 Receivables	C	L	L	L	*No significant risks identified.*
	E	H	M	M	*Salespersons' bonuses are based on recorded sales.*
	A	L	L	L	
	V	H	M	M	*Large retailer receivables collection could be an issue if there is concern over product quality or returns made.*

H=High M= Moderate L = Low
As = Assertion NA = not applicable
IR = Inherent risk CR = Internal control risk
Comb. RMM = Combined risks of material misstatement
FSA = Financial statement area

Part C
Risk Response

3.1 Detailed Audit Plan

Exhibit 3.1-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.

Chapter Purpose	Primary ISA Reference
To respond to the identified risks of material misstatement by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.	**300**

3.1.1 Overview

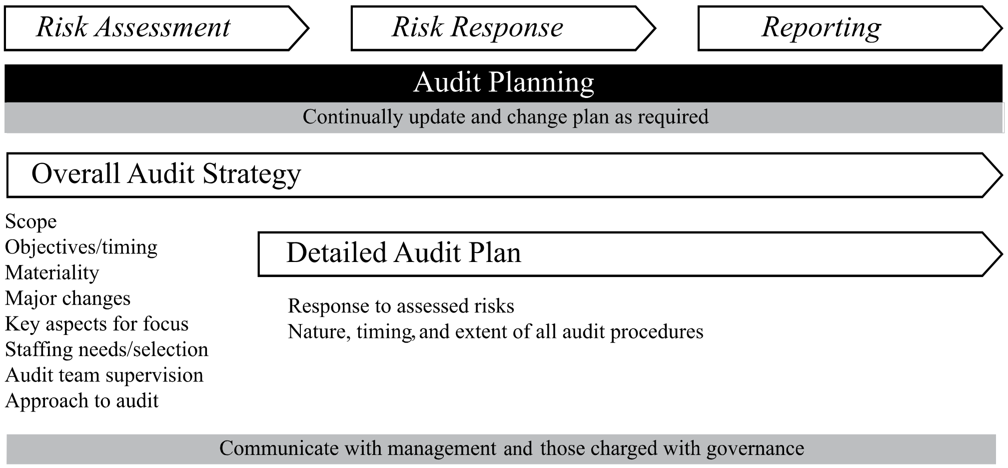
ISA 300 states:

> **13. The auditor should develop an audit plan for the audit in order to reduce audit risk to an acceptably low level.**
>
> **16. The overall audit strategy and the audit plan should be updated and changed as necessary during the course of the audit.**
>
> **22. The auditor should document the overall audit strategy and the audit plan, including any significant changes made during the audit engagement.**

The overall audit strategy (discussed in Chapter 2.2 of this Guide) sets out the scope, timing, and direction of the audit and guides the development of the more detailed audit plan, which is discussed in this chapter. The more detailed audit plan addresses the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

Although the overall audit strategy will be established before developing the detailed audit plan, the two planning activities are not necessarily discrete or sequential processes. They are closely interrelated since changes in one may result in consequential changes to the other. This is illustrated in the exhibit below.

Exhibit 3.1-2



The objective of the detailed audit plan is to respond appropriately to the identified and assessed risks, thereby reducing audit risk to an acceptably low level.

The detailed plan:

- Provides a clear linkage between the assessed risks and the further audit procedures; and
- Outlines the nature, timing, and extent of such further audit procedures (tests of controls and substantive procedures).

Consider Point

The detailed plan should link the design of further audit procedures to the assessed risks addressed during the risk assessment phase of the audit. This "linkage" is quite different from some traditional audit approaches where standard audit programs were completed with few, if any, changes made to reflect the specific risks present within the entity.

3.1.2 Responding to Assessed Risks

The nature, timing and extent of further audit procedures should:

- Respond to the assessed risks (identified during the risk assessment process);
- Reduce audit risk to an acceptable level; and
- Respond to assessed risks of material misstatements for each material class of transactions, account balance, and disclosure.

The basic information and considerations needed to design further audit procedures include:

- Nature of assessed risks;
- Use of tests of controls;
- Need for unpredictability; and
- Other basic or required audit procedures.

These are discussed as follows.

Nature of Assessed Risks
Audit attention should be directed in responding to those risks that have the highest potential for material misstatement. Considerations include:

- **How significant is the assessed risk?**
  What would be the impact if it occurred? This would relate to materiality.
- **How likely is the assessed risk to occur?**
  What is the likelihood or probability of the risk actually occurring?
- **What is combined assessment of impact and likelihood?**
- **What assertions are effected?**
  Consider the impact of the risk on each of the assertions (completeness, existence, accuracy, and valuation) relevant to the account balance, class of transactions, or disclosure.
- **Is it a "significant risk"?**
  Significant risks require separate attention and response by the auditor. Planned audit procedures should directly address these risks.
- **What is management's response?**
  Consider the nature of the internal control system in place and its possible effectiveness in mitigating the risks involved. Are the controls:
  - Routine in nature (occur daily) or periodic such as monthly?
  - Designed to prevent or detect and correct errors?
  - Manual or automated?
- **Are there any unique characteristics?**
  Consider the existence of any particular characteristics (inherent risks) in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures. Examples could include high value inventory, complex contractual agreements, absence of a paper trail on certain transaction streams or a large percentage of sales coming from a single customer.

Use of Tests of Controls
The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In the case of very small entities, there may not be many control activities that could be tested. In this case, the further audit procedures are likely to be primarily substantive.

There are two matters to consider when determining whether the response to assessed risks should include testing the operating effectiveness of internal control.

- **Is it efficient to test internal control?**
  Where internal control exists and is expected to operate effectively, consider:
  - Whether testing controls would achieve an effective response to the assessed risk of material misstatement for a particular assertion; and

  – What substantive testing could be reduced by performing tests of controls.

  Even in a very small entity, there are often well-designed and effective controls over revenues that, if tested, could reduce the extent of substantive procedures required.

  If testing the operating effectiveness of internal control would not be effective or efficient, it will then be necessary to perform substantive procedures that respond to assessed risks for specific assertions. No credit can be taken for the effective operation of controls that have not been tested.

- **Are there assertions that can only be effectively addressed by tests of controls?**
  In some cases, suitable substantive procedures (to obtain evidence for a particular assertion) may not be available, so tests of controls will be necessary. An example of this would be highly automated systems with little or no paper trail available. If such internal control is not considered reliable (controls are not likely to operate effectively) or is absent, the auditor will have to determine whether it is possible at all to obtain sufficient appropriate audit evidence.

Need for Unpredictability
Based on the nature of the assessed risks, consider whether some of the planned procedures should be unannounced, changed from prior years, or performed at unpredictable times.

Other Basic or Required Audit Procedures
A number of specific further audit procedures may be required (regardless of the assessed risks) to comply with the ISAs and local requirements. Examples might include attending the inventory count, external confirmations, and subsequent events.

3.1.3 Design of Audit Procedures

The auditor can respond to assessed risks through the design of further audit procedures. These procedures usually involve elements such as inspection, observation, inquiry, confirmation, recalculation, re-performance, or analytical procedures. There are three major categories:

- Risk assessment procedures (refer to Chapter 2.5);
- Tests of the operating effectiveness of internal control (refer to Chapter 3.2); and
- Substantive procedures. This includes tests of detail and substantive analytical procedures (refer to Chapter 3.3).

An appropriate response to assessed risks may contain a combination of procedures such as tests of controls and substantive procedures.

The following exhibit outlines some of the considerations in developing the appropriate response.

Exhibit 3.1-3

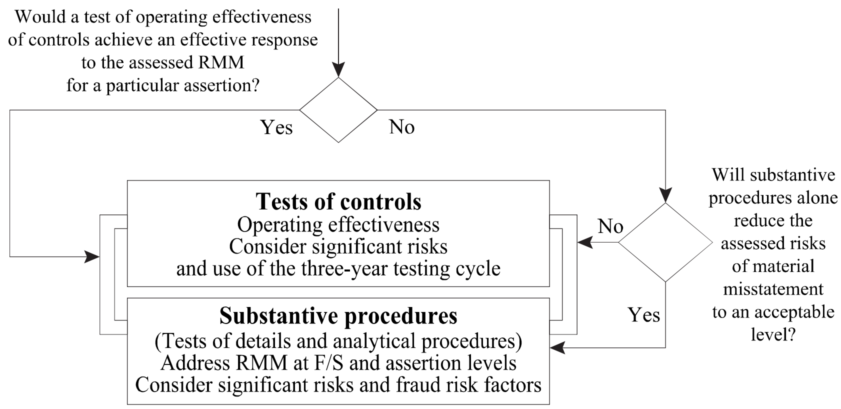


Exhibit 3.1-4

Factors to Consider in Designing the Nature of Procedures	
Nature of Assertions	Certain audit procedures may: • Be more appropriate for addressing some assertions than others. Evidence for completeness of sales may best be obtained through a test of controls, whereas evidence to support the valuation of inventory will probably be obtained with substantive procedures; and • Provide more reliable evidence for an assertion. A confirmation of receivables to determine existence may provide better evidence than simply examining invoices or performing some analytical procedures.
Assessed Level of Risk	The higher the risk of misstatement, the more reliable and relevant is the audit evidence required. This may affect both the types and the combination of different types of audit procedures to be performed. For example, to ensure the existence of high value inventory, a physical inspection may be performed in addition to examining the supporting documents.
The Reasons for Risk	The underlying reasons for the risk should be considered in the design of both tests of controls and substantive procedures. This will include the characteristics of the financial statement area (inherent risks) and the internal control in place (control risk). If the assessed risk is low because of good internal control, tests of controls may reduce the need for or extent of substantive procedures.
Source of Information	If non-financial information produced by the entity's information system is used in performing audit procedures, evidence should be obtained about its accuracy and completeness. For example, the number of rental units in a high-rise apartment could be multiplied by the monthly apartment rental to compare with the total revenues recorded.

Factors to Consider in Designing the Nature of Procedures	
Dual Purpose Tests	Where efficient, a test of internal control could be performed concurrently with a test of details on the same transaction. An invoice could be examined for approval (tests of controls) and to substantiate the transaction (tests of detail). If the test of details reveals a misstatement not caught by the internal control system, it might be indicative of a material weakness in internal control. Such weaknesses should be communicated to management and to those charged with governance, and the need for additional audit procedures considered. This will include updating the risk assessment and developing an appropriate audit response.

3.1.4 Timing of Procedures

Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies.

Before or at the Period End?

In most instances (particularly with small entities), audit procedures will be carried out at the period end and later. In addition, the higher the risks of material misstatement, the more likely it would be for substantive procedures to be performed nearer to, or after, the period-end.

In some situations though, there can be some advantages to performing audit procedures before the period end. For example:

- Helping to identify significant matters at an early stage. This provides time for the issues to be addressed and further audit procedures to be performed;
- Balancing the audit firm’s workload by shifting some busy season procedures to a period when there is more time; and
- Performing procedures unannounced or at unpredictable times.

The following exhibit outlines the factors to consider when determining whether to perform procedures at an interim date.

Exhibit 3.1-5

	Factors to Consider
Should Audit Procedures be Performed Before the Period End?	• How good is the overall control environment? Performing a roll forward between an interim date and the period end is unlikely to be effective if the general control environment is poor. • How good are the specific controls over the account balance or class of transactions being considered? • Is the required evidence available to perform the test? Electronic files may subsequently be overwritten or procedures to be observed may occur only at certain times. • Would a procedure before the period end address the nature and substance of the risk involved? • Would the interim procedure address the period or date to which the audit evidence relates? • How much additional evidence will be required for the remaining period between the date of procedure and period end?

Chapter 3.2 provides further information on the timing of tests of controls.

After Period End
Certain audit procedures can be performed only at, or after, the period-end. This would include cut-off procedures (where there is minimal reliance on internal control), period-end adjustments, and subsequent events.

3.1.5 Extent of Procedures

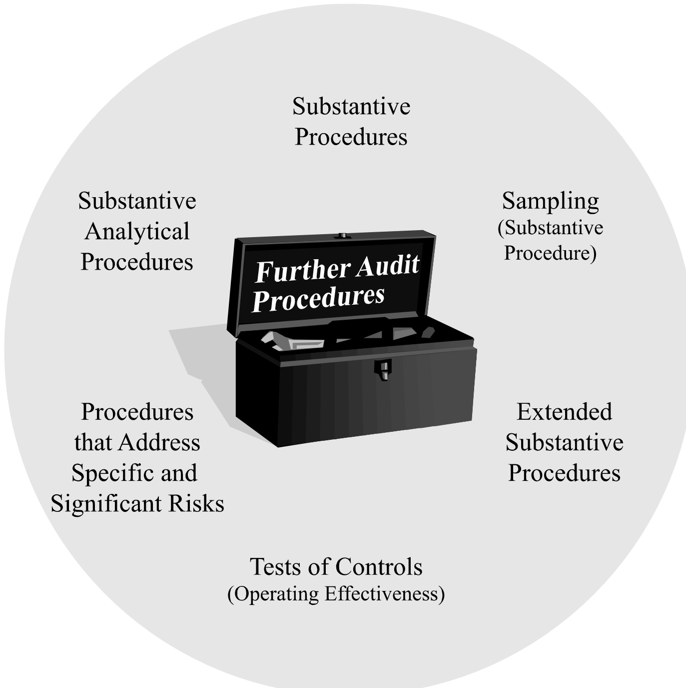
Extent relates to the quantity (sample size) of a specific audit procedure to be performed. The general rule is that as the risks of material misstatement increase, so should the sample size. However, this will only be effective if the procedure is relevant to the assessed risk. Extent of testing is addressed in Chapter 3.5.

The Audit Toolbox
As stated earlier, the objective of the detailed audit plan is to respond appropriately to the assessed risks and thereby reduce the audit risk to an acceptably low level.

The most effective approach would be to consider each assessed risk and then design an appropriate audit response in the form of further audit procedures. What is not appropriate is to use a standard ("one size fits all") audit program that may address each assertion, but has not been tailored in any way to address the assessed risks.

In developing the detailed plan, there are a number of different types of procedures that can be considered. An effective audit program will be based on an appropriate mix of procedures that collectively reduce audit risk to an acceptably low level. For the purposes of this Guide, the different types of audit procedures available to the auditor have been categorized as illustrated in the exhibit below.

Exhibit 3.1-6



Substantive Procedures

These include those procedures that would always be performed regardless of the risks of material misstatement (RMM) identified. Where the RMM is very low, these procedures alone might be sufficient for a specific area or assertion. Where the RMM is high, these basic procedures should be expanded in response to the assessed risks. A typical example would be obtaining a list of the items that make up the period-end balance, comparing this year's balance to that of last year, and performing some cut-off procedures.

Substantive Sampling

Where a basic procedure (such as confirmation of accounts receivable balances selected by a judgmental sample) is not sufficient to reduce audit risk to an acceptable level, additional confirmations may be selected using statistical sampling techniques. Refer to Chapter 3.5 for an illustrative example of sample selection.

Extended Substantive Procedures

These are basic substantive procedures that have been extended or tailored to address an assessed risk such as management override. For example, a basic substantive procedure would include confirming selected accounts receivable balances. Under the basic procedure, the confirmations obtained would be compared to the account balances. An extended procedure designed to address fraud risk would go a step further to include further work such as checking the telephone directory to establish that the company actually exists at the address provided.

Tests of Controls

Based on the understanding of internal control and the walk-through procedures, certain key controls may be identified (controls that address more than one assertion) that are expected to operate effectively. Testing of these controls may be the most effective audit procedure and will reduce the extent of other substantive procedures required.

Procedures that Address Specific and Significant Risks

These audit procedures would respond directly to a specific assessed risk. This would include audit procedures that respond directly to significant risks identified. Refer to Chapter 2.9 for more information on significant risks.

Substantive Analytical Procedures

There are substantive analytical procedures that could be used to predict the total of a transaction stream such as sales. These procedures are addressed in further detail in Chapter 3.3.

3.1.6 Documenting the Audit Plan

When the detailed plan has been determined, the results can be documented in the form of an audit program that outlines the nature and extent of procedures and the assertion(s) being addressed. Space can then be provided to record details about who performed each step and the findings is illustrated below.

A typical audit program (excluding the details of each specific audit step) might look as follows.

Note: This illustration includes all types of procedures, whereas there may be just one or two types of procedures required for a particular account balance or class of transactions.

Exhibit 3.1-7

Receivables – Audit Procedures

	Assertions addressed	Work completed by (intials)	W/P ref.	Comments
BASIC PROCEDURES				
Analytical procedures…	CEA			
Balance listing…	C			
Allowance for doubtful accounts, cut-off, reconciliations etc.…	VAE			
Accounting policies…	A			
SAMPLING (i.e. confirmation of balances, etc.)	E			
TESTS OF CONTROLS ON SALES	A			
SUBSTANTIVE ANALYTICAL PROCEDURES	EC			
EXTENDED SUBSTANTIVE PROCEDURES				
Accounts receivable confirmations – fraud risk…	EA			
SPECIFIC PORCEDURES TO ADDRESS SPECIFIC/ SIGNIFICANT RISKS	EV			
FINANCIAL STATEMENT PRESENTATION AND DISCLOSURE	CEAV			

AUDIT CONCLUSIONS

a) These procedures (including tests of controls, where applicable) have been tailored (as necessary) to respond to the assessed risks of material misstatement at the financial statement and assertion level.
b) The risks of material misstatement in the accounts receivable balance have been reduced to an acceptable level.
c) All relevant assertions have been addressed.

	Date	Initials
Prepared by		
Reviewed by		

3.1.7 Communication of the Plan

An ongoing dialogue with management and those charged with governance can play an important role in the audit planning process. Communicating various aspects of the overall audit strategy may also be helpful to those charged with governance in understanding the role of the auditor and for discharging their responsibilities. Chapter 4.2 provides guidance on communication with those charged with governance.

Case Study — Detailed Audit Plan

For details of the case study, refer to the Introduction to the Case Study in this Guide.

The following outlines the considerations and possible audit procedures that could be used in developing a detailed audit plan for accounts receivable at Dephta Furniture.

The questions to ask in developing the receivables audit plan are as follows.

Planning Considerations	Response
1. Are there assertions that cannot be addressed by substantive tests alone?	*Not at this time. However if the Internet sales are further automated, there may be a loss of paper trail.*
2. Is internal control over related transaction streams/processes expected to be reliable? If so, could the controls be tested to reduce need/scope for other substantive procedures?	*We should design tests of controls to provide a "moderate" level of assurance for existence and completeness of sales. This will reduce the level of assurance required from other substantive procedures.*
3. Are there substantive analytical procedures available that would reduce the need/scope for other audit procedures?	*No.*
4. Is there a need to incorporate an element of unpredictability or further audit procedures (such as to address fraud, risk, and so forth)?	*Should be considered in responding to the fraud risks identified.*
5. Are there significant risks that require special attention?	*Not in relation to receivables (excluding additional work performed on related-party transactions).*

An appropriate mix of the following types of procedures could be used to reduce the risks of material misstatement (RMM) on assertions relevant to the receivable balance to an acceptable level.

Basic Substantive Procedures
These are the procedures that the auditor would always be expected to perform regardless of assessed risks, such as obtaining a list of the items that make up a balance, comparing the balance this year to that of last year, and performing cut-off procedures.

Tests of Controls
Based on our walkthrough for the revenue process, certain key controls were identified that if tested would reduce the extent of receivable sampling required.

Substantive Sampling
A statistical selection of receivable balances will be used for confirmation. This will test the existence and accuracy of the accounts receivable. In this example, we have reduced the need for substantive sampling based on the planned tests of operating effectiveness of internal control. Refer to Chapter 3.5 for an illustrative example of a sample selection.

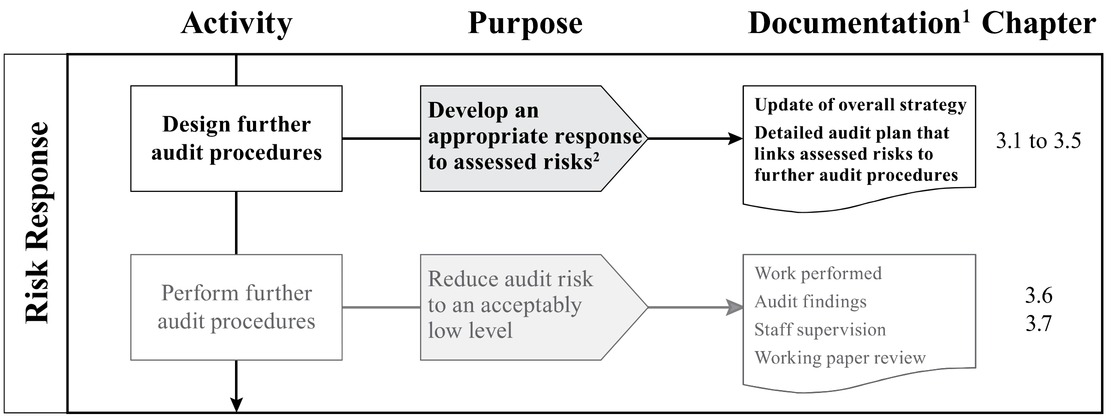
Substantive Analytical Procedures
There are no substantive analytical procedures that could be used to predict the level of sales in this situation.

Extended Substantive Procedures
Several fraud risks have been identified. Refer to the case study notes in Chapter 2.7. Extended procedures should be used over existence and accuracy.

A sample audit program that responds to the risks identified is outlined in the case study notes for Chapter 3.5.

3.2 Tests of Controls

Exhibit 3.2-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.

Chapter Purpose	Primary ISA References
To provide guidance on the use and design of audit procedures to obtain evidence about the operating effectiveness of internal control.	**315, 330**

3.2.1 Overview

ISA 315 states:

> **115. As part of the risk assessment as described in paragraph 100, the auditor should evaluate the design and determine the implementation of the entity's controls, including relevant control activities, over those risks for which, in the auditor's judgment, it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures.**

ISA 330 states:

> **23. When the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit.**

25. When, in accordance with paragraph 115 of ISA 315, the auditor has determined that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, the auditor should perform tests of relevant controls to obtain audit evidence about their operating effectiveness.

29. The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls.

37. When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor should determine what additional audit evidence should be obtained for the remaining period.

44. When, in accordance with paragraph 108 of ISA 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk and the auditor plans to rely on the operating effectiveness of controls intended to mitigate that significant risk, the auditor should obtain the audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period.

Tests of controls are considered when:

- The risk assessment is based on an expectation that internal control operates effectively; or
- Substantive procedures alone will not provide sufficient appropriate audit evidence at the assertion level. This might apply where sales are made over the Internet and no documentation of transactions is produced or maintained, other than through the IT system.

Selecting sample sizes is addressed in Chapter 3.5 on extent of testing.

Purpose

Tests of controls are tests performed to obtain audit evidence about the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. The controls selected for testing should be those that provide evidence for a relevant assertion.

Tests of controls should be designed to obtain audit evidence about:

- How internal controls were applied at relevant times during the period under audit. If substantially different controls were used at different times during the period, each control system should be considered separately;
- The consistency with which internal controls were applied; and
- By whom or by what means controls were applied.

Consider Point

Tests of controls have to be performed where:

- The control or procedure is expected to operate effectively; or
- Substantive procedures alone will not reduce the risks of material misstatement at the assertion level to an acceptably low level.

Due to the control environment encountered in many SMEs, it will often be more effective for the auditor to perform substantive procedures which are supported by tests of controls where necessary.

3.2.2 Designing Tests of Controls

Exhibit 3.2-2

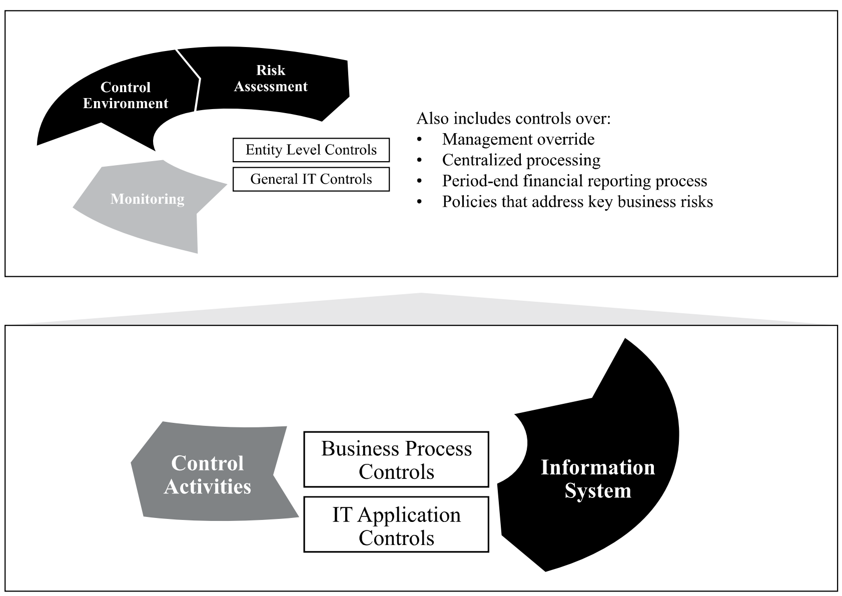
Tests of Internal Control Over Operating Effectiveness	
Types of Procedures	Inquiries of appropriate personnel
	Inspection of relevant documentation
	Observation of the company's operations
	Re-performance of the application of the control

Inquiry alone is not sufficient evidence to support a conclusion about the effectiveness of a control. A combination of the above audit procedures is required. It is the nature of the control to be tested that influences the type of audit procedure required.

For example, to test the operating effectiveness of internal control over cash receipts, the auditor might observe the procedures for opening the mail and processing cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor would supplement the observation with inquiries of entity personnel and inspection of documentation about the operation of such internal control at other times.

Tests of controls can be applied to the internal control that exists at each level in the entity as illustrated in the chart below.

Exhibit 3.2-3



Tests of controls at the entity level tend to be more subjective (such as the commitment to competence). They can also be more difficult to document than internal control at the business process level (such as checking to see if a payment was authorized), which can be documented with a simple yes/no response. As a result, the evaluation of entity level and IT general controls is often documented with memorandums to the file and supporting evidence.

For example, to test whether management communicates the need for integrity and ethical values to all personnel, a sample of employees could be selected for interviews. The employees could be asked about communications they have received from management, what relevant policies and procedures exist, and what values they see demonstrated on a day-to-day basis by management. If the common response among the employees is that management has indeed communicated the need for integrity and ethical values, then the test would be a success. Details of each employee interview and supporting documentation (such as the entity's policies or communications) would then be recorded in a memo to file with the conclusions reached.

Note: Consider whether the employees have been told to give certain answers. This could even be asked as a direct question during the interview.

Consider Point

It is preferable to test the entity level controls early on in the audit process. This is because the results of testing these controls could impact the nature and extent of other planned audit procedures. For example, if it is found that management's attitude toward controls is not as good as expected, further procedures will be required in relation to account balances and classes of transactions.

Although most entity level and IT general controls will be tested through the exercise of professional judgment, objectively applied to the circumstances, there are some situations where the application of a statistically-based formula may be applicable. The appendices of ISA 530 provide further guidance on factors influencing the sample sizes for tests of controls.

There are a number of factors to consider when designing tests of controls. As a general rule, it is not worth testing controls that are unreliable. These are controls where there is no likelihood that exceptions may be found. This is because the sample sizes commonly used for testing controls are based on no exceptions being found. Otherwise the sample sizes required would be much larger.

Some of the factors to consider in assessing the reliability of controls are outlined in the exhibit below.

Exhibit 3.2-4

Test Design	
Factors to Consider	• Is it possible for the established procedures to have been circumvented by management (that is, management override)? • Is there a significant manual element involved in the control that could be prone to error? • Does the small number of staff involved in the control operation make meaningful segregation of duties impractical? • Is there a weak control environment? • Are general IT controls poor? • Is the ongoing monitoring of internal control poor? • Have personnel changes occurred during the period that significantly affect the application of the control? • Have changing circumstances necessitated the need for changes in the operation of the control?

If any of the above factors are significant, it may be more effective to perform substantive procedures.

Consider Point

Determine what constitutes a control deviation. When designing tests of controls, spend time to define exactly what constitutes an error or exception to the test. This will save time spent by audit staff in determining whether a seemingly minor exception (such as an incorrect phone number) is, in fact, a control deviation.

Indirect Internal Controls

Consider the need to obtain audit evidence supporting the effective operation of significant indirect internal control, that is, those controls on which other controls depend. This could include non-financial information produced by a separate process, the treatment of exceptions, and periodic reviews of reports by managers. Where significant, obtain evidence of the operating effectiveness of the indirect internal control.

Automated Controls

There may be some instances where control activities are performed by a computer and supporting documentation does not exist. In these situations, the auditor may have to re-perform some controls to ensure the software application controls are working as designed. Another approach is to use what is called Computer Assisted Audit Techniques or CAATs. One example of this application is a software package that can import an entity's data file (such as sales or payables), which can then be tested. Such programs can often provide the audit evidence needed. In addition, they provide the potential to perform much more extensive testing of electronic transactions and account files.

Some possible uses of CAATs are outlined in the exhibit below.

Exhibit 3.2-5

Use of CAATs	
Typical Types of Procedures	• Select sample transactions from electronic files. • Sort transactions with specific characteristics. • Select nature of statistical samples/parameters or criteria. • Extract records based on specified criteria. • Test an entire population instead of a sample. • Find gaps and duplicates (numeric, text, and date). • Add files and check extensions such as pricing. • Stratify, summarize, and age information. • Match data across files.

3.2.3 Timing of Tests of Controls

Tests of controls may provide evidence of effective operation:

- At a particular point in time (that is, physical inventory count); or
- Over a period of time such as the period under audit.

When the tests of controls take place before the period end, the auditor should consider what additional evidence may be required to cover the remaining period. This evidence may be obtained by extending the tests to cover the remaining period or testing the entity's monitoring of internal control.

Exhibit 3.2-6

Gap Between the Tests of Controls and Period End	
Factors to Consider	• Significance of assessed risks of material misstatement at the assertion level. • Specific controls that were tested during the interim period. • Degree to which audit evidence about the operating effectiveness of those controls was obtained. • Length of the remaining period. • Extent to which the auditor intends to reduce further substantive procedures based on the reliance on internal control. • The control environment. • Any significant changes in internal control, including changes in the information system, processes, and personnel that occurred subsequent to the interim period.

Consider Point

Where efficient, consider performing tests on the operating effectiveness of internal control at the same time as evaluating the design and implementation of controls.

3.2.4 Rotational Control Testing

ISA 330 states:

> **39. If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit. The auditor should obtain audit evidence about whether such changes have occurred by performing inquiry in combination with observation or inspection to confirm the understanding of those specific controls.**
>
> **40. If the auditor plans to rely on controls that have changed since they were last tested, the auditor should test the operating effectiveness of such controls in the current audit.**
>
> **41. If the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of such controls at least once in every third audit.**
>
> **43. When there are a number of controls for which the auditor determines that it is appropriate to use audit evidence obtained in prior audits, the auditor should test the operating effectiveness of some controls each audit.**

Assuming internal control has not changed since the controls were last tested, the tests of operating effectiveness may only need to be performed (with certain exceptions such as outlined below) once every third audit. The actual period of reliance would be based on professional judgment but cannot exceed two years.

When there are a number of controls where evidence could be used from prior audits, the reliance should be staggered so that some testing of internal control is performed during each audit. Testing at least a few controls each year also provides collateral evidence about the continuing effectiveness of the control environment.

Before audit evidence obtained in prior audits can be used, the continuing relevance of such evidence needs to be established each year. This will include confirming the understanding of those specific controls through:

- Inquiry of management and others; and
- Observation or inspection (walkthroughs) of the internal control.

Reliance on evidence obtained in previous audits would not normally be applicable in the following situations outlined in the exhibit below.

Exhibit 3.2-7

Situations Where Rotational Testing is NOT Permitted	
Factors to Consider	• Reliance is required to mitigate a "significant risk". • Internal control has changed. • A weak control environment exists. • The ongoing monitoring of internal control is poor. • There is a significant manual element to the operation of relevant controls. • Personnel changes have occurred that significantly affect the application of the control. • Changing circumstances indicate the need for changes in the operation of the control. • There are weak or ineffective general IT controls.

In general, the higher the risks of material misstatement or the greater the reliance placed on internal control, the shorter the time period should be between tests of controls.

3.2.5 Documentation

The details of the proposed tests of controls could be documented as illustrated below.

Exhibit 3.2-8

Tests of Controls

Ref #	Control to be tested	Assertion Addressed	Testing Procedure (Describe nature of test)	Results: Control Exists	Control Operates Effectively	Reliance on Prior Period TOC	W/P Ref

An example of documentation for entity level controls is illustrated below.

Exhibit 3.2-9

Tests of Controls – Entity Level

Control Attribute	Nature of evidence obtained (inquiries, observations, inspections, etc.)	Conclusion N, S, Y [1]	W/P Ref
Control Environment			
• Management communicates the need for integrity and ethical values to all personnel.			
• Employees believe that the entity is ethical and that management acts with integrity.			
• Procedures exist to minimize the potential for management override such as: – Unsupported entries in the accounting records; and – Internal control overrides.			

The design and sample selection information could be documented in a format such as the one illustrated below.

Exhibit 3.2-10

Tests of Controls Design Account balance/class of transactions ___________________________
Describe test objective, assertions being addressed, and choice of population to be tested:
Description of test: • Did the walk-through procedure confirm the controls exist and appear reliable? Yes/No? ___ If no, explain: • Will controls for the entire period under review be tested? Yes/No? ___ If no, explain: • Will reliance be placed on tests of controls performed in the last two years? Yes/No? ___ If yes, have the steps been taken to ensure no changes have taken place? Yes/No? ___ W/P #______ Comments:

[1] N = No (does not happen) S = Some (some elements of control attribute in place) Y = Yes (control attribute operates effectively).

Describe exactly what would constitute a control deviation(s) for this test:
Sample selection: • Will statistical or judgmental sampling be used? ________________________ (Judgmental testing would apply to testing entity level and general IT controls) Indicate how sample will be selected (manual or using CAATs?): ___________ Total population: _____________ (population/sample size) Sampling interval: _____________ Sample starting point: _________________ **Test results:** (Refer to details of test on W/P #__) Number of control deviations found: _____ • Was sample size extended to allow for isolated deviations? Yes/No ____ If yes, explain:
Describe control deficiencies (if any) that should be addressed: • Has the impact of control deficiencies on risk assessment, planning and further procedures to be performed been determined? Yes/No ___ • Have these control deficiencies been communicated to management? Yes/No ___ • If yes, describe management's response:

Case Study — Tests of Controls

For details of the case study, refer to the Introduction to the Case Study in this Guide.

The following outlines some of the possible documentation for a planned test of the operating effectiveness of controls over the existence of sales.

Dephta Furniture
A planned test of operating effectiveness of internal control will be performed to obtain assurance for the existence and accuracy in this transaction stream.

Tests of Controls Design
Account balance/class of transactions *Revenues, Receivables, Receipts*

Describe test objective, assertion being addressed, and choice of population to be tested:
To test accuracy of revenue by selecting a sample of transactions selected from sales invoices.

Description of test:

- Did the walk-through procedure confirm the controls exist and appear reliable? Yes/No? *Yes*
  If no, explain:
- Will controls for the entire period under review be tested? Yes/No *Yes*
  If no, explain:
- Will reliance be placed on tests of controls performed in the last two years? Yes/No *No*
  If yes, have the steps been taken to ensure no changes have taken place?
  W/P Ref #______

Comments:

Describe exactly what would constitute a control deviation(s) for this test:
Absence of Arjan's or Surja's signature on the contract for contract sales.

1. *For sales over 500, the sales order is not approved by Arjan.*
2. *...*

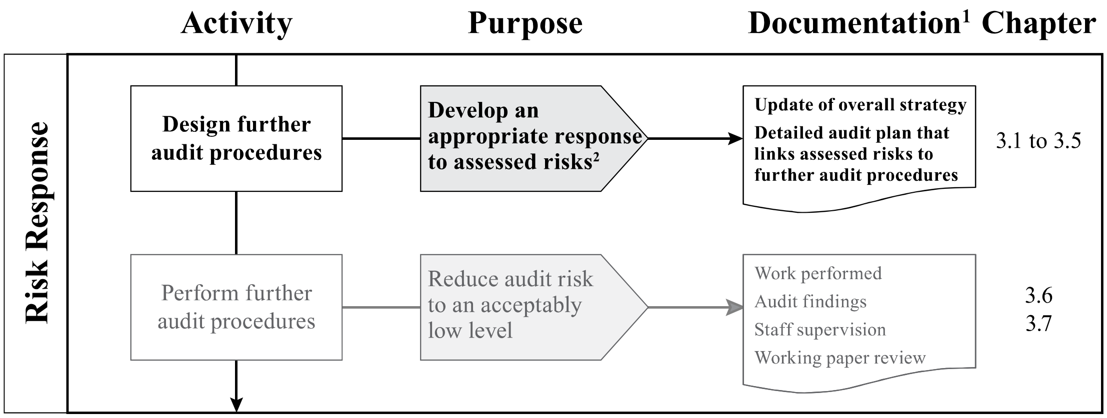
Sample selection:

- Will statistical or judgmental sampling be used? *judgmental*
  (Judgmental testing would apply to testing entity level and general IT controls)

Indicate how sample will be selected (manual or using CAATs?): *manual*
Total population: *1,500 invoices* (population/sample size)
Sampling interval: *not applicable*
Sample starting point: *judgmental*

3.3 Substantive Procedures

Exhibit 3.3-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.

Chapter Purpose	Primary ISA References
To provide guidance on performing substantive procedures (tests of details) that are designed to detect material misstatements at the financial statement and assertion levels.	**330, 500 520, 540**

3.3.1 Overview

ISA 330 states:

49. Irrespective of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

50. The auditor's substantive procedures should include the following audit procedures related to the financial statement closing process:

- **Agreeing the financial statements to the underlying accounting records; and**
- **Examining material journal entries and other adjustments made during the course of preparing the financial statements.**

51. When, in accordance with paragraph 108 of ISA 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk.

56. When substantive procedures are performed at an interim date, the auditor should perform further substantive procedures or substantive procedures

combined with tests of controls to cover the remaining period that provide a reasonable basis for extending the audit conclusions from the interim date to the period end.

65. **The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with the applicable financial reporting framework.**

ISA 500 states:

2. **The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.**

11. **When information produced by the entity is used by the auditor to perform audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information.**

ISA 520 states:

13. **The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.**

17. **When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative audit evidence.**

Substantive procedures are used to gather evidence (that is, substantiate) in respect to all material classes of transactions, account balances, and disclosures. They are designed to be responsive to the assessed risks of material misstatement at the assertion level.

There are two types of substantive procedures:

- Tests of details; and
- Substantive analytical procedures.

Tests of Details

These procedures are designed to gather evidence that will substantiate a financial statement amount. They are used to obtain audit evidence regarding certain assertions such as existence, accuracy, and valuation.

Substantive Analytical Procedures

These procedures are designed to substantiate predictable relationships among both financial and non-financial data. They are mostly applicable to large volumes of transactions that tend to be predictable over time.

3.3.2 Designing Substantive Procedures

In some situations where there are not significant risks of material misstatement, performing only substantive analytical procedures may be sufficient to reduce the risks of material misstatement to an acceptably low level. However, the completeness and accuracy of the underlying information used (such as non-financial data) to perform the substantive analytical procedures still needs to be established.

The auditor may determine that only tests of details are appropriate, or that a combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

Required Substantive Procedures

There are certain substantive procedures that are required to be performed as follows:

- **For each material class of transactions, account balance and disclosure**
  This requirement is irrespective of the assessed risks of material misstatement or the effectiveness of the control environment. Refer to paragraph 49 of ISA 330.

- **Specific requirements**
  This would include any procedures necessary to comply with International Standards on Auditing. A summary of some of the procedures required under various ISAs that relate to the audit of small entities is contained in Chapter 3.5. Required procedures include:
  – Observing an inventory count;
  – Confirming some receivable balances;
  – Examining material journal entries and other adjustments made during the course of preparing the financial statements;
  – Performing procedures to address management override; and
  – Agreeing the financial statements to the underlying accounting records.

- **Designing substantive procedures for significant risks**
  For each "significant risk" identified as part of the risk assessment process, procedures should be designed and performed that are specifically responsive to the identified risk and will provide the audit evidence with a high amount of reliability.

Use of Assertions in Selecting Samples

When designing a procedure, the auditor needs to consider carefully the nature of the assertion for which evidence is required. This will determine the type of evidence to be examined, the nature of the procedure, and the population from which to select the sample.

For example, evidence for the existence assertion would be obtained by selecting items that are already contained in a financial statement amount. Selecting receivable balances for confirmation will provide evidence that the receivable balance exists. However, selecting items that are already contained in a financial statement amount would not provide any evidence in respect of the completeness assertion. For completeness, items would be selected from evidence indicating that an item should be included in the relevant financial statement amount. To determine whether the sales are complete (that is, there are no unrecorded sales), the selection of shipping orders and matching them to sales invoices would provide evidence for any omitted sales.

3.3.3 Timing

Performing Substantive Procedures at an Interim Date
When substantive procedures are performed at an interim date, the auditor should perform further substantive procedures or substantive procedures combined with tests of controls to cover the remaining period. This provides a reasonable basis for extending the audit conclusions from the interim date to the period end and reduces the risk that misstatements existing at the period end are not detected. However, if substantive procedures alone would not be sufficient, tests of the relevant controls should also be performed.

Procedures to Address the Period between the Interim Date and Period End
When procedures are performed at an interim date:

- Compare and reconcile information at the period end with comparable information at the interim date;
- Identify amounts that appear unusual. These amounts should be investigated by performing further substantive analytical procedures or tests of details for the intervening period;
- When substantive analytical procedures are planned, consider whether the period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance and composition; and
- Consider the entity's procedures for analyzing and adjusting the classes of transactions or account balances at interim dates and for establishing proper accounting cut-offs.

The substantive procedures related to the remaining period depend on whether the auditor has performed tests of controls.

Use of Substantive Procedures Performed in Prior Periods
The use of audit evidence obtained from substantive procedures performed in prior periods may be useful in audit planning but provides little or no audit evidence for the current period. Its use in the current period is therefore inappropriate.

3.3.4 Responding to the Risk of Fraud

Chapter 2.8 outlines some of the fraud risks that exist at the entity level (such as management override) and at the assertion level (such as determining the existence of a particular inventory balance).

When designing substantive audit procedures to respond to the risk of fraud, there are three areas to consider:

- Overall responses relating to the financial statements in general;
- Specific responses relating to risks at the assertion level; and
- Risks relating to management override.

Some specific considerations for each of these areas are outlined in the exhibit below.

Exhibit 3.3-2

Overall Responses Relating to the Financial Statement in General	
Pervasive Risks Exist at the Financial Statement Level	• Consider the need for heightened professional skepticism when examining certain documentation or corroborating significant management representations. • Consider the need to use people with specialized skills/knowledge, such as information technology (IT). • Introduce an element of unpredictability in the selection of audit procedures. For example, perform procedures on selected account balances and assertions not otherwise tested, adjust the timing of audit procedures, use different sampling methods, or perform procedures on an unannounced basis.
Specific Responses Relating to Risks at the Assertion Level	
Specific Risks Exist at the Assertion Level	• Change the nature, timing, and extent of the auditing procedures to address the risk. Examples include the following: – Obtain more reliable and relevant audit evidence or additional corroborative information to support management assertions. – Perform a physical observation or inspection of certain assets. – Observe inventory counts on an unannounced basis. – Perform further review of inventory records to identify unusual items, unexpected amounts and other items for follow-up procedures. – Perform further work to evaluate the reasonableness of management estimates and the underlying judgments and assumptions. – Increase sample sizes or perform analytical procedures at a more detailed level. • Use computer-assisted audit techniques (CAATs). – Gather more evidence about data contained in significant accounts or electronic transaction files; – Perform more extensive testing of electronic transactions and account files; – Select sample transactions from key electronic files; – Sort transactions with specific characteristics, and – Test an entire population instead of a sample. • Request additional information in external confirmations. For example, on a receivables confirmation, the auditor could ask for confirmation on the details of sales agreements, including date, any rights of return and delivery terms. • Change the timing of substantive procedures from an interim date to near the period end. If a risk of intentional misstatement or manipulation exists, audit procedures to extend audit conclusions from an interim date to the period end would not be effective.

Risks Related to Management Override	
Journal Entries	• Identify, select, and test journal entries and other adjustments based on the following: – An understanding of the entity's financial reporting process and design/implementation of internal control. – Consideration of the: ◦ Characteristics of fraudulent journal entries or other adjustments; ◦ Presence of fraud risk factors that relate to specific classes of journal entries and other adjustments; and ◦ Inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity.
Estimates	• Review estimates relating to specific transactions and balances to identify possible biases on the part of management. Further procedures could include the following: – Reconsidering the estimates taken as a whole; – Performing a retrospective review of management's judgments and assumptions related to significant accounting estimates made in the prior year; and – Determining whether the cumulative effect of the bias amounts to a material misstatement in the financial statements.
Significant Transactions	• Obtain an understanding of the business rationale for significant transactions that are unusual or outside the normal course of business. This includes an assessment as to whether: – Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction; – The arrangements surrounding such transactions appear overly complex; – Management has discussed the nature of and accounting for such transactions with those charged with governance; – The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit; – Transactions that involve non-consolidated related parties, including special purpose entities, have been properly reviewed and approved by those charged with governance; and – There is adequate documentation.

Risks Related to Management Override	
Revenue Recognition	• Perform substantive analytical procedures. Consider computer-assisted audit techniques to identify unusual or unexpected revenue relationships or transactions. • Confirm with customers relevant contract terms (acceptance criteria, delivery, and payment terms) and the absence of side agreements (right to return the product, guaranteed resale amounts, and so forth).

3.3.5 Accounting Estimates

ISA 540 states:

> **2. The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates.**
>
> **8. The auditor should design and perform further audit procedures to obtain sufficient appropriate audit evidence as to whether the entity's accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed.**
>
> **10. The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:**
>
> **(a) Review and test the process used by management to develop the estimate;**
>
> **(b) Use an independent estimate for comparison with that prepared by management; or**
>
> **(c) Review of subsequent events which provide audit evidence of the reasonableness of the estimate made.**

Accounting estimates range from simple ones (such as an accrual for rent) to complex ones (such as a provision for slow-moving or surplus inventory which may involve considerable analyses of current data and a forecast of future sales).

The degree of misstatement in accounting estimates is more difficult to assess than other types of misstatement. This difficulty results from the following:

- The complexity and subjectivity involved in preparing estimates;
- The availability and reliability of data;
- The nature and extent of assumptions required; and
- The degree of uncertainty of future events.

Determining Whether Management's Estimates are Reasonable
To determine whether management's estimates are reasonable within the context of the financial statements as a whole, the following procedures may be performed:

- **Evaluate management's process**
  Review and evaluate the estimation process used by management including the development of the underlying assumptions and the reliability of data used.

- **Establish an independent point estimate or zone of reasonableness**
  Based on available evidence and discussions with management, develop an independent point estimate or zone of reasonableness for comparison with the entity's estimate. The amount by which management's estimate differs from the point estimate or falls outside the zone of reasonableness would be considered to be a misstatement.

- **Consider potential for bias**
  Consider the cumulative effect of bias in the preparation of management's accounting estimates. This could occur where estimates consistently lie at one boundary of the zone of reasonableness or move from one boundary to the other in successive periods.

- **Utilize prior experience and subsequent events**
  Compare similar estimates prepared in previous years to what actually happened and review subsequent events or transactions for the current period to ensure they support management's estimates.

Where the estimate is complex or involves specialized techniques, it may be necessary to use the work of an expert. Refer to ISA 620. Chapter 3.4 of this Guide provides guidance on using the work of an expert.

Where insufficient appropriate evidence is available or the evidence refutes management's estimates, the findings should be discussed with management and the need to change the risk assessment and perform additional audit procedures considered.

3.3.6 Substantive Analytical Procedures

Substantive analytical procedures involve a comparison of amounts or relationships in the financial statements with a precise expectation developed from information obtained from understanding the entity and other audit evidence.

To use an analytical procedure as a substantive procedure, the auditor should design the procedure to reduce the risk of not detecting a material misstatement in the relevant assertion to an acceptably low level. This means that the expectation of what the recorded amount should be is precise enough to indicate the possibility of a material misstatement, either individually or in the aggregate, in other misstatements.

Consider Point

For audit planning purposes, substantive analytical procedures may be grouped into three distinct levels based on the level of assurance obtained. These are described below.

Impact on reducing audit risk	Description
Highly effective (high level of risk reduction)	Procedure is intended to be the primary source of evidence regarding a financial statement assertion. It "effectively" proves the recorded amount.
Moderately effective	Procedure is only intended to corroborate evidence obtained from other procedures. A moderate level of assurance is obtained.
Limited	Basic procedures, such as comparing an amount in the current period to a previous period, are useful but only provide a limited level of assurance.

Techniques

There are a number of techniques that can be used to perform the analytical procedures. The objective is to select the most appropriate technique to provide the intended levels of assurance and precision. These techniques include:

- Ratio analysis;
- Trend analysis;
- Break-even analysis;
- Pattern analysis; and
- Regression analysis.

Each technique has its own particular strengths and weaknesses that need to be considered when designing procedures. A complex technique such as regression analysis may provide statistically reliable conclusions about a recorded amount. However, a simple technique may suffice. For example, multiplying the number of apartments by the approved rental rates (per leases) and adjusting the result for actual vacancies may provide a reliable and precise estimate of the rental revenue for a property rental business.

Exhibit 3.3-3

Designing Substantive Analytical Procedures	
Factors to Consider	• Suitability given the nature of the assertions. • Reliability of the data (internal or external) from which the expectation of recorded amounts or ratios is developed. This will require tests on the accuracy, existence and completeness of the underlying information such as tests of controls or performing other specific audit procedures, possibly including the use of computer assisted audit techniques (CAATs). • Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance. • Amount of any difference in recorded amounts from expected values that would be acceptable.

Establishing Meaningful Relationships Between Information	
Questions to Address	• Are the relationships developed from a stable environment? Reliable and precise expectations may not be possible in a dynamic or unstable environment. • Are the relationships considered at a detailed level? Disaggregation of amounts can provide more reliable and precise expectations than an aggregated level. • Are there offsetting factors or complexity among highly summarized components that could obscure a material misstatement? • Do the relationships involve items subject to management discretion? If so, they may provide less reliable or precise expectations.

The degree of reliability of data used to develop expectations needs to be consistent with the levels of assurance and precision intended to be derived from the analytical procedure. Other substantive procedures may also be required to determine whether the underlying data is sufficiently reliable. Tests of controls may also be considered to address other assertions such as the data's completeness, existence and accuracy. Internal control over non-financial information can often be tested in conjunction with other tests of controls.

Exhibit 3.3-4

Is the Data Sufficiently Reliable for Achieving the Audit Objective?	
Questions to Address	• Is the data obtained from sources within the entity or from independent sources outside the entity? (Independent sources are generally more reliable.) • Is data from sources within the entity developed by persons not directly responsible for its accuracy? (If so, consider further procedures to check on accuracy.) • Was the data developed under a reliable system with adequate internal control? • Is broad industry data comparable for use within the entity? • How relevant is the data? • Was the data subject to audit testing in the current or prior periods? • Were the auditor's expectations regarding recorded amounts developed from a variety of sources?

To avoid unwarranted reliance on a source of data used, the auditor would perform substantive tests of the underlying data to determine whether it is sufficiently reliable or test whether internal control over the data's completeness, existence, and accuracy is operating effectively.

In some cases, non-financial data (for example, quantities and types of items produced) will be used in performing analytical procedures. Accordingly, the auditor needs an appropriate basis for determining whether the non-financial data is sufficiently reliable for the purposes of performing the analytical procedures.

Differences from Expectations

When differences are identified between recorded amounts and the auditor's expectations, the auditor would consider the level of assurance that the procedures are intended to provide and the auditor's materiality level. The amount of the acceptable difference without investigation would, in any event, need to be less than that which the auditor believes could be material.

Procedures used for the investigation could include:

- Reconsidering the methods and factors used in forming the expectation;
- Making inquiries of management regarding the causes of differences from the auditor's expectations and assessing management's responses, taking into account the auditor's knowledge of the business obtained during the course of the audit; and
- Performing other audit procedures to corroborate management's explanations.

As a result of this investigation, the auditor may conclude that:

- Differences between the auditor's expectations and recorded amounts do not represent misstatements; or
- Differences may represent misstatements and that further audit procedures need to be performed to obtain sufficient appropriate audit evidence as to whether a material misstatement exists or does not exist.

Exhibit 3.3-4

Examples of Highly Effective Substantive Analytical Procedures

Financial Statement Amount	Relationship and Procedure
Sales	Selling price applied to volume information about shipments.
Amortization expenses	Amortization rate applied to capital asset balances, allowing for effect of additions and disposals.
Overhead element of inventory	Relating actual overheads to actual direct labour or production volumes.
Payroll expense	Pay rates applied to number of employees.
Commission expense	Commission rate applied to sales.
Payroll accruals	Daily payroll applied to number of days accrued.

Other Analytical Procedures

Analysis can take the form of:

- **Detailed comparisons of current financial statement or financial data with that of prior periods or with current operating budgets**
  An increase in accounts receivable with no corresponding increase in sales could indicate that a problem exists in the accounts receivable collectibility. An increase in the number of employees in a professional organization would lead the auditor to expect an increase in salary expense and a corresponding increase in the professional fee revenue.

- **Comparative data on the various types of products sold or types of customers**
  This could help explain month-to-month or year-to-year sales fluctuations.

- **Ratio analysis**
  Ratios can provide support to the current financial statements (for example, comparable to industry norms or prior years' results) or raise points for discussion. Certain institutions, such as banks and trade associations, produce financial statistics on an industry-wide basis. Such statistics can be useful when compared to those of an entity's operation and inquiries made where differences from industry trends occur.

- **Graphs**
  Finally, consider the use of graphs to portray the results of procedures. Graphs visually highlight significant differences from month-to-month or year-to-year.

3.3.7 Use in Forming an Opinion

Upon substantial completion of the audit, the auditor is required to use analytical procedures to assist in evaluating the overall financial statement presentation.

Purpose

The purpose of using analytical procedures at or near the end of the audit is to determine whether the financial statements as a whole are consistent with the auditor's understanding of the entity.

These procedures would address questions such as:

- **Do the conclusions drawn from such procedures corroborate the conclusions formed during the audit of individual components or elements of the financial statements?**
  Analytical procedures may reveal that certain financial statement items differ from expectations formed by the auditor based on his or her knowledge of the entity's business and other information accumulated during the audit. Such differences would need to be investigated using procedures such as those described above. This investigation may indicate the need for changes in presentation or disclosure in the financial statements.

- **Are there risks of material misstatement that have not been previously recognized?**
  If additional risks are identified, the auditor may need to re-evaluate the planned audit procedures to respond appropriately.

Case Study — Substantive Tests

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Refer to the case study material in Chapter 3.5 that outlines an audit program and addresses the extent of testing required.

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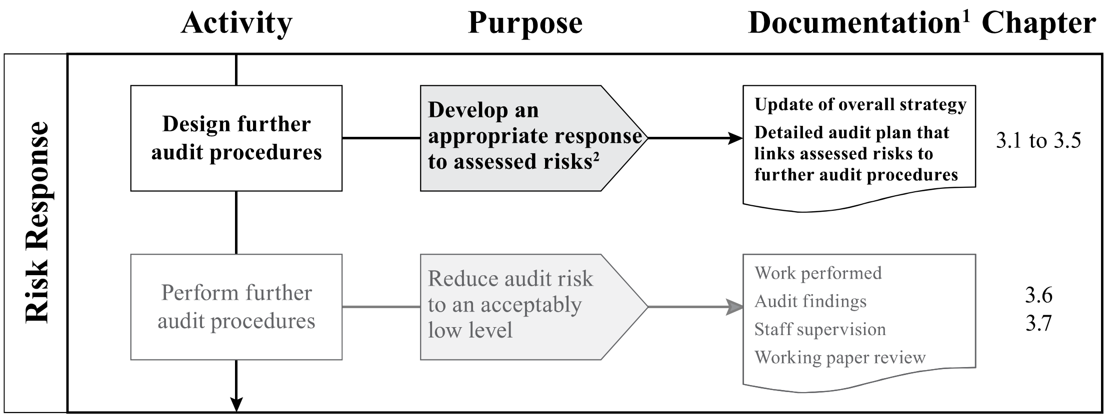
3.4 Summary of ISAs not Addressed Elsewhere

Exhibit 3.4-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.

Chapter Purpose	Primary ISA References
To provide a summary of the audit requirements of specific ISAs that address special areas in the audit.	**250, 402, 501, 505, 510, 545, 550, 560, 570, 600, 620**

3.4.1 Overview

This chapter contains a summary of the audit requirements contained in the ISAs that have not been specifically addressed elsewhere, including:

- ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements
- ISA 402 Audit Considerations Relating to Entities Using Service Organizations
- ISA 501 Audit Evidence — Additional Considerations for Specific Items
- ISA 505 External Confirmations
- ISA 510 Initial Engagements — Opening Balances
- ISA 545 Auditing Fair Value Measurements and Disclosures
- ISA 550 Related Parties
- ISA 560 Subsequent Events
- ISA 570 Going Concern
- ISA 600 Using the Work of Another Auditor
- ISA 620 Using the Work of an Expert

Because of their limited application in the audit of smaller entities, the following ISAs have not been specifically addressed in this Guide:

- ISA 610 Considering the Work of Internal Auditing
- ISA 720 Other Information in Documents Containing Audited Financial Statements

3.4.2 ISA 250 — Consideration of Laws and Regulations in an Audit of Financial Statements

Provides guidance on how non-compliance by the entity with laws and regulations may materially affect the financial statements.

The responsibility for the prevention and detection of non-compliance rests with management. Management actions could include:

- Maintaining a register of significant laws and a record of any complaints;
- Monitoring legal requirements and designing procedures/internal control to meet these requirements;
- Engaging legal advisors to assist in monitoring legal requirements; and
- Developing, publicizing, implementing, and following a code of conduct (in larger entities).

Exhibit 3.4-2

Audit Requirements

- Plan/perform the audit with an attitude of professional skepticism.
  The audit may well reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations.
- Obtain a general understanding of the applicable legal/regulatory framework.
  This would address how the entity is complying with that framework.
- Design/perform further audit procedures.
  These procedures will help identify instances of non-compliance that should be considered when preparing financial statements. Such procedures include:
  - Inquiring of management as to whether the entity is in compliance with such laws and regulations; and
  - Inspecting correspondence with the relevant licensing or regulatory authorities.
- Obtain sufficient appropriate audit evidence about compliance.
  Evidence is required about compliance with the laws and regulations that have an effect on the determination of material amounts and disclosures in the financial statements.

Audit Findings
When instances of possible non-compliance with laws and regulations are suspected:

- Obtain an understanding of the nature of the act and the circumstances.
  This should be sufficient to evaluate the possible effect on the financial statements.
- Document the findings and discuss them with management.
  If non-compliance is believed to be intentional and material, the auditor should communicate the finding without delay. When adequate information about suspected non-compliance and the potential effects on the financial statement cannot be verified, the auditor should consider the effect of the lack of sufficient appropriate audit evidence on the auditor's report.
- Consider the implications of non-compliance in relation to other aspects of the audit.
  In particular, consider the reliability of management representations.
- Report the matter to the next higher level of authority if it involves senior management or those charged with governance.
- Express a qualified or an adverse opinion if non-compliance has a material effect on the financial statements, and has not been properly reflected in the financial statements.

3.4.3 ISA 402 — Audit Considerations Relating to Entities Using Service Organizations

This standard provides guidance regarding how an entity's use of a service organization affects its internal control. For this reason, the auditor should obtain sufficient information to assess the risks of material misstatement and design further audit procedures in response.

Audit Requirements
Many entities (including small ones) outsource certain processing activities such as payroll. When this occurs, the auditor needs to consider the effect of such arrangements on the entity's internal control.

Exhibit 3.4-3

Audit Requirements

- Determine the significance of service organization activities to the entity.

  If the activities of the service organization are significant to the entity, the auditor should:
  – Review the nature of services and the terms of contract;
  – Compare the period covered by the third party report to that of the current audit period;
  – Obtain sufficient understanding of the service organization and its environment, including its internal control, to identify and assess the risks involved; and
  – Design further audit procedures in response to the assessed risks.
- Consider third-party reports prepared by service organization auditors, internal auditors, or regulatory agencies.

  These reports, if available, can often provide a means of obtaining information about the internal control of the service organization and about its operation and effectiveness. However, the auditor should:
  – Consider the nature and content of the report and the scope of work performed;

Audit Requirements
– Assess the usefulness and appropriateness of the report; and – Make inquiries concerning that auditor's professional competence in the context of the specific assignment undertaken by the service organization auditor. If no such report exists and the understanding obtained is insufficient, the auditor would consider: – Requesting the service organization to have its auditor perform such risk assessment procedures to supply the necessary information; or – Visiting the service organization to obtain the information. • For those specific tests of controls and results that are relevant (contained in a service organization report), determine whether they provide sufficient appropriate audit evidence. Assess whether the nature, timing, and extent of tests about the effectiveness of the accounting and internal control systems support the client's assessed level of control risk.

Reports by service organization auditors will ordinarily be one of two types as follows:

- **Type A – Report on the design and implementation of internal control**
  Because no tests of operating effectiveness have been performed, an auditor would not use such reports as audit evidence about the operating effectiveness of controls.

- **Type B – Report on the design, implementation and operating effectiveness of internal control**
  In this case the auditor would consider whether:
  - The controls tested by the service organization auditor are relevant to the entity's transactions, account balances, disclosures, and related assertions; and
  - Whether the service organization auditor's tests of controls and the results are adequate (that is, the length of the period covered by the service organization auditor's tests and the time elapsed since the performance of those tests).

Note: These reports often contain restrictions as to use. These restrictions generally apply to management, the service organization and its customers, and the entity's auditors.

When a report from the auditor of a service organization is used, the client's auditor's report should not make reference to the auditor's report on the service organization.

3.4.4 ISA 501 — Audit Evidence – Additional Considerations for Specific Items

This standard provides guidance additional to that contained in ISA 500 – Audit Evidence with respect to certain specific financial statement account balances and other disclosures.

Attendance at Physical Inventory Counting

Exhibit 3.4-4

Audit Requirements
• Attend the physical count of inventory (where the balance is material to the financial statement). The auditor should obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attending a physical inventory counting unless impracticable. In planning attendance, consider: – The risks of material misstatement related to inventory; – The nature of the internal control related to inventory; – Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting; – The timing of the count; and – The locations at which inventory is held. • If unable to attend, perform counts at an alternative date. If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and, when necessary, perform tests of intervening transactions. • If attendance is not possible, consider effectiveness of alternative procedures to gather the required evidence. Where attendance is not possible, due to factors such as the nature and location of the inventory, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition. If alternative procedures are not sufficient, the auditor would need to make reference to a scope limitation.

Inquiry Regarding Litigation and Claims

Exhibit 3.4-5

Audit Requirements

- Identify the existence of any litigation and claims.
  Carry out procedures designed to become aware of any litigation and claims involving the entity which may have a material effect on the financial statements.

  These procedures could include:
  – Making appropriate inquiries of management including obtaining representations;
  – Reviewing minutes of those charged with governance and their correspondence with the entity's legal counsel;
  – Examining legal expense accounts; and
  – Using any information obtained regarding the entity's business.

- Communicate directly with the entity's lawyers.
  Seek direct communication with the entity's lawyers when litigation or claims have been identified or when the auditor believes they may exist. The letter would ordinarily specify the following:

  – A list of litigation and claims;
  – Management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved; and
  – A request that the entity's legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's legal counsel to be incomplete or incorrect.

  The letter, which should be prepared by management and sent by the auditor, should request the lawyer to communicate directly with the auditor. If management refuses to give the auditor permission to communicate with the entity's lawyers, this would be a scope limitation and should ordinarily lead to a qualified opinion or a disclaimer of opinion.

Valuation and Disclosure of Long-term Investments

Exhibit 3.4-6

Audit Requirements
• Obtain sufficient appropriate audit evidence regarding the valuation and disclosure of long-term investments (where material to the financial statement). Typical audit procedures would include: – Determining whether the entity has the ability to continue to hold the investments on a long-term basis and discussing with management their intentions; – Obtaining written management representations; and – Obtaining market quotations (where possible) and comparing such values to the carrying amount of the investments up to the date of the auditor's report. • Obtain sufficient appropriate audit evidence regarding the valuation and disclosure of long-term investments (where material to the financial statement). Typical audit procedures would include: – Determining whether the entity has the ability to continue to hold the investments on a long-term basis and discussing with management their intentions; – Obtaining written management representations; and – Obtaining market quotations (where possible) and comparing such values to the carrying amount of the investments up to the date of the auditor's report.

Segment Information

Exhibit 3.4-7

Audit Requirements
• Obtain sufficient appropriate audit evidence regarding segment information disclosure in accordance with the identified financial reporting framework (where material to the financial statements). Typical audit procedures would include: – Analytical procedures and other appropriate audit procedures; – Discussions with management regarding the methods used in determining segment information; – Considering whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework and perform audit procedures over the application of such methods; – Considering sales, transfers and charges between segments, and elimination of inter-segment amounts; and – Comparisons with budgets and other expected results.

3.4.5 ISA 505 — External Confirmations

This standard provides guidance on the auditor's use of external confirmations as a means of obtaining audit evidence.

External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items.

Audit evidence is considered more reliable when it is obtained from independent sources outside the entity. For this reason, written responses to confirmation requests received directly from unrelated third parties may assist in reducing the risk of material misstatement for the related assertions to an acceptably low level.

Exhibit 3.4-8

Audit Requirements
• Determine whether the use of external confirmations is necessary. Consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions. • Tailor external confirmation requests to the specific audit objective. Consider: – The assertions being addressed and the factors that are likely to affect the reliability of the confirmations; and – The type of information respondents will be able to readily confirm, since this may affect the response rate and the nature of the audit evidence obtained. Also include management's authorization to the respondent to disclose the information to the auditor. • Address instances where management requests NOT to confirm certain balances. If management requests the auditor not to confirm a balance, consider if there are valid grounds for such a request. If so, obtain evidence to support the validity of management's requests. If the auditor agrees to management's request, alternative procedures should be applied to obtain sufficient appropriate evidence regarding that matter. If the auditor does not agree to management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope and the possible impact on the auditor's report should be considered.

Audit Requirements
• Maintain control over the external confirmation process. The auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests. • Perform alternative procedures where no response is received or exceptions found. Where a positive external confirmation request is sent but there is no reply or the reply is unsatisfactory, alternative audit procedures should be designed to provide evidence about the financial statement assertions that the confirmation request was intended to provide. • Evaluate the results of the confirmation process. Determine whether the results of the external confirmation process together with the results from any other procedures performed, provide sufficient appropriate audit evidence regarding the financial statement assertion being audited.

3.4.6 ISA 510 — Initial Engagements – Opening Balances

This standard provides guidance regarding opening balances when the financial statements are audited for the first time or when the financial statements for the prior period were audited by another auditor.

Exhibit 3.4-9

Audit Requirements
• Obtain sufficient appropriate audit evidence regarding opening balances and the consistent use of accounting policies. Perform procedures to ensure: – Opening balances do not contain misstatements that materially affect the current period's financial statements. This could include: ◦ Determining whether the prior period's financial statements were audited and, if so, whether the auditor's report was modified, ◦ Consideration of the nature of the accounts and the risk of material misstatement in the current period's financial statements, and ◦ The materiality of the opening balances relative to the current period's financial statements; – Prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated; and – Appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately disclosed. If, after performing such procedures, it is impossible to obtain sufficient appropriate audit evidence concerning opening balances, the auditor's report should include a qualified opinion, a disclaimer of opinion, or in those jurisdictions where it is permitted, an opinion which is qualified or disclaimed regarding the results of operations but unqualified regarding financial position. Examples of such audit opinions are contained in ISA 510.

If an audit report modification regarding the prior period's financial statements remains relevant and material to the current period's financial statements, the auditor should modify the current auditor's report accordingly.

3.4.7 ISA 545 — Auditing Fair Value Measurements and Disclosures

This standard provides guidance on auditing fair value measurements and disclosures contained in financial statements.

ISA 545 addresses audit considerations relating to the measurement, presentation and disclosure of material assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.

Exhibit 3.4-10

Audit Requirements
• Obtain an understanding of the entity's process for determining fair value measurements and disclosures; the relevant control procedures; and assessing risk. Consider the: – Relevant control activities over the processes used; – Expertise and experience of those persons determining the fair value measurements; – Role that information technology has in the process; – Types of accounts or transactions requiring fair value measurements or disclosures (Do they arise from routine and recurring transactions or non-routine or unusual transactions?); – Extent service organizations are used to provide fair value measurements or the data that supports the measurement; – Extent the work of experts is used in determining fair value measurements and disclosures; – Significant management assumptions used in determining fair value and the extent they have changed from prior years; – Documentation supporting management's assumptions; – Methods used to develop and apply management assumptions and to monitor changes in those assumptions; – Integrity of change controls and security procedures for valuation; – Models and relevant information systems, including approval processes; and – Controls over the consistency, timeliness, and reliability of the data used in valuation models.

Audit Requirements

- Assess inherent and control risk related to the fair value measurements/disclosures.
  This is required to develop an effective audit approach that will respond to the assessed risks.

  In some cases, this will be considered a significant risk that will require special audit consideration. This could include a careful evaluation as to whether the significant assumptions used by management provide a reasonable basis for the fair value measurements and disclosures.

- Evaluate whether the fair value measurements/disclosures are in accordance with the entity's financial reporting framework and consistently applied.

  Sufficient appropriate audit evidence should be obtained. This includes an understanding of the requirements of the applicable financial reporting framework and knowledge of the business and industry, together with the results of other audit procedures, which are used to assess whether:
  - The accounting for assets or liabilities requiring fair value measurements is appropriate; and
  - Disclosures about the fair value measurements and significant uncertainties related thereto are appropriate under the entity's applicable financial reporting framework.

- Obtain evidence of management intentions where they are used as criteria for determining measurement, presentation and disclosure requirements.
  Management often documents plans and intentions relevant to specific assets or liabilities and the applicable financial reporting framework may require it to do so.

  Procedures could include inquiries of management, such as:
  - Management's past history of carrying out its stated intentions with respect to assets or liabilities;
  - Reviewing written plans and other documentation, including, where applicable, budgets, minutes and so forth;
  - Management's stated reasons for choosing a particular course of action; and
  - Management's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its contractual commitments.

- Determine if the method of measurement used is appropriate in the circumstances.

  This requires the use of professional judgment and consideration of whether:
  - Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method;
  - The valuation method is appropriate in the circumstances given the nature of the asset or liability being valued and the entity's applicable financial reporting framework; and
  - The valuation method is appropriate in relation to the business, industry and environment in which the entity operates.

Audit Requirements
• Determine the need to use the work of an expert. When the use of such an expert is planned, the auditor would obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit, and complies with the requirements of ISA 620.
• Design and perform further audit procedures in response to assessed risks of material misstatement of assertions relating to the entity's fair value measurements and disclosures. Such further audit procedures would include tests of controls and substantive procedures, as appropriate.
• Consider the effect of subsequent events. Review transactions and events that occur after the period end but prior to completion of the audit.
• Evaluate the results of audit procedures. Evaluate the sufficiency and appropriateness of the audit evidence obtained as well as the consistency of that evidence with other evidence obtained and evaluated during the audit.

Management Representations

The auditor should obtain written representations from management regarding the reasonableness of significant assumptions, including whether they appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity where relevant to the fair value measurements or disclosures.

3.4.8 ISA 550 — Related Parties

This standard provides guidance on the auditor's responsibility and audit procedures regarding related parties and transactions with such parties.

Management is responsible for the identification and disclosure of related parties and transactions with such parties. This responsibility requires management to implement adequate internal control to ensure that transactions with related parties are appropriately identified in the information system and disclosed in the financial statements.

In smaller entities, these procedures are likely to be unsophisticated and informal.

Exhibit 3.4-11

Audit Requirements
• Review information provided by those charged with governance and management identifying the names of all known related parties. Make inquiries of management about related parties and the extent of transactions and perform the following audit procedures in respect of the completeness of this information: – Review prior year's working papers for names of known related parties; – Review the entity's procedures for identification of related parties; – Inquire as to the affiliation of those charged with governance and officers with other entities; – Review shareholders' records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register; – Review minutes of the meetings of shareholders and those charged with governance and other relevant statutory records such as the register of directors' interests; – Inquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties; and – Review the entity's income tax returns and other information supplied to regulatory agencies. Also consider as part of the risk assessment process, the adequacy of control activities over the authorization and recording of related-party transactions. • During the course of the audit, be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties. Examples include: – Transactions which have abnormal terms of trade, such as unusual prices, interest rates, guarantees, and repayment terms; – Transactions which lack an apparent logical business reason for their occurrence; – Transactions in which substance differs from form; – Transactions processed in an unusual manner; – High volume or significant transactions with certain customers or suppliers as compared with others;

Audit Requirements
– Unrecorded transactions such as the receipt or provision of management services at no charge; and – Audit procedures which identify the existence of transactions with related parties such as: ◦ Performing detailed tests of transactions and balances, ◦ Reviewing minutes of meetings of shareholders and those charged with governance, ◦ Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period, ◦ Reviewing confirmations of loans receivable and payable, and confirmations from banks. Such a review may indicate guarantor relationship and other related party transactions, and ◦ Reviewing investment transactions. • Obtain sufficient appropriate audit evidence as to whether related-party transactions have been properly recorded and disclosed. Because of the limited availability of appropriate audit evidence about such transactions, consider performing audit procedures such as: – Asking the bookkeeper and other staff about the existence of related parties; – Confirming the terms and amount of the transaction with the related party; – Inspecting information in possession of the related party, where possible; and – Confirming or discussing information with persons associated with the transaction, such as banks, lawyers, guarantors and agents. • Ensure that the financial statement disclosure is adequate. Where the applicable financial reporting framework requires disclosure of related-party relationships, ensure that the disclosure is adequate. • Obtain management representations. Obtain a written representation (which does not replace obtaining other audit evidence) from management concerning: – The completeness of information provided regarding the identification of related parties; and – The adequacy of related-party disclosures in the financial statements.

Audit Conclusions and Reporting

The auditor's report should be appropriately modified if it was not possible to:

- Obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties; or
- Conclude that their disclosure in the financial statements as required by the financial framework was adequate.

3.4.9 ISA 560 — Subsequent Events

This standard provides guidance on the auditor's responsibility regarding subsequent events.

"Subsequent events" refers to:

- Events occurring between period end and the date of the auditor's report; and
- Facts discovered after the date of the auditor's report.

Exhibit 3.4-12

Audit Requirements
• Determine if all events up to the date of the auditor's report that may require adjustment or disclosure in the financial statements have been identified. Such audit procedures would take into account the auditor's risk assessment. They may include the following: – Reviewing procedures management has established to ensure subsequent events are identified; – Reading minutes of the meetings of shareholders, those charged with governance, including those held after period end and inquiring about matters discussed at meetings for which minutes are not yet available; – Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports; – Inquiring, or extending previous verbal or written inquiries, of the entity's legal counsel concerning litigation and claims; and – Inquiring of management as to whether any subsequent events have occurred which might affect the financial statements. Examples of inquiries of management on specific matters are: ◦ Current status of items that were accounted for on the basis of preliminary or inconclusive data, ◦ New commitments, borrowings or guarantees, ◦ Sales or acquisition of assets that have occurred or are planned, ◦ Issue of new shares or debentures or an agreement to merge or liquidate that is made or planned, ◦ Any assets that have been appropriated by government or destroyed, for example, by fire or flood, ◦ Any developments regarding risk areas and contingencies, ◦ Any unusual accounting adjustments made or contemplated, and ◦ Any events that have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements (such as going-concern issues). When events are identified, the auditor should consider whether such events are properly accounted for and adequately disclosed in the financial statements.

Facts Discovered After the Date of the Auditor's Report but Before the Financial Statements are Issued

When, after the date of the auditor's report but before the financial statements are issued, the auditor becomes aware of a fact which may materially affect the financial statements, the auditor should:

- Consider whether the financial statements need amendment;
- Discuss the matter with management; and
- Take the action appropriate in the circumstances.

When management does not amend the financial statements in circumstances that the auditor believes should be amended, a qualified opinion or an adverse opinion should be issued.

When the auditor's report has been released to the entity, the auditor would notify those charged with governance not to issue the financial statements and the auditor's report thereon to third parties. If the financial statements are subsequently released, the auditor needs to take action to prevent reliance on the auditor's report. The action taken will depend on the auditor's legal rights and obligations and the recommendations of the auditor's lawyer.

Facts Discovered After the Financial Statements Have Been Issued

When, after the financial statements have been issued, the auditor becomes aware of a fact which existed at the date of the auditor's report and which, if known at that date, may have caused the auditor to modify the auditor's report, the auditor should:

- Consider whether the financial statements need revision;
- Discuss the matter with management;
- Consider whether the actions taken are appropriate in the circumstances. This would include:
  - A review of steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation and the issue of a new report on the revised financial statements.
  - Management revisions and approval of the new financial statements including the audit procedures necessary in the circumstances; and
- Issue a new auditor's report dated not earlier than the date the revised financial statements are approved. The new auditor's report should include an emphasis of a matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor.

When management does not take the necessary steps, the auditor would notify those charged with governance of the entity that action will be taken by the auditor to prevent future reliance on the auditor's report. The action taken will depend on the auditor's legal rights and obligations and the recommendations of the auditor's lawyers.

3.4.10 ISA 570 — Going Concern

This standard provides guidance on the auditor's responsibility in the audit of financial statements with respect to the going-concern assumption used in the preparation of the financial statements, including considering management's assessment of the entity's ability to continue as a going concern.

The going-concern assumption is a fundamental principle in the preparation of financial statements.

Under the going-concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Exhibit 3.4-13

Audit Requirements

- Determine the appropriateness of management's use of the going-concern assumption in the preparation of the financial statements.
  In planning the audit, consider whether there are events or conditions which may cast significant doubt on the entity's ability to continue as a going-concern. As the audit progresses, be alert for evidence of events or conditions which may cast significant doubt on the entity's ability to continue as a going concern.
- When an event or condition is identified, perform further audit procedures.
  When events or conditions are identified:
  - Review management's plans for future actions based on its going-concern assessment;
  - Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists;
  - Carry out audit procedures including considering the effect of any plans of management and other mitigating factors; and
  - Seek written representations from management regarding its plans for future action.

  Evaluate management's assessment of the entity's ability to continue as a going concern.

  Consider the same period as that used by management in making its assessment under the financial reporting framework. If management's assessment covers less than 12 months from the balance sheet date, ask management to extend its assessment period to 12 months from the balance sheet date. (Some local regulations might consider management or the auditor to consider a period of greater than 12 months.)

Audit Requirements

If management is unwilling to make or extend its assessment when requested to do so, consider the need to modify the auditor's report as a result of the scope limitation.

Also inquire of management as to its knowledge of events or conditions beyond the period of assessment that may cast significant doubt on the entity's ability to continue as a going concern.

Consider communicating with third-party lenders, who may hold the key to whether the company continues in existence.

3.4.11 ISA 600 — Using the Work of Another Auditor

This standard provides guidance when an auditor, reporting on the financial statements of an entity uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity.

This ISA addresses the situation where an auditor (principal auditor) has responsibility for reporting on the financial statements of an entity that includes one or more components (division, branch, subsidiary, etc.) that are audited by another auditor (other auditor).

Exhibit 3.4-14

Audit Requirements

- The principal auditor should determine how the work of the other auditor will affect the audit.
  In planning the audit, the principal auditor should determine whether the financial statements of one or more components, (audited by other auditors) are material. If they are material, the requirements of this ISA will apply.
- Determine whether the principal auditor's participation is sufficient to be able to act as the principal auditor.

  This decision will be based on professional judgment after considering factors such as:
  - The materiality of the portion of the financial statements which the principal auditor audits;
  - The principal auditor's degree of knowledge regarding the business of the components;
  - The risk of material misstatements in the financial statements of the components audited by the other auditor; and
  - The performance of additional procedures as set out in this ISA regarding the components audited by the other auditor resulting in the principal auditor having significant participation in such audit.

Audit Requirements

- Consider the professional competence of the other auditor in the context of the specific assignment.

  Sources of information to consider:
  - Common membership of a professional organization;
  - Common membership of, or affiliation, with another firm;
  - Reference to the professional organization to which the other auditor belongs; and
  - Supplemental inquiries with other auditors, bankers, etc. and discussions with the other auditor.

- Perform procedures to obtain sufficient appropriate audit evidence that the work of the other auditor is adequate, in the context of the specific assignment.

  Advise the other auditor of:
  - Independence requirements and obtain written representation as to compliance;
  - The use that will made of the other auditor's work/report and make sufficient arrangements for the coordination efforts at the initial planning stage of the audit;
  - Matters such as areas requiring special consideration, procedures for the identification of intercompany transactions that may require disclosure and the timetable for completion of the audit; and
  - Accounting, auditing and reporting requirements and obtain written representation as to compliance.

  Inquire about the audit procedures applied by the other auditor, review a written summary of their procedures (which may be in the form of a questionnaire or checklist), or review their working papers. This could occur during a visit to the other auditor.

- Consider the significant findings of the other auditor.

  Consider:
  - Discussing with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the component; and
  - Whether supplementary tests of the records or the financial information of the component are necessary. Such tests may be performed by the principal auditor or the other auditor.

- Document.

  Documentation should include:
  - Components whose financial information was audited by other auditors;
  - Significance of components to the financial statements of the entity as a whole;
  - The names of the other auditors;
  - Any conclusions reached that individual components are immaterial; and
  - Procedures performed and the conclusions reached. For example, working papers reviewed and results of discussions with the other auditor.

  The other auditor should cooperate with the principal auditor and vice versa. Both auditors would bring to the other's attention any matters that may have an important bearing on the other's work.

Reporting

If the principal auditor concludes that the work of the other auditor cannot be used (and it is not possible to perform sufficient additional procedures), the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation in the scope of the audit.

Where local regulations permit a principal auditor to base the audit opinion on the financial statements taken as a whole solely upon the report of another auditor regarding the audit of one or more components, the principal auditor's report should state this fact clearly and should indicate the magnitude of the portion of the financial statements audited by the other auditor.

3.4.12 ISA 620 — Using the Work of an Expert

This standard provides guidance on using the work of an expert as audit evidence.

In some situations, the auditor may need to obtain, in conjunction with the entity or independently, audit evidence in the form of reports, opinions, valuations, and statements of an expert. Examples include:

- Valuations of assets such as land and buildings, plant and machinery, works of art, and precious stones;
- Determination of quantities or physical condition of assets such as minerals stored in stockpiles, underground mineral and petroleum reserves, and the remaining useful life of plant and machinery;
- Determination of amounts using specialized techniques or methods such as actuarial valuation;
- The measurement of work completed and to be completed on contracts in progress; and
- Legal opinions concerning interpretations of agreements, statutes and regulations.

Exhibit 3.4-15

Audit Requirements
• Evaluate the professional competence of the expert. Consider the expert's: – Professional certification or licensing by, or membership in, an appropriate professional body; and – Experience and reputation in the field in which the auditor is seeking audit evidence. • Evaluate the objectivity of the expert. The risk that objectivity may be impaired increases when the expert is: – Employed by the entity; or – Related in some other manner to the entity, for example, by being financially dependent upon or having an investment in the entity.

Audit Requirements
The auditor needs to discuss any reservations about competence or objectivity with management. In some cases the auditor may need to undertake additional audit procedures or seek audit evidence from another expert. • Obtain sufficient appropriate audit evidence that the scope of the expert's work is adequate for the purposes of the audit. Review the terms of reference or instructions to the expert. These may cover matters such as the following: – The objectives and scope of the expert's work; – A general outline as to the specific matters the auditor expects the expert's report to cover; – The intended use by the auditor of the expert's work, including the possible communication to third parties of the expert's identity and extent of involvement; – The extent of the expert's access to appropriate records and files; – Clarification of the expert's relationship with the entity, if any; – Confidentiality of the entity's information; and – Information regarding the assumptions and methods intended to be used by the expert and their consistency with those used in prior periods. Clarify any matters not clearly set out by communicating with the expert directly. Consider whether to include the expert during the engagement team's discussion of the susceptibility of the entity's financial statements to material misstatement. • Evaluate the appropriateness of the expert's work as audit evidence regarding the assertion being considered Evaluate whether the substance of the expert's findings is properly reflected in the financial statements or supports the assertions, and consider: – Source data used; – Assumptions and methods used and their consistency with prior periods; and – Results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of other audit procedures. To ensure the source data used is appropriate in the circumstances consider: – Making inquiries regarding any procedures undertaken by the expert to establish whether the source data is relevant and reliable; and – Reviewing or testing the data used by the expert. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. However, the auditor will need to obtain an understanding of the assumptions and methods used and to consider whether they are appropriate and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures.

If the results of the expert's work are unsatisfactory or inconsistent with other evidence, the auditor should resolve the matter. This may involve discussions with the entity and the expert, applying additional audit procedures, including possibly engaging another expert, or modifying the auditor's report.

Reporting

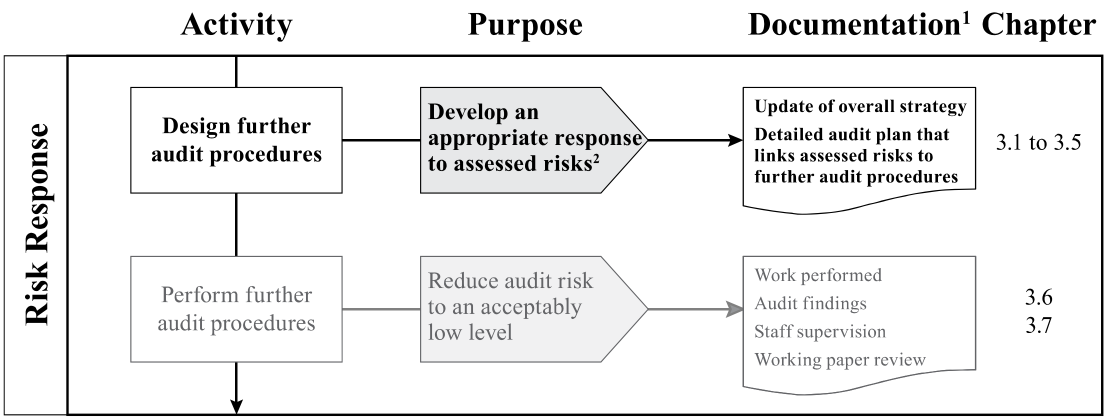
An unmodified auditor's report should not refer to the work of an expert. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended.

If the auditor decides to issue a modified auditor's report as a result of the expert's involvement, it may be appropriate, in explaining the nature of the modification, to refer to or describe the work of the expert (including the identity of the expert and the extent of the expert's involvement). In these circumstances, the auditor would obtain the permission of the expert before making such a reference. If permission is refused and the auditor believes a reference is necessary, the auditor may need to seek legal advice.

This chapter does not contain case study materials.

3.5 Extent of Testing

Exhibit 3.5-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.

Chapter Purpose	Primary ISA References
To provide guidance on the extent of testing required to obtain evidence that is responsive to the assessed risks of material misstatement at the assertion level for each material class of transaction, account balance and disclosure.	**330, 530**

3.5.1 Overview

ISA 330 states:

> **7. The auditor 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.**

ISA 530 states:

> **2. When designing audit procedures, the auditor should determine appropriate means for selecting items for testing so as to gather sufficient appropriate audit evidence to meet the objectives of the audit procedures.**
>
> **22. When designing audit procedures, the auditor should determine appropriate means of selecting items for testing.**
>
> **31. When designing an audit sample, the auditor should consider the objectives of the audit procedure and the attributes of the population from which the sample will be drawn.**
>
> **40. In determining the sample size, the auditor should consider whether sampling risk is reduced to an acceptably low level.**

42. The auditor should select items for the sample with the expectation that all sampling units in the population have a chance of selection.

44. The auditor should perform audit procedures appropriate to the particular audit objective on each item selected.

Sufficient appropriate audit evidence should be obtained to be able to draw reasonable conclusions on which to base the audit opinion. Sufficiency is the measure of the quantity of audit evidence. Quantity is affected by the risks of material misstatement. The greater the risk, the more audit evidence is likely to be required.

Absolute assurance cannot be obtained due to the inherent limitations in an audit that affect the auditor's ability to detect material misstatements. These limitations result from factors such as the following:

- The inherent limitations of internal control (such as the possibility of management override or collusion); and
- The fact that most audit evidence is persuasive rather than conclusive.

3.5.2 Sufficient Appropriate Audit Evidence

Sufficient appropriate audit evidence may be obtained by:

- **Selecting all items (100% examination)**
  This is appropriate when:
  - The population constitutes a small number of large value items;
  - There is a significant risk and other means do not provide sufficient appropriate audit evidence; and
  - CAATs can be used in a larger population to electronically test a repetitive calculation or other process.
- **Selecting specific items**
  This is appropriate for:
  - High value or key items;
  - All items over a certain amount;
  - Items to obtain information such as about matters such as the nature of the entity, the nature of transactions, and internal control; and
  - Items to test control activities.
- **Selecting a representative sample of items from the population**
  This can be performed using judgment or statistical methods. Sampling is discussed in more detail below.

The decision as to which approach to use will depend on the circumstances. The application of any one or combination of the above means may be appropriate in particular circumstances.

Valid conclusions can ordinarily be reached by using sampling approaches and other means of selecting items for testing. The reasons for this include:

- Reasonable assurance and not absolute certainty is the audit objective;

- Evidence obtained from one source, corroborated by evidence obtained from another source, will normally provide increased assurance;
- Examining all data will not provide absolute certainty as, for example, where there are certain unrecorded transactions; and
- The cost of examining every entry in the accounting records and all supporting evidence would generally be uneconomic.

Consider Point

Use the information obtained from assessing the risks of material misstatement (RMM) to reduce or eliminate the need for substantive procedures in areas where the assessed risk is low. In addition, use the information obtained about internal control to identify key controls that could be tested for operating effectiveness. Testing controls (some of which may only require testing once every three years) can often result in much less work than performing extensive substantive procedures each year.

Refer to Chapters 3.2 and 3.3 for information on the nature and timing of tests of controls and substantive procedures.

3.5.3 Types of Audit Tests

The types of audits tests fall into two basic categories, specific item tests and sampling, as illustrated in the exhibit below.

Exhibit 3.5-2

Specific Item Tests	Sampling
Individual (significant) items in a set of data are selected for examination because of their significance, size, nature or method of recording. When identifying significant items, consider: • Any items/transactions that could individually result in a material misstatement; • Any unusual or sensitive items or financial statement disclosures; and • Any items that are highly susceptible to misstatement. These may have been identified from performing risk assessment (including analytical) procedures.	This is the selection of an appropriate sample of unbiased items in a population to reach a conclusion about the entire set of data. The determination of sample size may be made using either statistical or non-statistical methods. Conclusions from statistical sampling can be expressed in mathematical terms such as the extent of uncertainty that is inherent in the test. However, the use of statistical methods does not eliminate the need for the auditor to exercise professional judgment.

Sampling

Audit sampling involves the application of audit procedures to less than 100% of items (population) within a class of transactions or account balance. Sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected. A conclusion can then be drawn concerning the population from which the sample is drawn.

There are two types of sampling commonly used in auditing. These are:

- Statistical sampling, where the results of the procedure can be mathematically projected; and
- Non-statistical or judgmental sampling.

Statistical sampling has the following characteristics:

- Random selection of a sample; and
- Use of probability theory to evaluate sample results, including measurement of sampling risk.

Any sampling approach that does not have the characteristics outlined above is considered non-statistical sampling.

In any sample of less than 100% of the population, there is always the risk that a misstatement may not be identified and that it might exceed the tolerable level of misstatement. This is called sampling risk. Sampling risk can be reduced by increasing the sample size, while non-sampling risk can be reduced by proper engagement planning, supervision and review.

The tolerable level of misstatement (exceptions) acceptable to an auditor is a significant factor in forming a conclusion about the population. For substantive sampling it will be set in relation to materiality for the financial statements as a whole or to a lower materiality level established for particular classes of transactions, account balances or disclosure. The sample size will be affected by the relative difference between the tolerable level of exceptions and the expected level of exceptions. The greater the tolerable level of exceptions, the smaller the sample size.

Whether statistical or non-statistical techniques are used, the following matters would be addressed and documented on the file when preparing to sample.

Exhibit 3.5-3

Factors to Consider	Comments
What is the purpose of the test and what assertions will be addressed?	This will establish the starting point for the test design.
What was the experience (if any) in performing similar tests in previous periods?	Consider the effectiveness of the test and the existence and disposition of deviations (errors), if any, found in the samples selected.
How will the population of items to be tested be defined?	Testing an undefined or inappropriate population could result in the test objectives not being achieved or invalid conclusions being reached.

Factors to Consider	Comments
What sampling unit should be used?	Consider the purpose of the test and the assertion being addressed. This decision will determine what items will be selected to test. Examples include sales invoices, sales orders and customer account balances.
Will the test be statistical or non-statistical?	A statistical test requires a representative sample where deviations could reasonably occur in any item in the population (that is, not restricted to items having particular characteristics).
How will a deviation in the sample be defined?	Failure to properly define a deviation will result in time being wasted by staff in reviewing minor exceptions that may not constitute a deviation. Also consider how deviations that meet the definition will be followed up by audit staff.
Are there specific (substantive) items that could be excluded from the sample and evaluated separately?	If there are larger transactions or balances in the population that can be evaluated separately, it may result in less confidence being required from the sample of remaining items in the population. In some cases, the confidence gained from tests of the larger transactions or balances may be sufficient to eliminate the need for sampling altogether.
Are there subgroups within the defined population that could be tested separately?	If there is a subgroup that is highly significant, a sample of these items may have an impact on the level of confidence required from other subgroups. Where subgroups are tested separately, the results can be combined at the end to provide one overall level of confidence.
What level of confidence is required from the test?	This will determine the sample size. Remember that a statistical conclusion cannot be drawn if the sample size is too small. This would apply to testing internal control systems such as month-end reconciliations where the total population is only 12 items.
What is the maximum deviation rate that is tolerable?	Sampling should not be considered where it is likely that a number of deviations may be found. The test may simply confirm this assessment without any further audit confidence being gained.

Note: When using statistical sampling, remember that it is only an auditing tool and is not a substitute for professional judgment.

3.5.4 The Use of Assertions in Testing

Tests should be designed to provide evidence about the particular assertion such as the existence of inventory items. A test designed to address existence will focus on items already recorded as part of an account balance or transaction stream, whereas a test of completeness would focus on other items that indicate whether an amount should be included in the relevant financial statement amount.

Extent of Tests of Controls

The test objective is to obtain sufficient appropriate audit evidence that the internal control operated effectively throughout the period of reliance.

In designing tests of controls, the auditor should focus on the evidence that will be obtained in respect of the relevant assertions (the points where misstatements could occur in the financial statements) addressed as opposed to nature of the control itself. Controls are designed to mitigate risks and ensure, for example, the completeness of sales.

There are also a number of practical advantages in designing tests of controls that focus first on the assertion to be addressed. For example:

- The controls tested can be linked directly to the risks of material misstatements in the financial statements;
- Because the test objective is not dependent on specific controls, other controls that address the same risks (or control objectives) can be tested. This enables unpredictability or variation in the testing to be introduced; and
- It makes it easier to evaluate and test new controls introduced by the entity that address the same assertions.

Tests of controls are often designed to provide either a low or a moderate level of control risk (high or moderate level of assurance (confidence)) that the control being tested is operating effectively.

Consider Point

When statistical (attribute or discovery) sampling is used for testing the operating effectiveness of internal control, the sample size required does not increase as the size of the population grows. A random sample of as little as 30 items with no deviation found can provide a high level of confidence that the control is operating effectively.

When designing audit procedures, it can be useful to consider two levels of confidence to be gained from tests of controls:

- A high level of confidence (low level of risk remaining); and
- A moderate level of confidence (moderate level of risk remaining).

If the primary evidence is coming from tests of controls, then a high level of confidence would normally be appropriate. If the tests of controls are combined with other substantive procedures to address a particular assertion, a lower (moderate) level of confidence from tests of controls may be all that is required.

Discovery or Attribute Sampling

This sampling method is ideal for testing the operating effectiveness of internal control. A discovery sample is the smallest sample size that is capable of providing a specified chance of detecting a deviation rate that exceeds the tolerable amount. It assumes that **no** deviations will be found in such a sample, which will enable the auditor to assert that the control is operating effectively.

Consider Point

If any level of deviation is expected in the operating effectiveness of a control, it is recommended that alternative approaches to gathering audit evidence be considered.

Sample sizes are based on the following formula:

Sample Size = Confidence Factor ÷ Maximum Tolerable Deviation Rate

Use a random number generator or another appropriate method to select the individual items to be checked. Every item in the population should have an equal chance of being selected.

Based on a 95% confidence rate (a 5% deviation rate), it is suggested that:

- A sample of 60 items and up to one deviation will provide a high level of assurance. If two deviations are found, only a moderate level of assurance can be gained. If more than two deviations are found, no assurance can be gained from testing of control;
- A sample of 30 items with no deviations will provide a high level of assurance. If a single deviation is found, only a moderate level of assurance can be gained. If more than one deviation is found, no assurance can be gained; and
- A sample of 10 items with no deviations will provide a moderate level of assurance. If a deviation is found, no assurance can be gained.

A sample size of 60 is based on a confidence factor of 3.0 (95% confidence) and a maximum tolerable deviation rate of .05 (5%). A sample of 30 is based on a confidence factor of 1.5 (78% confidence).

The above is summarized in the exhibit below. "LR" is a low level of control risk remaining that is equivalent to a high level of assurance that the control is operating effectively. "MR" is a moderate level of control risk remaining.

Exhibit 3.5-4

Tests of Controls			
Tolerable # of Errors	Sample Size		
	10	30	60
0	MR	LR	LR
1		MR	LR
2			MR

3.5.5 Extent of Substantive Procedures

The greater the risks of material misstatement, the greater the extent of substantive procedures required. Where reliance was planned on the operating effectiveness of internal control, the extent of substantive procedures may also need to be increased as a result of unsatisfactory results from tests of controls.

Where there is a large population of items to be tested, a statistical or non-statistical sample is often used for a test of details. However, before designing the test, consider the following:

- What is the primary source of evidence for each assertion to be addressed and what is secondary? This will help to ensure audit effort is directed to the right place;
- Is there a more effective means of testing than a straight representative sample? Large or unusual items could be extracted from a population for separate evaluation. The population could also be stratified into homogeneous subpopulations for sampling; and
- Would the use of computer assisted audit techniques (CAATs) provide a better or more efficient result? For many tests, 100% of the population can be tested by CAATs (as opposed to just a sample) and custom reports can be prepared that identify unusual items for follow up.

The sample size for substantive procedures is usually based on the level of assurance required. This will be influenced by:

- Evidence obtained from other sources including analytical procedures and assurance gained from testing the operational effectiveness of related controls;
- The size of the population; and
- Materiality.

A selection of confidence factors based on the level of assurance required is outlined in the following exhibit.

Exhibit 3.5-5

Level of Assurance	Confidence Factor
50%	0.7
55%	0.8
60%	0.9
65%	1.1
70%	1.2
75%	1.4
80%	1.6
85%	1.9
90%	2.3
95%	3.0
98%	3.7
99%	4.6

Sample sizes (using monetary unit sampling) can be determined as follows:

Step 1 — Calculate the sampling interval
Sampling Interval = Precision (Materiality) ÷ Confidence Factor

Note: The precision (materiality) should be discounted for any expected deviations in the sample. For example, where anticipated deviations would not exceed 1/3 materiality and the entity will correct all deviations noted, the precision could be set at 2/3 of remaining materiality.

If the sampling interval was 17,391€, the first account to be selected could be randomly chosen at, for example, the 10,000th€ (on a cumulative basis). The second account selected would be the account containing the 27,391st € (starting point + sampling interval = 10,000€ + 17,391€). The third account selected would be the account that contained the 44,782nd € (27,391€ + 17,391€). This process would continue to the end of the population.

Step 2 — Calculate the sample size
Sample Size = Population to Be Tested ÷ Sampling Interval

The population to be tested should exclude any specific items removed for separate evaluation.

Step 3 — Select the sample
Remove any high-value and key items from the population (for separate consideration) and compute the sampling interval (refer to Step 2 above). Then select a random starting point for selecting the first item. The random starting point can range from 1€ to the sampling interval. Each successive selection is made on the value of the previous selection plus one sampling interval.

The following three examples illustrate this process.

Example 1 — Sampling Accounts Receivable Balances

Exhibit 3.5-6

Question	Response
Purpose of test	To ensure the existence of accounts receivable by selecting a sample of receivable balances and sending confirmation letters.
Risks of material misstatement in the relevant assertions	Existence = high risk
Population to be tested	Accounts receivable balances at period end.
Monetary value of population	177,203€
Specific items subject to separate evaluation	38,340€
Assurance obtained from testing controls	None.
Assurance from other procedures such as risk assessment procedures	Limited.
Confidence factor to be used (reduce for assurance gained from other sources)	No other sources of assurance so 95% or 3.0 will be used.
Materiality	15,000€
Expected deviations in sample	None

Sampling Interval = 15,000€ / 3.0 = 5,000€

Sample Size = (177,203€ - 38,340€) / 5,000€ = 28

In this example, the sampling interval was 5,000€. So if the first item would be chosen randomly at 436€, the next item would be in the transaction or balance that contained the cumulative value of 5,436€. The third item would be in the transaction or balance that contained the cumulative value of 10,436€ and so on until the 28 items have been selected.

Note: It is likely that the higher value items get selected for testing (see the partial population of accounts receivable balances below).

Exhibit 3.5-7

	Accounts Balance Receivable	Cumulative Total	Sampling Sampling Interval	Include in sample?
Customer A	11,000	11,000	436	Yes
Customer B	15,000	26,000	19,436	Yes
Customer C	12,000	38,000	38,436	No
Customer D	25,000	63,000	57,436	Yes
Customer E	16,000	79,000	76,436	Yes
Customer F	14,000	93,000	95,436	No

Example 2 — Sampling Accounts Receivable Balances

Exhibit 3.5-8

Question	Response
Purpose of test	To ensure the existence of receivables by selecting a sample of accounts receivable balances and sending confirmation letters.
Risks of material misstatement in the relevant assertions	Existence = moderate risk
Population to be tested	Accounts receivable balances at year end.
Monetary value of population	177,203€
Specific items subject to separate evaluation	38,340€
Assurance obtained from testing controls	A low level of control risk has been established over related controls.

Question	Response
Assurance from other procedures such as risk assessment procedures	Limited.
Confidence factor to be used (reduce for assurance gained from other sources)	In light of other sources of evidence, a confidence factor of 70% (1.2) will be used.
Materiality	15,000€
Expected deviations in sample	None.

Sampling interval = 15,000€ / 1.2 = 12,500€

Sample size = (177,203€ - 38,340€) / 12,500€ = 12

Example 3 – Sampling Purchase Invoices

Exhibit 3.5-9

Question	Response
Purpose of test	To ensure the existence and accuracy of purchases by selecting a sample of purchase invoices
Risks of material misstatement in the relevant assertions	Existence = Low risk Accuracy = Low risk
Population to be tested	Purchase invoices for year
Monetary value of population	879,933€
Specific items subject to separate evaluation	46,876€
Assurance obtained from testing controls	None
Assurance from other procedures such as risk assessment procedures	Moderately effective substantive analytical procedures
Confidence factor to be used (reduce for assurance gained from other sources)	In light of the other sources of evidence, a confidence factor of 80% (1.6) will be used
Materiality	15,000€
Expected deviations in sample	None

Sampling interval = 15,000€ / 1.6 = 9,375€

Sample size = (879,933€ – 46,876€) / 9,375€ = 89

As illustrated above, the sample sizes for substantive tests can become very large when examining transaction streams. It is often more efficient to test internal control (where the sample size is smaller) or perform other types of audit procedures to obtain the required evidence.

Selection of Confidence Factors

When designing a substantive test, the auditor may find it useful to use three levels of assurance such as high, moderate, and low. The difference between the levels can be based on the confidence factor used for selecting the sample. The higher the confidence factor, the higher the sample size and the level of assurance obtained. This is illustrated in the following exhibit.

Exhibit 3.5-10

Assurance Required	Confidence Factor
Low	1.0 – 1.4
Moderate	1.5 – 2.2
High	2.3 – 3.0

An effective set of audit procedures designed to respond to assessed risks and specific assertions may contain a mixture of tests of controls and substantive procedures.

3.5.6 Extent of Substantive Analytical Procedures

Substantive analytical procedures will either be the primary test of the account balance or they will be used in combination with other tests of details that have been appropriately reduced in extent.

Refer to Chapter 3.3, which outlined two levels of assurance that can be gained from performing substantive analytical procedures. These are highly effective (that is, the primary test) and moderately effective.

Simple analytical procedures (such as comparison of last year's results to this year) may help to identify an issue that needs to be followed up but provide little further audit evidence. This type of analytical procedure can be used in understanding the entity, performing risk assessment procedures, and reviewing the final financial statements.

When designing substantive analytical procedures, the auditor should:

- Develop the amount of difference from the expectation that can be accepted without further investigation. This should be influenced primarily by materiality and consistency with the desired level of assurance;
- Consider the possibility that a combination of misstatements in the specific account balance, class of transactions or disclosure could aggregate to an unacceptable amount; and
- Increase the desired level of assurance as the risks of material misstatement increase.

3.5.7 Adequacy of Presentation and Disclosure

Audit procedures should be designed to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework.

These audit procedures should address whether:

- The individual financial statements are presented in a manner that reflects the appropriate classification, and description of financial information;
- The presentation of financial statements includes adequate disclosure of material matters. This includes the form, arrangement, and content of the financial statements and their appended notes (including terminology used), the amount of detail given, the classification of items in the statements, and the bases of amounts set forth; and

- Management has disclosed particular matters in light of the circumstances and facts of which the auditor is aware at the time of signing the auditor's report.

Case Study — Extent of Testing

For details of the case study, refer to the Introduction to the Case Study in this Guide.

The following is an outline of an audit program for accounts receivable. This program includes:

- The planned tests of controls (refer to Chapter 3.2); and
- The statistical sample of accounts receivable (refer to Chapter 3.4).

Dephta Furniture Inc.
Accounts Receivable – Audit Procedures

Client: Dephta Furniture

	Assertions addressed	Work completed by (initials)	W/P Ref	Comments
PROCEDURES				
1. Analytical Procedures Develop expectations for the period-end accounts receivable balances based on information obtained from understanding the entity. Investigate significant changes or trends in the: • Accounts receivable balance. • Aging of accounts receivable by customer. • Day's sales in accounts receivable. • Credit balances in accounts receivable. • Other unexpected variations. Explain. • Other (non-trade receivables). Document findings.	CEA	MAG	C.120	*Accounts receivable have increased by 60% from the prior year.* *Debtor's days in accounts receivable have also increased from 39 days to 45 days.*
2. Listing Obtain a detailed (and aged) listing of receivables at the period end:			C.122	*No errors found*
a) Check arithmetic accuracy and agree to general ledger.	C	MAG		

Dephta Furniture Inc.
Accounts Receivable – Audit Procedures

Client: Dephta Furniture

	Assertions addressed	Work completed by (initials)	W/P Ref	Comments
b) Check names and amounts to subsidiary ledger. c) Ask staff dealing with receivables about any instances where a customer has been given preferential treatment, the terms of sale have been modified, there are related parties or internal credit limits have been significantly overridden.	C A	MAG MAG		*Per discussion with Arjan and Karla, the sales terms do vary between customers but are approved by Arjan.*
3. Allowance for Doubtful Accounts Ensure that the allowance for doubtful accounts relates to specific accounts and is adequate: a) Review the aged accounts receivable trial balance and compare it to preceding year or periods.	CV	MAG		*Accounts receivable over 60 days have increased as a percentage of sales from the prior year.*
b) Review payments received subsequent to year-end (if possible, obtain an aged trial balance as at the period end date with subsequent collections posted on it).	AV	MAG		
4. Cut-off Perform and document cut-off procedures.		MAG		
SUBSTANTIVE PROCEDURES – SAMPLING				
S1. Extended Confirmation Selected 16 confirmation of accounts as outlined in accounts receivable confirmation checklist. Summarize the results and investigate differences by examining supporting documentation and inquiry.		MAG		

	Assertions addressed	Work completed by (initials)	W/P Ref	Comments
TESTS OF CONTROLS				
T1. Identify the risk reduction obtained, MODERATE Risk/LOW Risk (circle one), and the assertions addressed from performing relevant tests of controls on related transaction streams. (i.e., purchases, payables, payments, etc.). If internal control has not changed, utilize the results of tests of controls performed in the LAST PERIOD or the PERIOD BEFORE THAT (circle one). Describe the reduction (if any) in planned substantive procedures as a result of performing the tests of controls.		MAG		*No exceptions noted during control testing.* *Based on the moderate level of assurance obtained from tests of controls, a lower confidence factor can be used when selecting invoices for confirmation.*
EXTENDED PROCEDURES – for specific fraud risks identified				
E1. Accounts Receivable Confirmations – (fraud risk) a) Verify a sample of names, addresses and fax/telephone numbers of customers selected to telephone or business directories to ensure that they are valid businesses. b) Consider calling some customers in addition to sending a confirmation to verify account details and sales terms/conditions. Ask about any side deals or special terms. c) Consider accepting only original (signed) copies of confirmation or following-up all faxed confirmations with a phone call.	EA	MAG		*No exceptions noted.*
E2. Allowance for Doubtful accounts a) Test a sample of 10 subsequent payments to bank deposits. b) Review all credit memos issued after period end. Consider reviewing customer files or supporting documentation as appropriate. c) Review all write-offs of accounts receivable after period end to ensure these were not doubtful in the prior period.	V	MAG		*No exceptions noted.* *There were 2 credit memos issued after year end but these were not material. The customers returned the items since they were damaged upon arrival. It is not clear whether they were damaged in transport or already damaged when leaving the factory.*

The following exhibit illustrates the test design of a statistical sample for determining the existence and accuracy of the accounts receivable balances. Invoices have been chosen as the source document for selecting the customers chosen for confirmation, as the larger retailers will not confirm actual year-end balances.

A statistical sample (using monetary unit sampling) will be performed to determine the existence of accounts receivable:

Question	Response
Purpose of test	*To ensure the existence of accounts receivable by selecting a sample of receivable balances and sending confirmation letters.*
Risks of material misstatement (RMM) in the relevant assertions	*Existence = Moderate risk* *Accuracy = Low risk*
Population to be tested	*Accounts receivable balances at year end.*
Monetary value of population	*177,203€*
Specific items subject to separate evaluation	*38,340€*
Assurance obtained from testing the operational effectiveness of internal control	*None*
Assurance from other procedures such as risk assessment procedures	*Limited*
Confidence factor to be used (Reduce for assurance gained from other sources)	*Test of controls planned for Revenue/ Receivables/Receipts; therefore, a confidence interval of 75%, or 1.4, will be used.*
Materiality	*15,000€*
Expected deviations in sample	*None*

Estimating the Sample Size
Specific items will be tested separately. There are two related party receivables of 28,340€ and 10,000€ from Kalyani Dephta and Vinjay Sharma respectively that should be confirmed separately.

The remaining accounts receivable balance of 138,863€ (177,203€ - 38,340€) will need to be tested for existence and accuracy using accounts receivable confirmations. Since some customers cannot confirm balances after the fact, accounts receivable confirmations will be based on confirming invoices and:

- Sampling Interval

  Precision (Materiality) ÷ Confidence Factor

  15,000€ ÷ 1.4 (75%) = 10,714€

- Sample Size

  Population to be Tested ÷ Sampling Interval

  Exclude Specific Items Removed for Separate Evaluation

  138,340€ ÷ 10,714€ = 13

Since the sampling units in this population are invoices, the sample consists of 13 invoices to be selected for confirmation plus the two related party transaction balances identified above.

Selecting Invoices to be Tested
To select the invoices and customers for confirmation, the invoices will be chosen using monetary unit sampling. For the remaining accounts receivable balance of 138,340€, a starting point of 913€ was chosen. Using the sampling interval of 10,714€, the 13 invoices were selected.

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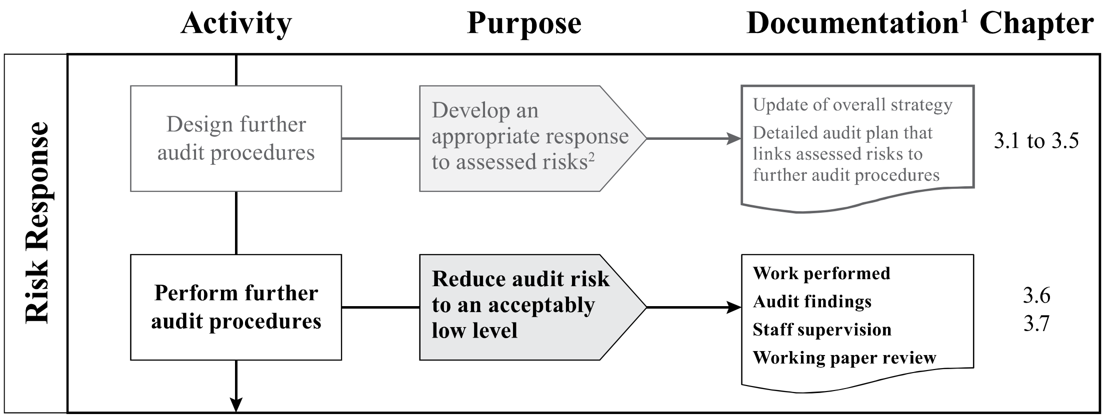
3.6 Documenting Work Performed

Exhibit 3.6-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.

Chapter Purpose	Primary ISA References
To outline the various requirements associated with developing, altering and storing audit documentation.	**230, 300, 315**

3.6.1 Overview

ISA 230 states:

2. **The auditor should prepare, on a timely basis, audit documentation that provides:**
   (a) **A sufficient and appropriate record of the basis for the auditor's report; and**
   (b) **Evidence that the audit was performed in accordance with ISAs and applicable legal and regulatory requirements.**

9. **The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:**
   (a) **The nature, timing, and extent of the audit procedures performed to comply with ISAs and applicable legal and regulatory requirements;**
   (b) **The results of the audit procedures and the audit evidence obtained; and**
   (c) **Significant matters arising during the audit and the conclusions reached thereon.**

12. In documenting the nature, timing and extent of audit procedures performed, the auditor should record the identifying characteristics of the specific items or matters being tested.

16. The auditor should document discussions of significant matters with management and others on a timely basis.

18. If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor should document how the auditor addressed the contradiction or inconsistency in forming the final conclusion.

21. Where, in exceptional circumstances, the auditor judges it necessary to depart from a basic principle or an essential procedure that is relevant in the circumstances of the audit, the auditor should document how the alternative audit procedures performed achieve the objective of the audit, and, unless otherwise clear, the reasons for the departure.

23. In documenting the nature, timing and extent of audit procedures performed, the auditor should record:

(a) Who performed the audit work and the date such work was completed; and

(b) Who reviewed the audit work performed and the date and extent of such review.

25. The auditor should complete the assembly of the final audit file on a timely basis after the date of the auditor's report.

28. After the assembly of the final audit file has been completed, the auditor should not delete or discard audit documentation before the end of its retention period.

30. When the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor should, regardless of the nature of the modifications or additions, document:

(a) When and by whom they were made, and (where applicable) reviewed;

(b) The specific reasons for making them; and

(c) Their effect, if any, on the auditor's conclusions.

31. When exceptional circumstances arise after the date of the auditor's report that require the auditor to perform new or additional audit procedures or that lead the auditor to reach new conclusions, the auditor should document:

(a) The circumstances encountered;

(b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached; and

(c) When and by whom the resulting changes to audit documentation were made, and (where applicable) reviewed.

ISA 300 states:

22. The auditor should document the overall audit strategy and the audit plan, including any significant changes made during the audit engagement.

ISA 315 states:

122. The auditor should document:

(a) The discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, and the significant decisions reached;

(b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment identified in paragraph 20, including each of the internal control components identified in paragraph 43, to assess the risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures;

(c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 100; and

(d) The risks identified and related controls evaluated as a result of the requirements in paragraphs 113 and 115.

ISA 330 states:

73. The auditor should document 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, the linkage of those procedures with the assessed risks at the assertion level, and the results of the audit procedures. In addition, if the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should document the conclusions reached with regard to relying on such controls that were tested in a prior audit.

A number of other ISAs contain specific documentation requirements. The following list provides a reference to the main paragraphs in all the ISAs that set out specific documentation requirements.

Exhibit 3.6-2

ISA	Title	Paragraph
210	Terms of Audit Engagements	5
220	Quality Control for Audits of Historical Financial Information	11–14, 16, 25, 27, 30, 31, 33
230	Audit Documentation	All
240	The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements	60, 107, 108, 109, 110, 111
250	Consideration of Laws and Regulations	28
260	Communication of Audit Matters with Those Charged with Governance	16
300	Planning an Audit of Financial Statements	22–26
315	Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement	122, 123
330	The Auditor's Procedures in Response to Assessed Risks	73, 73a, 73b
505	External Confirmations	33
580	Management Representations	10
600	Using the Work of Another Auditor	14

3.6.2 The Goals of File Documentation

File documentation plays a critical role in the planning and performance of the audit. It provides the record that work was in fact performed and it forms the basis for the auditor's report. It will also be used for quality control reviews, monitoring of adherence to the accounting firm's standards, and possibly inspections by third parties.

Exhibit 3.6-3

The Goals of Documentation	• Supports the basis for the auditor's conclusions concerning every relevant financial statement assertion. • Demonstrates that the engagement complies with professional standards. • Demonstrates that the underlying accounting records agree or reconcile with the financial statements.

To comply with the quality control standards, firms should have policies and procedures that specifically address engagement documentation. These documentation policies should be documented and communicated to all staff.

Audit documentation should also be sufficient to do the following:

- Assist the engagement team in planning and performing the audit;
- Assist reviewers in carrying out their responsibilities in accordance with professional standards;
- Demonstrate that the audit work was performed;
- Record matters of continuing significance for future audits of the entity;
- Enable an experienced auditor to conduct quality control reviews and inspections in accordance with generally accepted auditing standards (refer to ISA 220 and ISQC 1); and
- Enable an experienced auditor to conduct external inspections in accordance with applicable legislation, regulations or other requirements.

Form, Content and Extent of Audit Documentation

Audit documentation should be appropriately organized to provide a clear link to the significant matters.

The Experienced Auditor

The audit documentation should be such that an experienced auditor, who has had no previous connection with the audit, is able to understand (without the need for any verbal explanations):

- The nature, timing, and extent of the audit procedures performed to comply with the applicable legal, regulatory and professional requirements;
- The results of the audit procedures and the audit evidence obtained; and
- The nature of significant matters arising and the conclusions reached.

File Ownership

Unless otherwise specified by legislation or regulation, audit documentation is the property of the audit firm.

Copies of Entity's Records

Abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) may be included as part of audit documentation if considered appropriate. Audit documentation, however, is not a substitute for the entity's accounting records.

3.6.3 Specific Documentation Requirements

Audit documentation should include the documents as outlined in the exhibit below.

Exhibit 3.6-4

Matters to be Addressed	File Documentation	Comments
Risk Assessment	• Pre-engagement procedures. • Independence assessment. • Materiality. • Terms of engagement. • Firm planning and budgeting documents. • Understanding of the entity and its environment. • Design and implementation of internal control relevant to the audit. • Risk assessment procedures to be performed. • Results of risk assessment procedures. • Notes on discussions among the engagement team regarding possible causes of material misstatement due to fraud. • Risks of material misstatement associated with the assertions being tested. • Copy of communications with management and those charged with governance.	Information should be organized appropriately to provide a clear link to the significant findings and issues and be understood by an experienced auditor.

Matters to be Addressed	File Documentation	Comments
Response to Assessed Risks	• The overall audit strategy and the detailed audit plan response setting out the nature, timing, and extent of all the auditing procedures performed. • The nature/characteristics of the specific items selected for examination. There should be enough identifying information that a test could be re-performed if necessary. This also helps to facilitate the investigation of exceptions or inconsistencies. • Matters that give rise to significant risks that need to be specifically addressed in the audit. • Extent of judgment required in performing work and evaluating results. Accounting estimates require greater judgment and accordingly more extensive documentation. • Memoranda, analysis, details of assumptions used and how the validity of the underlying information was established.	Also provide details of how samples were selected, the sampling interval and the confidence factors used. For procedures requiring: • Selection/review of all items over a specific amount Record the scope of the procedure and identify the population. • Inquiries of specific entity personnel Include the dates of the inquiries and the names and job designations of the entity personnel. • Observation Identify the process or subject matter being observed, the relevant individuals and their individual responsibilities, and the date carried out.

Matters to be Addressed	File Documentation	Comments
Results of Performing Audit Procedures And the Audit Evidence Obtained	• Completed audit programs. • Significance of the evidence obtained to the assertion being tested. • A clear explanation of the results obtained from the test and how any exceptions or deviations were followed up. This includes the basis for the test, choice of population, level of assessed risk, sampling intervals, and choice of the starting point. • Results of auditing procedures that indicate a need for: – Modification of planned auditing procedures; – The existence of material misstatements; – Omissions in the financial statements; or – The existence of significant deficiencies or material weaknesses in internal control over financial reporting. • Information that is inconsistent with or contradicts the final conclusions. • Any required engagement completion documents that the firm uses. • Summary of financial effect of all unadjusted errors.	Verbal explanations, on their own, do not represent sufficient support for the work performed or conclusions reached and should be documented in a memorandum. Relevant records to be retained relating to information that is inconsistent with or contradicts the final conclusions include: • Procedures performed in response to the information; and • Records documenting consultations on, or resolutions of, differences in professional judgment among members of the engagement team or between the engagement team and others consulted.
Identification of Preparers and Reviewers	• Details of audit team members, consultants, experts and the engagement quality control reviewer (where applicable); • Who performed the audit work and when; and • Who reviewed the audit documentation and when.	Document who reviewed specific elements of the audit work performed.

Matters to be Addressed	File Documentation	Comments
Significant Matters	• Documentation setting out: – Significant matters; – Actions taken to address them (including additional evidence obtained); and – The basis for the conclusions reached.	This requirement can be met by preparing a memorandum to file that sets out: • The nature of each audit finding/issue; • The various factors that were considered; • Results of performing further work or inquiries; • Verbal discussions/ correspondence/e-mails with management and those charged with governance; and • How the final conclusion was reached. Information already contained elsewhere in the file should be cross-referenced.

Matters to be Addressed	File Documentation	Comments
Reporting	• Significant matters (see discussion above). • Significant changes in the assessed level of audit risk for particular audit areas, and the response to those changes. • Notes of discussions with management and the subsequent responses. • Nontrivial uncorrected misstatements. • If assistance was provided (where permissible under independence requirements) in preparing draft financial statements, describe the nature of discussions held with management to review the content of the statements. This would include: – Dates discussions were held; – Explanations provided on the application of complex accounting principles; and – Major questions raised by management. • File completion checklists. • Copy of the financial statements and the auditor's report cross-referenced to the audit file sections. • Copy of any communication with management and those charged with governance.	Take notes of verbal discussions with management on significant matters and record their responses. Also include copies of relevant e-mails and other supporting documentation as applicable. Document conclusions not readily determinable from earlier documentation.
Key Dates	• Audit report date and the documentation completion date (see discussion on file completion below).	These dates should be documented as part of engagement completion process.

3.6.4 Electronic Documents

Many accounting firms have replaced (or are in the process of replacing) paper-based engagement files with electronic files. In some cases, even though the work was performed and reviewed electronically, paper files are maintained as the permanent record of work performed. Documents/forms were initiated in digital form, client records were scanned electronically, and all data was stored electronically. Only after all the work was completed and reviewed was it printed on paper.

There are two types of electronic document:

- The first is often referred to as "work-in-process"; and

- The second as "static information".

Work-in-process consists of dynamic information that is being developed and updated as the audit progresses. Examples include blank audit forms and letter templates, industry knowledge and key performance indicators, questionnaires, logic trees, firm policies, diagnostics and even previous year's financial data, information and assumptions, etc. that may be used in performing this year's analytical procedures. This information is often contained within software applications and electronic audit tools.

The second type of electronic document, static information, consists of final file documents such as the financial statements and completed working papers that will not change and may well be required for reference in future years. Final or static documents need to be retained in a format where the information can be retrieved easily in later years. Leaving the information in a format used by a software application can be problematic if the software application is updated with a new file format. The old file may not be capable of being opened unless a copy of the old software application is also maintained. To overcome this problem, many firms are now saving their final file documents in a medium called portable document format (PDF). PDF has been accepted and used by government agencies and accounting firms around the world. The firm's policies should state that final documents are not to be edited.

Using Electronic Tools in Working Papers
There are three important principles to note when using electronic tools in working paper preparation:

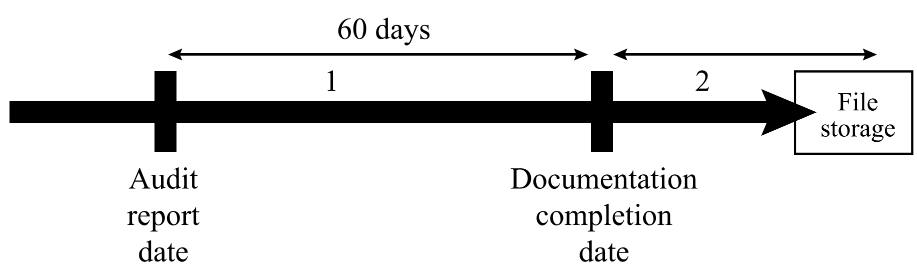
- All the requirements of the ISAs still apply;
- Electronic files require electronic document management. This addresses matters such as accessibility (such as password access), data security, application management (including training), back-up routines, edit rights, storage locations, review procedures, and decisions on what changes to files will be tracked to provide the necessary audit trail; and
- Final documents (all documents that are required to be maintained to support the audit opinion) must be retained and be accessible in accordance with the firm's file retention policies.

3.6.5 File Completion

The dating of the auditor's report signifies that the audit work is complete. After that date, there is no continuing responsibility to seek further audit evidence.

After the audit report date, there is a 60-day period to ensure all the evidence is documented and the audit file assembled and finalized as illustrated in the exhibit below. Refer to ISQC 1 and ISA 230 for more details.

Exhibit 3.6-5



Making Changes to the Audit File

Exhibit 3.6-6

<table>
<tr><th>Period</th><th>Dates</th><th>Requirements</th></tr>
<tr><td>1</td><td>BETWEEN
the audit report date and documentation completion date</td><td>For administrative changes:
• Document nature of audit evidence obtained, who prepared and reviewed each document, and any additional memos to file that may be required;
• Delete or discard superseded documentation;
• Sort, collate, and cross-reference working papers; and
• Sign off any completion checklists relating to the file assembly process.

For changes in the audit evidence or conclusions reached, additional documentation should be prepared that addresses three key questions:
• When and by whom such additions were made, and (where applicable) reviewed;
• The specific reasons for the additions; and
• The effect, if any, of the additions on the audit conclusions.</td></tr>
<tr><td>2</td><td>AFTER
the documentation completion date</td><td>NO documentation should be deleted or discarded from the audit file until the firm's file retention period has expired.

Where it is necessary to make additions (including amendments) to audit documentation after the documentation completion date, the three key questions about changes in audit evidence outlined in the first period above should be answered, regardless of the nature of the additions.</td></tr>
</table>

Storing and Maintaining Documentation

Policies and procedures should be established that maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.

Retaining Documentation

ISQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report. However, these retention periods may need to be longer to comply with local and firm-specific requirements.

Retention procedures should also address:

- **File retrieval**
  How will the firm retrieve and access documentation during the retention period? Consider electronic documentation where technology may have been upgraded or changed over time.
- **Recording of changes**
  How can it be assured that a record will be kept of all additions including amendments made to the engagement documentation after the engagement file has been completed?
- **Access and review**
  What are the procedures to enable authorized external parties to access and review specific engagement documentation for quality control or other purposes?

Case Study — Documenting Work Performed

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Examples of the appropriate file documentation for risk assessment and audit planning are contained in Chapters 2.4 to 2.12 of this Guide.

Sample documentation resulting from the performance of further procedures is outside the scope of this Guide.

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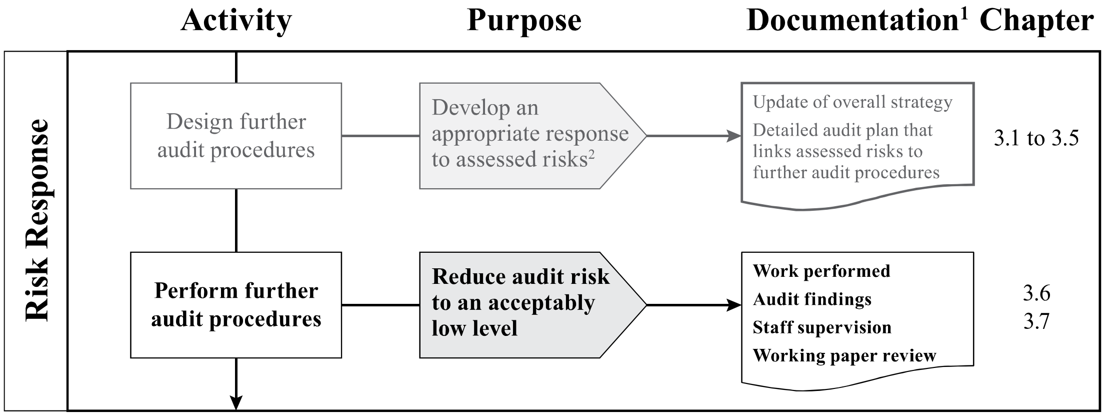
3.7 Management Representations

Exhibit 3.7-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning is a continual and iterative process throughout the audit.

Chapter Purpose	Primary ISA Reference
To provide guidance on: • The use of management representations in supporting sufficient appropriate audit evidence to draw reasonable conclusions on which to base the audit opinion; and • Obtaining written confirmation of management's representations.	**580**

3.7.1 Overview

ISA 580 states:

3. The auditor should obtain audit evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the applicable financial reporting framework, and has approved the financial statements.

4. The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

5a. The auditor should obtain written representation from management that:

(a) It acknowledges its responsibility for the design and implementation of internal control to prevent and detect error; and

(b) It believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as

a whole. A summary of such items should be included in or attached to the written representations.

9. **If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.**

15. **If management refuses to provide a representation that the auditor considers necessary, this constitutes a scope limitation and the auditor should express a qualified opinion or a disclaimer of opinion.**

During the course of the audit, management will make a number of representations to the auditor, verbal and written, that can be used as audit evidence to complement other audit procedures.

Management representations are not to be used as:

- A substitute for performing other audit procedures; or
- As the sole source of evidence on significant audit matters.

3.7.2 Forms of Management Representations

Management representations may be:

- Verbal, whether solicited or unsolicited; or
- Written, whether explicitly such as contained in a management representation letter or implicitly such as contained in financial information provided.

Exhibit 3.7-2

Forms of Management Representations	• Matters communicated in discussions. • Matters communicated electronically such as e-mails or telephone messages. • Schedules, analyses, and reports prepared by the entity, and management's notations and comments therein. • Internal and external memoranda or correspondence. • Minutes of meetings of those charged with governance and compensation committees. • Signed copy of the financial statements. • Representation letter from management.

Whatever form the representation takes, it should be documented in the audit file. This documentation will take the form of:

- Memoranda of discussions with management; or
- Written representations received from management.

3.7.3 Considerations in Performing the Audit

Exhibit 3.7-3

Evaluating Management Representations	
Matters to Consider	Can the person making the representation be expected to be objective and knowledgeable on the subject matter?
	Is the representation reasonable in light of: • The auditor's understanding of the entity and its environment? • Other evidence obtained, including other representations obtained from management? • Other evidence obtained through the performance of audit procedures to achieve other audit objectives?
	What further audit procedures are required to corroborate the representations? For corroborating management intent, consider sources of evidence such as board minutes, minutes of investment committees, legal documents, or internal correspondence and e-mails. For example, as part of the auditor's consideration of going concern, "substantiating" evidence would include inspection of board minutes, legal documents and availability of funding information, etc. Where corroborating evidence is not available, is there a scope limitation?
	If other evidence obtained contradicted management representation, determine what further procedures should be performed to support or refute the representation.
	Where management representations have been contradicted by other audit evidence obtained: • Is there reason to doubt management's honesty and integrity? If yes, the auditor would discuss the matter with those charged with governance and consider the impact on the risk assessment and the need for further audit procedures. • Is continued reliance on any other of management's representations appropriate and justified?
	Consider the most appropriate means of documenting the representation. For example: • A memorandum created by the auditor; • A written memorandum created by the client; and • Inclusion in the management representation letter.

Required Written Representations

Written confirmation should be obtained for all significant representations provided to the auditor for all financial statements on which the auditor reports.

The purpose of obtaining written representations from management is to:

- Confirm representations provided either explicitly or implicitly during the audit;
- Indicate and document the continuing appropriateness of such representations; and
- Reduce the possibility of misunderstanding concerning the matters that are the subject of the representations.

Exhibit 3.7-4

Matters to be Included in the Management Representation Letter	• Representations that directly relate to items that are material, either individually or in aggregate, to the financial statements. • Representations not directly related to items that are material to the financial statements but are significant, either individually or in aggregate, to the engagement. • Representations that are relevant to management's judgments or estimates that are material, either individually or in aggregate, to the financial statements.

Management's responsibility to provide written representations is included in the engagement letter that sets out the terms of engagement. Refer to Chapter 2.3 of this Guide.

Prior to the audit, there should be communication with management and those charged with governance that sets out a summary of the overall audit strategy. This should address the concept of materiality as relevant to the written representations and state that management's representations are:

- Integral to the audit evidence obtained; and
- Required in writing to support the content of the audit report.

3.7.4 Obtaining Written Representations

A written confirmation should be obtained from management that the representations provided during the course of the audit are effective as of the date of the audit report. Management's written confirmation is usually in the form of a letter addressed to the auditor and may contain matters such as outlined in the sample management representation letter in the case study materials in this chapter.

Because events and transactions up to the date of the audit report may require adjustment to or disclosure in the financial statements, ensure that:

- Management's written representations are not signed prior to the date of the audit report; and
- Management's written representations are obtained after substantial completion of the examination but before the release of the audit report.

When subsequent events have occurred, additional written representations would be obtained.

Management's representation letter should be signed by members of management who have overall responsibility for financial and operating matters and who are knowledgeable about the matters covered by the representations. This would normally include the owner-manager or the senior executive officer, senior financial officer, or equivalent.

Tailored Representations

The written representations should be tailored to reflect specific matters relating to the entity's business or industry and to the engagement.

When relevant, the tailored written representations might also include:

- Knowledge of liabilities or contingencies arising from environmental matters;
- Appropriate recognition, measurement and disclosure of environmental matters in the financial statements;
- Appropriate determination, accounting for and disclosure in the financial statements of the costs, assets, and obligations associated with employee future benefits;
- Information regarding transactions and events pertaining to derivative financial instruments; and
- The appropriateness of accounting policies and the application thereof for complex areas of accounting and areas involving management's judgment and estimates.

Comparatives

When comparative financial statements are covered by the auditor's report, written representations should be obtained (as of the date of the current auditor's report) for all the periods covered.

Refusal by Management to Sign

Refusal by management to provide a written representation requested by the auditor (and that the auditor deems necessary) constitutes a scope limitation and would result in a qualified opinion or a disclaimer of opinion. In such circumstances, also consider:

- Any reliance placed on other representations made by management during the audit; and
- Any additional implications of the refusal on the auditor's report.

Example of a Management Representation Letter

The example of a management representation letter found in the case study materials that follows is contained in ISA 580. It is not intended to be a standard letter, as representations by management will vary from one entity to another and from one period to the next.

Case Study — Management Representations

For details of the case study, refer to the Introduction to the Case Study in this Guide.

The following are examples of management representations by Suraj and some further audit procedures that could apply.

Management Representation	Evaluation
There is no impairment in the fixed assets (tools) that have been superseded by new machinery. This is because the machines break down. With expansion, these tools may still be needed in any case.	Make inquiries of the production manager and others to determine whether the tools will ever be used and if, in fact, they are still operable. This could be established by physical examination and review of maintenance records.
There is no additional provision required for the slightly damaged goods identified during the inventory count.	Check whether the damaged goods were in fact sold after the year end. Inquire with the production manager whether damaged goods are sold "as is", repaired (if so, at what cost), or sold for a discounted price.

At the conclusion of the audit, important representations would be documented in a management representation letter that would be signed by Suraj Dephta and Jawad Kassab.

Such representations might be included in a letter as follows.

Dephta Furniture Inc. Letterhead

(Date)

To Sang Jun Lee
Jamel, Woodwind & Wing LLP

Dear Sirs

This representation letter is provided in connection with your audit of the financial statements of Dephta Furniture Inc. for the year ended December 31, 20X6 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of Dephta Furniture Inc. as of December 31, 20X6 and of the results of its operations and its cash flows for the year then ended in accordance with (indicate applicable financial reporting framework).

We acknowledge our responsibility for the fair presentation of the financial statements in accordance with (indicate applicable financial reporting framework). We confirm, to the best of our knowledge and belief, the following representations:

1. There have been no irregularities involving management or employees who have a significant role in internal control or that could have a material effect on the financial statements.
2. We have made available to you all books of account and supporting documentation.
3. We confirm the completeness of the information provided regarding the identification of related parties.
4. The financial statements are free of material misstatements, including omissions.
5. The Company has complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance.
6. There has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance.
7. The following have been properly recorded and, when appropriate, adequately disclosed in the financial statements:
   - The identity of, and balances and transactions with, related parties.
   - Losses arising from sale and purchase commitments.
   - Agreements and options to buy back assets previously sold.
   - Assets pledged as collateral.

8. We have no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements.
9. We have no plans to abandon lines of product or other plans or intentions that will result in any excess or obsolete inventory, and no inventory is stated at an amount in excess of net realizable value.
10. The Company has satisfactory title to all assets and there are no liens or encumbrances on the company's assets, except for those that are disclosed in Note X to the financial statements.
11. We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent, and have disclosed in Note X to the financial statements all guarantees that we have given to third parties.
12. There have been no events subsequent to period end which require adjustment of or disclosure in the financial statements or Notes thereto.
13. There has been no impairment in the net realizable value of fixed assets (tools) whose functionality has now been superseded by new machinery.
14. There are no formal or informal compensating balance arrangements with any of our cash and investment accounts. Except as disclosed in Note X to the financial statements, we have no other line of credit arrangements.
15. We have properly recorded or disclosed in the financial statements the capital inventory conversions and other requirements.

Yours truly,

____

Suraj Dephta

Managing Director

____

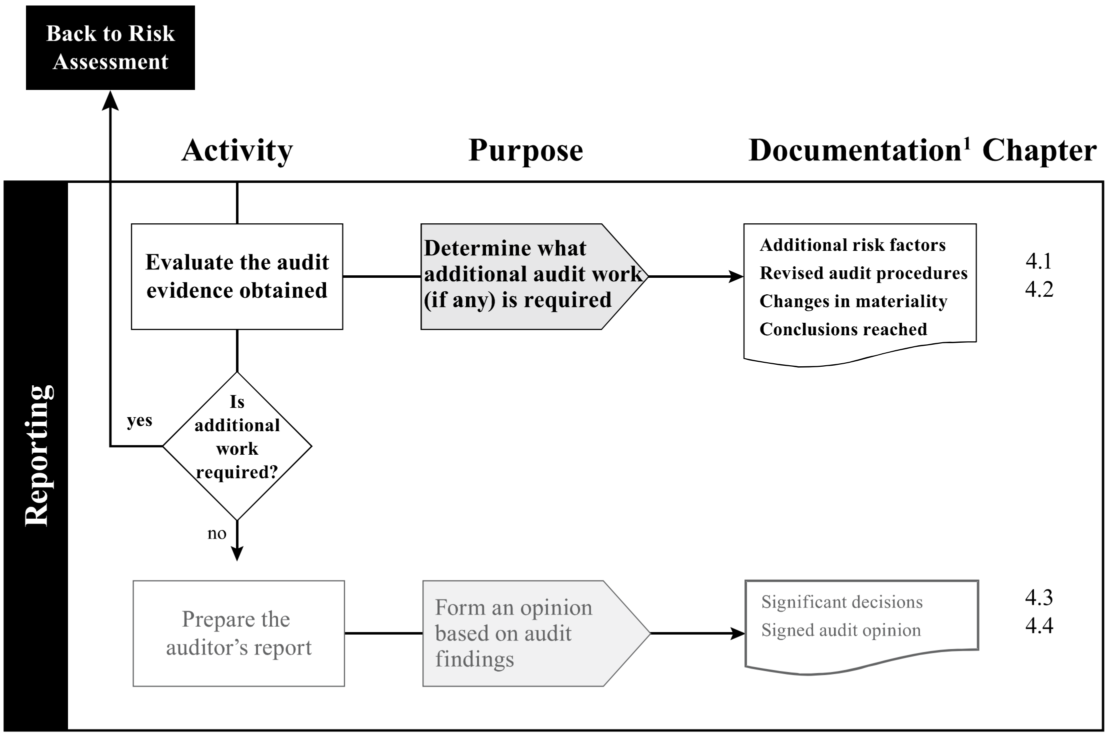
Jawad Kassab

Finance

Part D
Reporting

4.1 Evaluating Audit Evidence

Exhibit 4.1-1



Note:
1. Refer to ISA 230 for a more complete list of documentation required.

Chapter Purpose	Primary ISA References
To provide guidance on evaluating the sufficiency and appropriateness of audit evidence to enable the auditor to draw reasonable conclusions on which to base the audit opinion.	**220, 330, 520, 540**

4.1.1 Overview

ISA 220 states:

21. The engagement partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the auditor's report that is issued to be appropriate in the circumstances.

26. Before the auditor's report is issued, the engagement partner, through review of the audit documentation and discussion with the engagement team, should be satisfied that sufficient appropriate audit evidence has been

obtained to support the conclusions reached and for the auditor's report to be issued.

38. An engagement quality control review should include an objective evaluation of:

(a) The significant judgments made by the engagement team; and

(b) The conclusions reached in formulating the auditor's report.

ISA 320 states:

12. In evaluating whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material.

15. If management refuses to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should consider the appropriate modification to the auditor's report in accordance with ISA 701, "Modifications to the Independent Auditor's Report."

ISA 330 states:

66. Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.

70. The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risk of material misstatement in the financial statements.

72. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or a disclaimer of opinion.

ISA 520 states:

13. The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.

ISA 540 states:

24. The auditor should make a final assessment of the reasonableness of the entity's accounting estimates based on the auditor's understanding of the entity and its environment and whether the estimates are consistent with other audit evidence obtained during the audit.

4.1.2 The Goals in Evaluating Audit Evidence

The goals in evaluating audit evidence are to decide, after considering all relevant data obtained, whether:

- The assessments of the risks of material misstatement at the assertion level are appropriate; and
- Sufficient evidence has been obtained to reduce the risks of material misstatement (RMM) in the financial statements to an acceptably low level.

An audit is an ongoing, cumulative, and iterative process of gathering and evaluating evidence. This requires an attitude of professional skepticism to be applied by each member of the audit team, ongoing discussions throughout the engagement and making timely modifications to planned procedures to reflect any changes to the original assessment of risk. This will help to reduce the risk of:

- Overlooking suspicious circumstances;
- Over-generalizing when drawing conclusions; and
- Using faulty assumptions in planning or modifying audit procedures.

When misstatements or deviations are found in planned procedures, consideration should be given to the following:

- Reason for the misstatement or deviation:
  - Are there indicators or warning signals of possible fraud?
  - Do the misstatements/deviations indicate a previously unidentified risk or weakness in internal control that could be material?
- Impact on risk assessments and other planned procedures.
- Need to modify or perform further audit procedures.

In addition, analytical procedures performed at the overall review stage of the audit may indicate previously unrecognized risks of material misstatement.

4.1.3 Materiality

Before evaluating the results of performing procedures and any misstatements arising, consideration should be given to whether the established materiality levels need to be revised as a result of:

- New information, such as actual financial results being substantially different from those anticipated;
- A change in the understanding of the entity and its operations; or
- New circumstances.

If a revision is necessary, consider the impact on assessed risks and further audit procedures.

This relates to materiality level for the financial statements as a whole and materiality levels for a particular class of transactions, account balance or disclosure. Refer to Chapter 2.5 for more detail.

Changes to the Original Assessment of Risk

The original assessment of risk at the assertion level will have been based on audit evidence available before performing the planned tests of controls or substantive procedures. As a result of performing the planned tests, information may be obtained that will require the original risk assessment to be modified.

For example, in the audit of inventories, the assessed level of risk for the completeness assertion may be low, based on an expectation that internal control is operating effectively. If the tests of controls find the internal control is not effective, the risk assessment should be changed and further audit procedures performed to reduce the risk to an acceptably low level. The same is true for other audit procedures where the results do not match the expectations.

Some points to consider in determining whether the original assessment of risk has changed or not are outlined in the exhibit below.

Exhibit 4.1-2

Evaluating Possible Changes to Assessed Risks of Material Misstatement (RMM)	
Internal Control	• Tests of controls Do the results of performing tests of controls support the planned level of risk reduction based on their operating effectiveness? • Management override Is there any evidence of management override of existing internal control? • Control weaknesses Does a potential misstatement(s) result from a weakness in internal control that should be immediately brought to management's attention?
Nature of Audit Evidence Obtained	• New risk factors Does the evidence identify any new business risks, fraud risk factors or management override? • Contradictory evidence Does the evidence obtained contradict other sources of information available? • Conflicting evidence Does the evidence obtained conflict with the current understanding of the entity? • Accounting policies Is there evidence that the entity's accounting policies are not always consistently applied? • Unpredictable relationships Does the evidence substantiate predictable relationships among financial and non-financial data?

Evaluating Possible Changes to Assessed Risks of Material Misstatement (RMM)	
	• Fraud Is there evidence of any patterns, oddities, exceptions or deviations found in performing tests that could be indicative of possible fraud (including management override) occurring? • Reliability of representations Is there evidence that questions the reliability of representations made by management or those charged with governance?
Nature of Misstatements	• Bias in estimates Could misstatements found in accounting estimates and fair value measurements indicate a possible pattern of bias by management? • Misstatements Do misstatements either individually or combined with all other uncorrected misstatements constitute a material misstatement in the financial statements taken as a whole?

Where the original assessment of risk has changed, the details should be documented and a revised assessment of risk determined. There should also be details of how the detailed audit plan has been changed to address the revised risk assessment. This may be a modification to the nature, timing, or extent of other planned audit procedures or performance of further audit procedures.

Consider Point

Allocate some time in the audit budget for the audit engagement team to discuss their findings (as a group) immediately after the work is completed. The matters outlined in the above exhibit could form the agenda. Remember that the detection of fraud often comes from piecing together information about small and seemingly insignificant matters.

4.1.4 Sufficient Appropriate Audit Evidence

The objective is to obtain sufficient appropriate evidence to reduce the risks of material misstatement in the financial statements to an acceptably low level.

What constitutes sufficient appropriate audit evidence is ultimately a matter of professional judgment. It will be primarily based on the satisfactory performance of further audit procedures designed to address the assessed risks of material misstatement. This includes any additional or modified procedures that were performed to address changes identified in the original assessment of risk.

Some of the factors to consider in evaluating the sufficiency and appropriateness of audit evidence include the factors outlined in the exhibit below.

Exhibit 4.1-3

Evaluating the Sufficiency and Appropriateness of Audit Evidence	
Factors to Consider	• Materiality of misstatements How significant is a misstatement in the assertion being addressed and what is the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements? • Management responses How responsive is management to audit findings and how effective is the internal control in addressing risk factors? • Previous experience What has been the previous experience in performing similar procedures and were any misstatements identified? • Results of performed audit procedures Do the results of performed audit procedures support the objectives and is there any indication of fraud or error? • Quality of information Are the source and reliability of the available information appropriate for supporting the audit conclusions? • Persuasiveness How persuasive (convincing) is the audit evidence? • Understanding the entity Does the evidence obtained support or contradict the results of the risk assessment procedures (which were performed to obtain an understanding of the entity and its environment including internal control)?

If it is not possible to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or a disclaimer of opinion.

4.1.5 Final Analytical Procedures

In addition to performing analytical procedures for the purposes of risk assessment and then later as a substantive procedure, there is a requirement in ISA 520 to apply analytical procedures at or near the end of the audit when forming an overall conclusion.

The purpose is to:

- Identify a previously unrecognized risk of material misstatement;
- Ensure the conclusions formed during the audit on individual components or elements of the financial statements can be corroborated; and
- Assist in arriving at the overall conclusion as to the reasonableness of the financial statements.

If new risks or unexpected relationships between data are identified, the auditor may need to re-evaluate the audit procedures planned or performed.

Evaluating Misstatements
The objective of evaluating misstatements is to assess whether the financial statements are misstated by a material amount. In making this assessment, the auditor should give consideration to the possibility of similar undiscovered misstatements that may require investigation. This recognizes that a particular misstatement may not be an isolated occurrence.

Exhibit 4.1-4

Misstatements may Arise as a Result of the Following	
Performing Audit Procedures Some matters may be identified as a result of performing specific audit procedures on non-representative samples. This would also include significant unexplained differences from an analytical procedure.	**Projecting Sample Results** To arrive at the likely aggregate misstatement, it is necessary to project misstatements identified in a representative sample (whether corrected or not) over the population sampled.
Disagreements with Accounting Estimates The entity's estimate may fall outside the acceptable range (determined by the auditor) for that particular estimate. This also includes disagreements with respect to the fair value of those assets, liabilities, and components of equity required to be measured or disclosed at fair values.	**Uncorrected Misstatements in Opening Equity** If uncorrected misstatements exist from prior periods that affect equity, bring them forward (adjust opening equity) as they may affect income in the current period.
Financial Statement Presentation or Disclosures Omitted, incomplete, or inaccurate financial statement disclosures or a presentation not in accordance with the applicable financial reporting framework.	

Specific misstatements identified by audit procedures, including other routine period-end adjusting entries required, should be discussed with management. Management should then be requested to make the appropriate adjustments to the accounting records.

Other types of misstatement might include the misclassification of amounts in the financial statements, the projection of deviations in a representative sample, or a qualitative type of misstatement. These misstatements should also be discussed with management and a request made for the appropriate type of action to be taken, such as correcting the financial statements or rectifying inadequate disclosure.

Aggregating Possible Misstatements
Misstatements identified during the audit, other than those that are clearly trivial, should be aggregated. They can also be distinguished between factual misstatements, judgmental misstatements, and projected misstatements.

Most quantitative misstatements can be aggregated so that the overall impact on the financial statements can be evaluated. However, some misstatements (such as incomplete or inaccurate financial statement disclosures) and qualitative findings (such as the possible existence of fraud) cannot be aggregated. These misstatements should be documented and evaluated on an individual basis.

To enable the aggregate effect of uncorrected misstatements to be evaluated, they should be documented on a centrally maintained working paper. This will provide a summary of all non-trivial uncorrected misstatements that have been identified. Normal (routine) closing entries should not be included.

There are a number of stages in the aggregation process where the impact of aggregated misstatements can be considered. These include:

- Impact on each particular account balance or class of transactions;
- Impact on total current assets and current liabilities;
- Impact on total assets and liabilities;
- Impact on total revenues and expenses (pre-tax income); and
- Impact on net income.

A possible approach to the aggregation of misstatements is illustrated in the exhibit below.

Note: The level of misstatements (100€) has been deemed trivial and will therefore not be accumulated.

Exhibit 4.1-5

Summary of Possible Adjustments

			Impact on Financial Statements Amount of Over (Under) Statement					
Description	**Origin**	**W/P Ref.**	**Total Assets**	**Total Liabilities**	**Working Capital**	**Pre tax Income**	**Income Tax**	**Net Income**
Failure to accrue for rent liability	Factual resulting from oversight			(5,500)	5,500	5,500	1,375	4,125
Unrecorded sales	Projection from representative sample		(12,500)		(12,500)	(12,500)	(3,125)	(9,375)
Receivables netted with payables	Factual – Classification error		(5,500)	(5,500)				
Capital equipment expensed	Judgment – Error in applying accounting policy		(13,500)			(13,500)	(3,375)	(10,125)
Possible adjustments in the current year			(31,500)	(11,000)	(7,000)	(20,500)	(5,125)	(15,375)
Amounts unadjusted in prior years						0	0	0
Total possible adjustments for discussion with management			(31,500)	(11,000)	(7,000)	(20,500)	(5125)	(15,375)
Less: adjustments made by management			(31,500)	(11,000)	(7,500)	(20,500)	(5,125)	(15,375)
Likely Aggregate Misstatement			—	—	—	—	—	—

Correction of Misstatements

If the aggregate of misstatements accumulated during the audit approaches the materiality level or levels, consideration should be given as to whether the overall audit strategy and detailed audit plan need to be revised. This may be achieved as follows:

- Arrange for management to recheck certain areas where the perceived risks exist and correct the financial statements based on findings;
- Perform further audit procedures; or
- Have management address identified and likely misstatements.

In forming a conclusion as to whether the uncorrected misstatements, individually or in aggregate, cause the financial statements as a whole to be materially misstated, the auditor should consider the following factors:

- The size and nature of misstatements, in relation to:
  - The financial statements as a whole;
  - Particular classes of transactions, account balances and disclosures; and
  - The particular circumstances of their occurrence.
- The limitations inherent in judgmental or statistical testing. There is always the possibility that some misstatements may not be found.
- How close is the likely level of aggregate misstatement to the established materiality level(s)? The risks of material misstatement increase as the likely aggregate misstatement approaches the materiality threshold.
- Quantitative considerations or the possibility of fraud where misstatements of a relatively small amount could have a material effect on the financial statements.
- The effect of uncorrected misstatements related to prior periods.

It is management's responsibility to adjust the financial statements to correct material misstatements (including inadequate disclosures) and to implement any other actions required.

Management's responsibility should be evidenced by obtaining a written representation from management. This could state that any uncorrected misstatements (attach or include a list) are, in management's opinion, immaterial, both individually and in the aggregate. If management disagrees with the assessment of misstatements, they may add to their written representation words such as:

"We do not agree that items ... and ... constitute misstatements because [description of reasons]."

If management refuses to correct some or all of the misstatements:

- Obtain an understanding of management's reasons for not making the corrections; and
- Take this into account when evaluating whether the financial statements as a whole are free from material misstatement.

Consideration should also be given to whether the misstatements result from weaknesses in internal control that should be discussed with management or those charged with governance. For more information on such communications, refer to Chapter 4.2.

4.1.6 Significant Findings and Issues

The final step in the evaluation process is to record all the significant findings or issues in an engagement completion document. This document may include:

- All information necessary to understand the significant findings or issues; or
- Cross-references, as appropriate, to other available supporting audit documentation.

This document would also include conclusions about information the auditor has identified relating to significant matters that is inconsistent with or contradicts the auditor's final conclusions.

Note: This does not extend to retention of documentation that is incorrect or superseded, such as drafts of financial statements that may have been incomplete.

Case Study — Evaluating Audit Evidence

For details of the case study, refer to the Introduction to the Case Study in this Guide.

As a result of performing the planned audit procedures at Dephta Furniture, the following matters were noted.

Note: The planned responses may include additional risk assessment procedures or further audit procedures to address already identified risks.

Audit Finding	Planned Response
A number of clerical errors in the inventory valuation resulted in an understatement of 19,000€ worth of inventory.	*The nature of the errors should be reviewed to identify any area of weakness in internal control.* *Additional work should be performed to ensure all significant errors have now been discovered.* *Include comment in management letter.*
During expense testing, it was discovered that 4,800€ of equipment maintenance expenses were related to the service costs of Suraj's personal Mercedes-Benz SUV.	*Additional work should be performed to identify any other unidentified transactions that relate to personal use. If others are found, consider whether this is a lapse in management's integrity and an indicator of possible fraud.*
The testing of controls on sales failed since 3 invoices (amounting to 3,116€) in the sample of 10 items could not be found. Apparently, they were inadvertently destroyed.	*This is a highly unusual situation. Additional inquiries should be made to determine what exactly happened. Based on the findings, consideration should be given to alternative procedures to address the underlying assertions.*
Some of the tools and equipment in the accounting records do not seem to be used anymore. Machines have been purchased that do the same work in a fraction of the time. Management still feels the assets have value, as they would still be used in the event of a machine breakdown.	*Inquire whether the tools and equipment were, in fact, used in the past year.* *Determine the capital cost of the tools and equipment and whether a write-down is required.*

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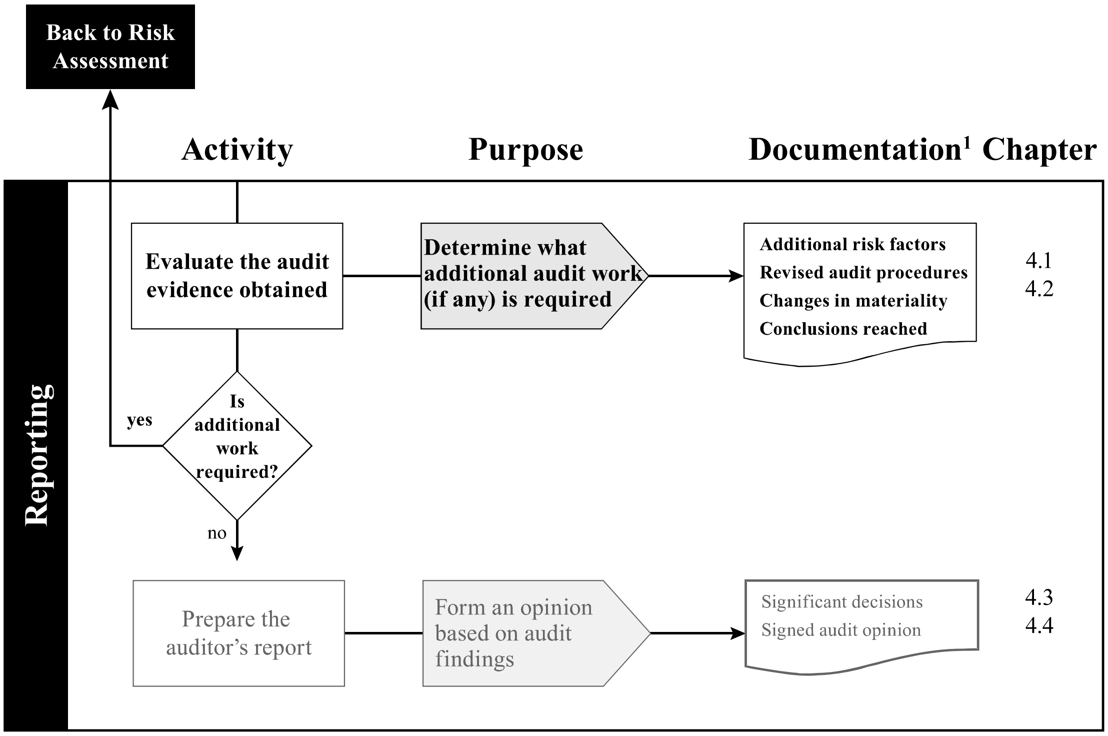
4.2 Communicating with Those Charged with Governance

Exhibit 4.2-1



Note:
1. Refer to ISA 230 for a more complete list of documentation required.

Chapter Purpose	Primary ISA Reference
To provide guidance on how to communicate audit findings and other matters with those charged with governance.	**260**

4.2.1 Overview

ISA 260 states:

2. **The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity.**

5. **The auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated.**

11. **The auditor should consider audit matters of governance interest that arise from the audit of the financial statements and communicate them with those charged with governance.**

11a. The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

13. The auditor should communicate audit matters of governance interest on a timely basis.

ISA 320 states:

17. If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with ISA 260 "Communication of Audit Matters with Those Charged with Governance."

This section outlines the auditor's responsibility to communicate audit findings and other matters with those charged with governance. ISA 260 does not establish requirements regarding the auditor's communication with an entity's management or owner-managers unless they are also charged with a governance role.

In smaller entities, management and those charged with governance may well be the same person(s). In other cases it may not be clear who is management and who is charged with governance. In these cases, the auditor should come to an agreement with the entity about who should be the person(s) to whom audit matters of governance interest are to be communicated (such as the owner-manager). The key is to ensure that all of those with whom the auditor would otherwise communicate in their governance capacity have indeed been informed.

The objective of communicating with those charged with governance is to:

- Outline the responsibilities of the auditor in relation to the financial statement audit, and the scope and timing of the audit;
- Obtain information relevant to the audit; and
- Provide timely observations arising from the audit that are relevant to their responsibility to oversee the financial reporting process.

Governance

Governance is the term used to describe the role of persons entrusted with the supervision, control and direction of an entity.

Those charged with governance ordinarily are accountable for:

- Ensuring that the entity achieves its objectives, with regard to reliability of financial reporting;
- Effectiveness and efficiency of operations;
- Compliance with applicable laws; and
- Reporting to interested parties.

Members of management would be included as part of those charged with governance when they perform functions such as outlined above.

4.2.2 Audit Matters of Governance Interest

Audit matters of governance interest arise from the audit of financial statements. They include only those matters that have come to the attention of the auditor as a result of the performance of the audit. However, the decision about what to communicate is not always a simple matter. An audit may bring about situations and discoveries that call for professional skepticism, judgment and prudence in deciding what to communicate.

The auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest unless specifically requested or required by country-specific auditing standards or by legislation.

In some cases, local requirements may impose obligations of confidentiality that restrict the auditor's communications of audit matters of governance interest. The auditor should refer to such requirements, laws or regulations before communicating with those charged with governance.

Engagement Letter

To avoid misunderstandings, the audit engagement letter may outline:

- That only those matters of governance interest that come to the auditor's attention as a result of the performance of an audit will be communicated. Then, describe the form in which any communications on audit matters of governance interest will be made;
- The relevant persons with whom such communications will be made; and
- Any specific audit matters of governance interest which it has been agreed are to be communicated.

Timeliness

Ensure that audit matters of interest are communicated on a timely basis so that those charged with governance can take appropriate action.

Consider Point

Take the time to develop constructive working relationships with those charged with governance. This will help to improve the effectiveness of communications between the parties.

4.2.3 Nature and Form of Communications

Except where a matter relates to management competence or integrity, the auditor would initially discuss audit matters of governance interest with management. These initial discussions serve to clarify the facts and issues and give management an opportunity to provide further information. Although many of these interactions with management will be verbal, it is advisable to document details of meetings/discussions held where significant matters were discussed. These notes will then become an important part of the audit evidence.

Audit matters of governance interest that would normally be communicated (preferably in writing) are outlined below.

Exhibit 4.2-1

Audit Matters	Communication Considerations
Overall Audit Strategy	The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements.
Accounting Policies	The selection of (or changes in) significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements.
Prior Period Communications	Matters of governance interest previously communicated that could have an effect on the current year's financial statements.
Risks of Material Misstatement	The potential effect on the financial statements of any material risks (such as pending litigation) that require disclosure in the financial statements.
Material Uncertainties	Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern.
Disagreements with Management	Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter.
Entity Management	This includes: • Questions regarding management competence; • Material weaknesses in internal control; • Questions regarding management integrity; • Significant transactions with related parties; • Illegal acts; and • Fraud involving management.
Audit Adjustments	Uncorrected audit adjustments that have, or could have, a material effect on the entity's financial statements.
Uncorrected Misstatements	Uncorrected misstatements that were determined by management to be immaterial (other than trivial amounts), both individually and in the aggregate, to the financial statements taken as a whole.

Audit Matters	Communication Considerations
The Auditor's Report	Outline the reasons for any expected modifications to the auditor's report.
Agreed-upon Matters	Any other matters agreed upon in the terms of the audit engagement.

The communications outlined above may not address specific legal, regulatory, or other requirements that may apply to a particular entity.

A common way to communicate with those charged with governance is to prepare a letter that outlines the matters of interest. This letter provides a record that matters have indeed been communicated.

When matters are communicated verbally, details of the discussion should still be documented for the working papers. This document should outline the matters communicated and any responses to those matters.

Case Study — Communicating with Those Charged with Governance

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Audit Matters of Governance Interest
Extract from the letter sent to management and shareholders:

JAMEL, WOODWIND & WING LLP
55 Kingston St, Cabetown, United Territories 123-50004

(Date)

Mr. Suraj Dephta, Managing Director
Dephta Furniture
2255 West Street
North Cabetown
United Territories
123-50214

Dear Mr. Dephta

The matters raised in this report arise from our financial statement audit and relate to matters that we believe need to be brought to your attention.

We have substantially completed our audit of Dephta Furniture's financial statements in accordance with professional standards. We expect to release our audit report dated April 25, 20X6 as soon as we obtain the signed letter of representation.

Our audit is performed to provide reasonable assurance whether the financial statements are free of material misstatements. Absolute assurance is not possible because of the inherent limitations of internal control, the fact we do not test 100% of transactions and that much of the audit evidence available to us is persuasive, rather than conclusive.

In planning our audit, we consider internal control over financial reporting to determine the nature, extent and timing of audit procedures. However, a financial statement audit does not provide assurance on the effective operation of internal control at Dephta Furniture. However, if in the course of our audit, certain deficiencies in internal control come to our attention, these will be reported to you. Please refer to Appendix A[1] to this letter.

Because fraud is always deliberately concealed, there are always risks that material misstatements, fraud and other illegal acts may exist and not be detected by our audit of the financial statements.

[1] The appendices to the letter have not been included in the case study materials.

The following is a summary of our audit findings.

1. We did not identify in the course of our financial statement audit:
   - Any significant unusual transactions;
   - Any illegal acts or possibly illegal acts;
   - Any material weaknesses in the design, implementation or operating effectiveness of internal control over financial reporting, including anti-fraud controls, other than those outlined in Appendix A to this letter;
   - Any related-party transactions outside the normal course of business;
   - Any accounting policies in controversial or emerging areas;
   - Any material changes in selection or application of accounting policies;
   - Any consultations by management with other accountants regarding accounting or auditing matters;
   - Matters that pose questions regarding the honesty and integrity of management;
   - Fraud or suspected fraud involving management;
   - Fraud or suspected fraud involving employees who have significant roles in internal control over financial reporting;
   - Fraud or suspected fraud (whether caused by management or other employees) that results, or may result, in a non-trivial misstatement of the financial statements; or
   - Matters that may cause future financial statements to be materially misstated.
2. The financial statements contain a number of significant estimates/judgments, which include:
   - Valuation of accounts receivable;
   - Valuation of inventory;
   - Valuation and amortization period for fixed assets;
   - Accrued liabilities; and
   - Expense allocations.

No misstatements in the financial statements were identified during the audit, other than those adjustments identified and discussed with you in Appendix B to this letter.

We received good cooperation from management and employees during our audit. To the best of our knowledge, we also had complete access to the accounting records and other documents that we needed in order to carry out our audit. We did not have any disagreements with management, and we have resolved all auditing, accounting and presentation issues to our satisfaction.

We would also like to draw the following matters to your attention:

- Changes during the year in professional pronouncements. See Appendix C.
- Other matters identified that may be of interest to management. See Appendix D. Please note that the objective of an audit is to obtain reasonable assurance whether the financial statements are free of material misstatement. It is not specifically designed to identify matters that may be of interest to management. Accordingly, an audit would not usually identify all such matters.

This communication is prepared solely for the information of management and is not intended for any other purpose. We accept no responsibility to a third party who uses this communication.

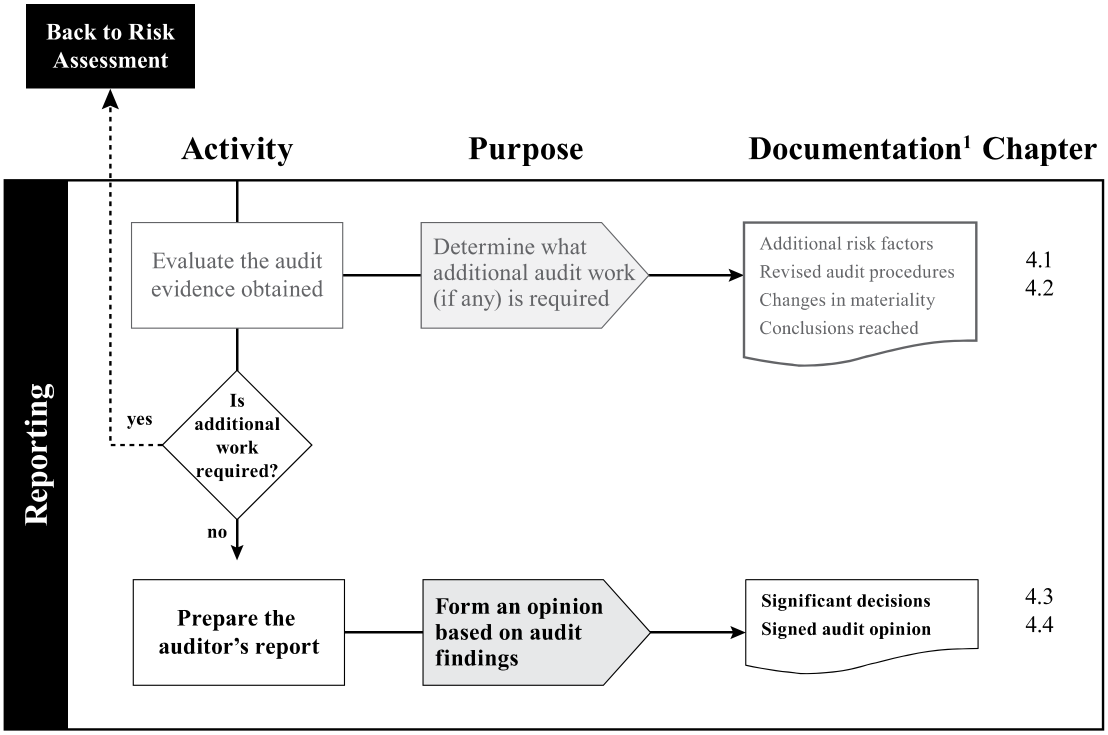
Yours truly,

____

Sang Jun Lee
Jamel, Woodwind & Wing LLP

4.3 The Auditor's Report

Exhibit 4.3-1



Note:
1. Refer to ISA 230 for a more complete list of documentation required.

Chapter Purpose	Primary ISA References
To provide an outline of the requirements and considerations related to forming an opinion on the financial statements and preparing an appropriately worded auditor's report.	**700, 710**

4.3.1 Overview

ISA 700 states:

> **4. The auditor's report should contain a clear expression of the auditor's opinion on the financial statements.**
>
> **11. The auditor should evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements.**
>
> **38. The auditor's report should state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.**

39. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

40. When expressing an unqualified opinion, the opinion paragraph of the auditor's report should state the auditor's opinion that the financial statements give a true and fair view or present fairly, in all material respects, in accordance with the applicable financial reporting framework (unless the auditor is required by law or regulation to use different wording for the opinion, in which case the prescribed wording should be used).

41. When International Financial Reporting Standards or International Public Sector Accounting Standards are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion should identify the jurisdiction or country of origin of the financial reporting framework.

48. When the auditor addresses other reporting responsibilities within the auditor's report on the financial statements, these other reporting responsibilities should be addressed in a separate section in the auditor's report that follows the opinion paragraph.

50. The auditor's report should be signed.

52. The auditor should date the report on the financial statements no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. Sufficient appropriate audit evidence should include evidence that the entity's complete set of financial statements has been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

62. The auditor's report should refer to the audit having been conducted in accordance with the International Standards on Auditing only when the auditor has complied fully with all of the International Standards on Auditing relevant to the audit.

64. When the auditor's report refers to both International Standards on Auditing and auditing standards of a specific jurisdiction or country, the auditor's report should identify the jurisdiction or country of origin of the auditing standards.

65. When the auditor prepares the auditor's report using the layout or wording specified by the law, regulation or auditing standards of the specific jurisdiction or country, the auditor's report should refer to the audit being conducted in accordance with both International Standards on Auditing and the auditing standards of the specific jurisdiction or country only if the auditor's report includes, at a minimum, each of the following elements:

(a) A title;

(b) An addressee, as required by the circumstances of the engagement;

(c) An introductory paragraph that identifies the financial statements audited;

(d) A description of management's responsibility for the preparation and fair presentation of the financial statements;

(e) A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:

(i) A reference to the International Standards on Auditing and the auditing standards of the specific jurisdiction or country, and

(ii) A description of the work an auditor performs in an audit.

(f) An opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the country of origin of the financial reporting framework when International Financial Reporting Standards or International Public Sector Accounting Standards are not used);

(g) The auditor's signature;

(h) The date of the auditor's report; and

(i) The auditor's address.

67. The auditor should be satisfied that any supplementary information presented together with the financial statements that is not covered by the auditor's opinion is clearly differentiated from the audited financial statements.

70. If the auditor concludes that the entity's presentation of any unaudited supplementary information does not differentiate it sufficiently from the audited financial statements, the auditor should explain in the auditor's report that that information has not been audited.

ISA 710 states:

2. The auditor should determine whether the comparatives comply in all material respects with the financial reporting framework applicable to the financial statements being audited.

6. The auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the applicable financial reporting framework.

10. When the comparatives are presented as corresponding figures, the auditor should issue an auditor's report in which the comparatives are not specifically identified because the audit opinion is on the current period financial statements as a whole, including the corresponding figures.

12. When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification is:

(a) Unresolved, and results in a modification of the auditor's report regarding the current period figures, the auditor's report should also be modified regarding the corresponding figures; or

(b) Unresolved, but does not result in a modification of the auditor's report regarding the current period figures, the auditor's report should be modified regarding the corresponding figures.

15. In such circumstances, the auditor should consider the guidance in ISA 560, "Subsequent Events" and:

(a) If the prior period financial statements have been revised and reissued with a new auditor's report, the auditor should obtain sufficient appropriate audit evidence that the corresponding figures agree with the revised financial statements; or

(b) If the prior period financial statements have not been revised and reissued, and the corresponding figures have not been properly restated and/or appropriate disclosures have not been made, the auditor should issue a modified report on the current period financial statements, modified with respect to the corresponding figures included therein.

17. When the auditor decides to refer to another auditor, the incoming auditor's report should indicate:

(a) That the financial statements of the prior period were audited by another auditor;

(b) The type of report issued by the predecessor auditor and, if the report was modified, the reasons therefor; and

(c) The date of that report.

18. When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited.

19. In situations where the incoming auditor identifies that the corresponding figures are materially misstated, the auditor should request management to revise the corresponding figures or if management refuses to do so, appropriately modify the report.

20. The auditor should obtain sufficient appropriate audit evidence that the comparative financial statements meet the requirements of the applicable financial reporting framework.

24. When the comparatives are presented as comparative financial statements, the auditor should issue a report in which the comparatives are specifically identified because the audit opinion is expressed individually on the financial statements of each period presented.

25. When reporting on the prior period financial statements in connection with the current year's audit, if the opinion on such prior period financial statements is different from the opinion previously expressed, the auditor should disclose the substantive reasons for the different opinion in an emphasis of matter paragraph.

26. When the financial statements of the prior period were audited by another auditor:

(a) The predecessor auditor may reissue the auditor's report on the prior period with the incoming auditor only reporting on the current period; or

(b) The incoming auditor's report should state that the prior period was audited by another auditor and the incoming auditor's report should indicate:

(i) That the financial statements of the prior period were audited by another auditor;

(ii) The type of report issued by the predecessor auditor and if the report was modified, the reasons therefor; and

(iii) The date of that report.

28. In these circumstances, the incoming auditor should discuss the matter with management and, after having obtained management's authorization, contact the predecessor auditor and propose that the prior period financial statements be restated. If the predecessor agrees to reissue the auditor's report on the restated financial statements of the prior period, the auditor should follow the guidance in paragraph 26.

30. When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the comparative financial statements are unaudited.

31. In situations where the incoming auditor identifies that the prior year unaudited figures are materially misstated, the auditor should request management to revise the prior year's figures or if management refuses to do so, appropriately modify the report.

4.3.2 Evaluating the Conclusions

The final step in the audit process is to evaluate the conclusions drawn from the audit evidence obtained (which will form the basis of forming an opinion on the financial statements) and prepare an appropriately worded auditor's report.

An unmodified audit report contains standard wording that provides a measure of uniformity in its form and content. This helps to improve the reader's understanding and to identify unusual circumstances when they occur.

In some jurisdictions, laws or regulations governing the audit of financial statements may prescribe different wording for the auditor's opinion. However, the auditor's responsibilities for forming the opinion remain the same. If the wording of the auditor's opinion differs significantly from the standard wording, the auditor would consider the risk that users might misunderstand the assurance obtained. If such a risk exists, further explanation could be added to the auditor's report.

Financial Reporting Frameworks

The auditor's opinion on the financial statements will be made in the context of the applicable financial reporting framework.

In some extremely rare circumstances, the application of a specific requirement in the financial reporting framework might result in misleading financial statements in respect to the particular circumstances of the entity. If this occurs, the auditor would consider how the financial reporting framework deals with such rare circumstances and whether the auditor's report needs to be modified.

4.3.3 Forming an Opinion

Forming an opinion on the financial statements involves the following five steps.

Step 1 — Evaluating the audit evidence obtained

Has sufficient appropriate audit evidence been obtained to reduce, to an acceptably low level, the risks of material misstatement in the financial statements?

Step 2 — Evaluating the effects of uncorrected misstatements identified and the qualitative aspects of the entity's accounting practices

Is there reasonable assurance that the financial statements taken as a whole are free from material misstatement?

Step 3 — Evaluating whether the financial statements have been prepared/presented in accordance with the applicable financial reporting framework

Are the financial statements (including classes of transactions, account balances and disclosures) presented in accordance with the applicable financial reporting framework?

This includes an evaluation of whether:

- The accounting policies selected and applied are consistent with the financial reporting framework and are appropriate in the circumstances;
- The accounting estimates made by management are reasonable in the circumstances;
- The information presented in the financial statements, including accounting policies, is relevant, reliable, comparable, and understandable; and
- The financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements. For financial statements prepared in accordance with the applicable financial reporting framework, this would include the entity's financial position, financial performance and cash flows.

Step 4 — Evaluating the fair presentation of the financial statements

- Are the financial statements, after any adjustments made by management as a result of the audit process, consistent with the understanding of the entity and its environment?
- Does the overall presentation, structure and content (including the note disclosures) of the financial statements faithfully represent the underlying transactions and events in accordance with the financial reporting framework?

Step 5 — Performing analytical procedures

Analytical procedures performed at or near the end of the audit help to corroborate conclusions formed during the audit and assist in arriving at the overall conclusion as to the fair presentation of the financial statements.

4.3.4 Components of the Auditor's Report

The main components of the auditor's report, which will be in writing, are outlined in the exhibit below.

Exhibit 4.3-2

Component	Comments
Title	The title is "Independent Auditor's Report". Using the word "independent" distinguishes the independent auditor's report from reports issued by others.
Addressee	As required by the circumstances of the engagement or local regulations. It is usually addressed to the shareholders or those charged with governance of the entity being audited.
Introductory Paragraph	• Identifies the entity whose financial statements have been audited. • States that the financial statements have been audited. • Identifies the title of each of the financial statements that comprise the complete set of financial statements. • Refers to the summary of significant accounting policies and other explanatory notes. • Specifies the date and period covered by the financial statements. Where supplementary information is presented, the auditor needs to ensure it is either clearly covered by the audit opinion or clearly differentiated as not being covered. Refer to paragraphs 25–27 of ISA 700 for additional guidance.
Management's Responsibility for the Financial Statements	State that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework and that this responsibility includes: • Designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; • Selecting and applying appropriate accounting policies; and • Making accounting estimates that are reasonable in the circumstances.

Component	Comments
Auditor's Responsibility	(a) State that the responsibility of the auditor is to express an opinion on the financial statements based on the audit. (b) State that the audit was conducted in accordance with *International Standards on Auditing.* The auditor's report should also explain that those standards require that the auditor comply with ethical requirements and that the auditor plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement. (c) Describe an audit by stating that: • An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements; • The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation 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 the entity's internal control; and • An audit also includes evaluating the appropriateness of the accounting policies used, the reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements. (d) State that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
Auditor's Opinion	The auditor's opinion whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework or such similar wording as required by law or regulation. When *International Financial Reporting Standards* are not used as the financial reporting framework, the wording of the opinion should identify the jurisdiction or country of origin of the financial reporting framework (for example, … in accordance with accounting principles generally accepted in country X …).
Other Matters	Standards, laws or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon. Such matters may be addressed in a separate paragraph following the auditor's opinion.

Component	Comments
Other Reporting Responsibilities	In some cases auditors may be required to report on other matters such as performance of additional specified procedures or an opinion on specific matters, such as the adequacy of accounting books and records. Where the auditor is required/requested and permitted to report on other matters (supplementary to the auditor's opinion outlined above), they should be addressed in a separate section in the auditor's report that follows the opinion paragraph.
Auditor's Signature	The auditor's signature is either the firm name, the personal name of the auditor or both – whatever is appropriate for the particular jurisdiction. In certain jurisdictions, the auditor may also be required to declare: • The auditor's professional accountancy designation; or • The fact that the auditor/firm has been recognized by the appropriate licensing authority.
Date of Report	This date should be no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. This would include evidence that: • The entity's complete set of financial statements has been prepared; • The effect of events and transactions (of which the auditor became aware) that occurred up to that date have been considered (refer to ISA 560); and • Those with the recognized authority have asserted that they have taken responsibility for the financial statements.
Auditor's Address	Indicate the name of the location in the country or jurisdiction where the auditor practices.

The standard wording for an auditor's report on general purpose financial statements prepared in accordance with the applicable generally accepted accounting principles (GAAP) and expressing an unqualified opinion is illustrated in the exhibit that follows.

Exhibit 4.3-3

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation 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 the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of *(or "present fairly, in all material respects,")* the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Continued on the next page…

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Audits Conducted in Accordance with Both ISAs and National Auditing Standards
Reference can be made to the audit as having been conducted in accordance with both ISAs and national auditing standards only when the auditor:

- Complies with each of the ISAs relevant to the audit;
- Performs any further audit procedures necessary to comply with relevant standards of that jurisdiction or country;
- Identifies the jurisdiction or country of origin of the auditing standards in the auditor's report; and
- Is satisfied that each of the standard report elements identified in the table above (even if using the layout and wording specified by national laws or regulations) has been included.

Such a reference is not appropriate when there is a conflict between the reporting requirements in the ISAs and the national auditing standards. In such cases, the auditor's report would refer only to the auditing standards (ISAs or national auditing standards) with which the auditor has complied.

Where possible, the use of the standard ISA report, as outlined above, will more readily enable report users to recognize the auditor's report as being conducted in accordance with ISAs.

Unaudited Supplementary Information
Any supplementary information (not covered by the auditor's opinion) that is presented with the financial statements should be clearly differentiated from the audited financial statements. Otherwise, the auditor's opinion will be considered to cover such supplementary information.

Differentiation of unaudited supplementary information may be achieved through the following methods:

- Clearly labeling such information as being unaudited;
- Ensuring unaudited notes are not intermingled with audited notes. Place any unaudited notes at the end of the required notes;
- Asking management to place the unaudited information outside of the set of financial statements, or at least to remove any cross-references from the financial statements to unaudited supplementary schedules or unaudited notes. Such references blur the demarcation between the audited and unaudited information; and
- Identifying the page numbers in the auditor's report on which the audited financial statements are presented.

If the entity's presentation of any unaudited supplementary information does not differentiate it sufficiently from the audited financial statements, the auditor should explain in the auditor's report that that information has not been audited.

Note: The existence of unaudited supplementary information does not relieve the auditor of the responsibility to read that information to identify material inconsistencies with the audited financial statements. Refer to ISA 720 for more information.

4.3.5 Subsequent Discovery of a Misstatement

After the release of his or her report, the auditor may become aware of a possible or actual misstatement in the financial statements. The first step is to discuss the matter as soon as possible with management.

If a misstatement has occurred and prompt disclosure is necessary, management may decide to:

- Notify persons known to be relying, or likely to rely, on the financial statements that a misstatement has been discovered; and
- Issue, as soon as practicable, revised financial statements or disclose the revision in financial statements of a subsequent period when issuance of such statements is imminent.

The auditor's report on revised financial statements should be clearly differentiated from the original report. This can be done by adding a final paragraph to the report explaining that the previous report dated (date) has been withdrawn and that the financial statements have been revised.

In some cases there may be disagreement between management and the auditor with respect to:

- Whether a misstatement was made;
- The auditor's further involvement;
- Whether users of the original report should be informed; and
- How promptly they should be informed and in what manner.

Where this occurs, the matter would be referred to those charged with governance for resolution. If there is still disagreement on how to proceed, the auditor may obtain legal advice.

4.3.6 Auditor's Report on Comparative Financial Statements

Where comparative information is provided in the financial statements, the auditor should determine whether the comparative information complies in all material respects with the financial reporting framework. Because financial reporting frameworks may vary between countries, comparative financial information can also be presented differently.

There are generally two types of comparative presentation:

- Corresponding figures; and
- Comparative financial statements.

Corresponding Figures

Amounts and other disclosures for the preceding period are included as part of the current period financial statements. They are intended to be read in relation to the current period. Corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period's financial statements.

Sufficient appropriate audit evidence would be obtained that the corresponding figures meet the requirements of the applicable financial reporting framework.

The extent of audit procedures performed on the corresponding figures is significantly less than for the audit of the current period figures and is ordinarily limited to ensuring that the corresponding figures have been:

- Correctly reported; and
- Are appropriately classified.

- **Audit procedures**

  This involves the auditor evaluating whether:
  - Accounting policies used for the corresponding figures are consistent with those of the current period or whether appropriate adjustments and/or disclosures have been made; and
  - Corresponding figures agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and/or disclosures have been made.

  When the financial statements of the prior period have:
  - Been **audited** by another auditor, the incoming auditor would assess the corresponding figures as outlined above and consider the appropriateness of the opening balances. Refer to ISA 510.
  - **Not been** audited, the incoming auditor still assesses the corresponding figures as outlined above and considers the appropriateness of the opening balances. Refer to ISA 510.

  Further audit procedures would be required where a possible material misstatement in the corresponding figures has been identified.

- **Reporting**

  The auditor's report only refers to the financial statements of the current period, because the audit opinion is on the current period financial statements as a whole, including the corresponding figures.

  The following exhibit sets out how the auditor should proceed when the prior period auditor's report includes a qualified opinion, disclaimer of opinion, or adverse opinion that is resolved or unresolved.

Exhibit 4.3-4

Resolved	**Unresolved**
If the matter has now been resolved, the current report does not ordinarily refer to the previous modification. However, if the matter is material to the current period, the auditor may include an emphasis of matter paragraph dealing with the situation.	If the matter results in a modification of the auditor's report on current period figures, it should also be modified regarding the corresponding figures. If it does not result in a modification of the auditor's report on the current period figures, it should be modified regarding the corresponding figures.

When prior period financial statements are not audited, the auditor's report should state that the corresponding figures are unaudited. Such a statement does not relieve the auditor of the requirement to perform appropriate audit procedures regarding opening balances of the current period. Clear disclosure in the financial statements that the corresponding figures are unaudited is encouraged.

Where the incoming auditor identifies that the corresponding figures are materially misstated, the auditor should request management to revise the corresponding figures or, if management refuses to do so, appropriately modify the report.

Comparative Financial Statements

Amounts and other disclosures for the preceding period are included for comparison with the financial statements of the current period, but do not form part of the current period financial statements.

- **Audit procedures**
  The auditor should obtain sufficient appropriate audit evidence that the comparative financial statements meet the requirements of the applicable financial reporting framework. This involves the auditor evaluating whether:
  - Accounting policies of the prior period are consistent with those of the current period or whether appropriate adjustments and/or disclosures have been made; and
  - Prior period figures presented agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and disclosures have been made.

  When the financial statements of the prior period have:
  - **Been audited** by another auditor, the incoming auditor would assess the comparative financial statements as outlined above and consider the appropriateness of the opening balances. Refer to Chapter 3.4 and ISA 510.
  - **Not been** audited, the incoming auditor still assesses the comparative financial statements as outlined above and considers the appropriateness of the opening balances. Refer to Chapter 3.4 and ISA 510.

- **Reporting**
  The auditor's report refers to each period that financial statements are presented. This is because the audit opinion is expressed individually on the financial statements of each period presented. Since the auditor's report applies to the individual financial statements presented, the auditor may modify the opinion with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements.

  When the financial statements of the prior period were audited by another auditor:
  – The predecessor auditor may reissue the auditor's report on the prior period with the incoming auditor only reporting on the current period; or
  – The incoming auditor's report should state that the prior period was audited by another auditor. The incoming auditor's report should indicate:
    ◦ That the financial statements of the prior period were audited by another auditor,
    ◦ The type of report issued by the predecessor auditor and if the report was modified, the reasons therefore, and
    ◦ The date of that report.

  If the opinion on the prior period financial statements (provided in connection with the current year's audit) is different from the opinion previously expressed, the auditor should disclose the substantive procedures for the different opinion in an emphasis of matter paragraph. This may arise when the auditor becomes aware of circumstances or events that materially affect the financial statements of a prior period during the course of the audit of the current period.

  In performing the current audit, the auditor may become aware of a material misstatement that affects the prior period financial statements on which an unmodified report has been previously issued. If so, the auditor would consider the guidance in ISA 560, Subsequent Events.

- **The issue is resolved**
  If the prior period financial statements have been revised and reissued with a new auditor's report, the auditor should obtain sufficient appropriate audit evidence that the corresponding figures agree with the revised financial statements; or

- **The issue is not resolved**
  The auditor should issue a modified report on the current period financial statements with respect to the corresponding figures included therein.

  If the incoming auditor becomes aware of a material misstatement that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, then the matter should be discussed with management and, after having obtained management's authorization, contact the predecessor auditor and propose that the prior period financial statements be restated.

  If the predecessor agrees to reissue the auditor's report on the restated financial statements of the prior period, the auditor would determine whether the comparatives comply in all material respects with the applicable financial reporting framework. If the predecessor does not agree with the proposed restatement or refuses to reissue the auditor's report on the prior period financial statements, the introductory paragraph of the auditor's report may indicate that the predecessor auditor reported on the financial statements of the prior period before restatement. In addition, if the incoming auditor is engaged to audit and applies sufficient audit procedures to be satisfied as to the appropriateness of the restatement adjustment, the auditor may also include the following paragraph in the report:

> "We also audited the adjustments described in Note X that were applied to restate the 20XX financial statements. In our opinion, such adjustments are appropriate and have been properly applied."

When prior period financial statements are not audited, the auditor's report should state that the corresponding figures are unaudited. Such a statement does not relieve the auditor of the requirement to perform appropriate audit procedures regarding opening balances of the current period. Clear disclosure in the financial statements that the comparative financial statements are unaudited is encouraged.

Where the incoming auditor identifies that the prior year unaudited figures are materially misstated, the auditor should request management to revise the corresponding figures. If management refuses to do so, the auditor should appropriately modify the report.

Incoming Auditor — Additional Requirements

In some jurisdictions, the incoming auditor is permitted to refer to the predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period.

When such a reference is made, the incoming auditor's report should indicate:

- That the financial statements of the prior period were audited by another auditor;
- The type of report issued by the predecessor auditor and, if the report was modified, the reasons therefore; and
- The date of that report.

Refer to ISA 710 for some examples of wording for the auditor's report for corresponding figures and comparative financial statements.

Case Study — The Auditor's Report

For details of the case study, refer to the Introduction to the Case Study in this Guide.

Having completed the audit and performed such additional work as was necessary (refer to Chapter 4.1), it is the opinion of the auditors that sufficient audit evidence has been obtained to reduce the risks of material misstatement to an appropriately low level.

Therefore, the standard auditor's report will be used for Dephta Furniture Inc.

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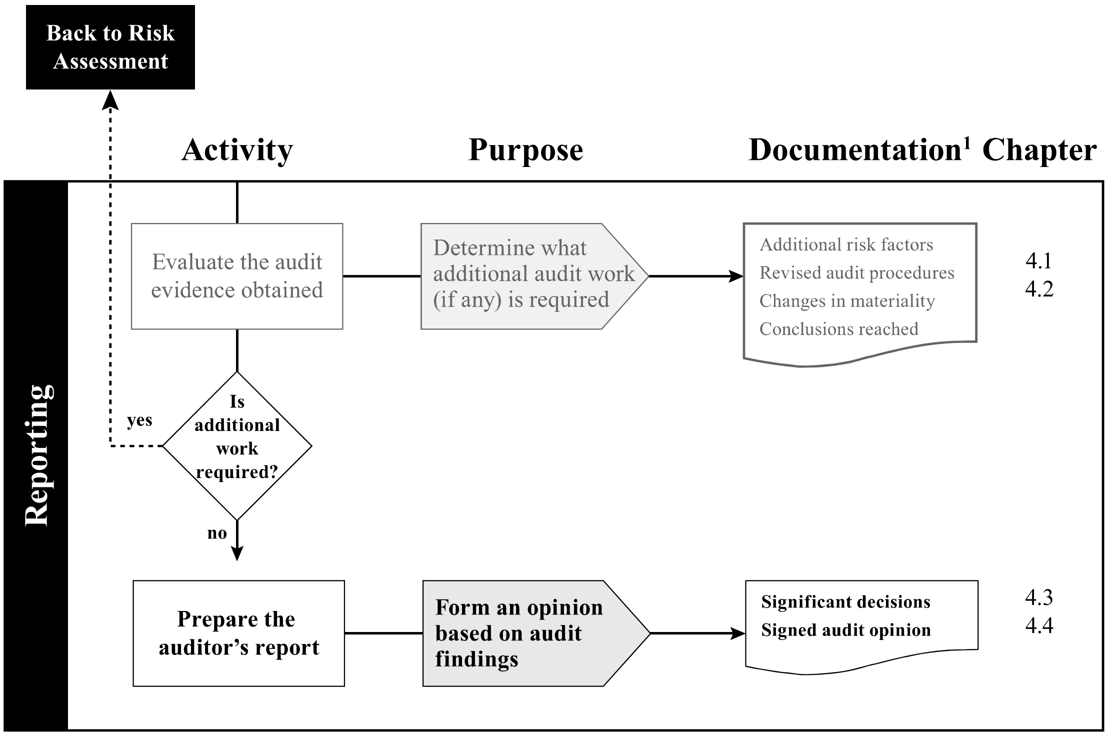
4.4 Modifications to the Auditor's Report

Exhibit 4.4-1



Note:
1. Refer to ISA 230 for a more complete list of documentation required.

Chapter Purpose	Primary ISA Reference
To provide an overview of the considerations required when modifying the wording of the auditor's report.	**701**

4.4.1 Overview

ISA 701 states:

6. **The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem.**

7. **The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than a going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements.**

12. **A *qualified opinion* should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material**

and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being 'except for' the effects of the matter to which the qualification relates.

13. A *disclaimer of opinion* should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

14. An *adverse opinion* should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

15. Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements.

18. When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

20. The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.

In some situations, the auditor's report will require additional or modified wording to emphasize a certain matter or to express a qualified, adverse, or disclaimer of opinion. This usually occurs when:

- A significant uncertainty exists that should be brought to the reader's attention;
- A limitation on the scope of the engagement exists; or
- There is disagreement with management regarding the selection or application of accounting policies or the adequacy of financial statement disclosures.

4.4.2 Emphasis of a Matter without Qualification of Opinion

An auditor's report may be modified by adding an emphasis of matter paragraph. This would apply where the resolution of a matter is dependent on future actions or events not under the direct control of the entity, but that may affect the financial statements. The paragraph would refer to a note in the financial statements that extensively discusses the matter.

An emphasis of a matter paragraph does not affect the auditor's opinion. The paragraph would:

- Follow the auditor's opinion paragraph but come before the section on any other reporting responsibilities, if any; and
- Refer to the fact that the auditor's opinion is not qualified in this respect.

The paragraph is used to highlight matters such as:

- Going-concern problems;
- Other significant uncertainties; and
- Inconsistencies.

Going-Concern Problems

Assuming the adequacy of the note disclosure in the financial statements, the wording of the paragraph could be as follows:

> Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X6 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern.

Other Significant Uncertainties

Assuming the adequacy of the note disclosure in the financial statements, the wording of the paragraph could be as follows:

> Without qualifying our opinion, we draw attention to Note X to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

Inconsistencies

If the document containing the audited financial statements contains information that is materially inconsistent with the financial statements, the auditor would first request the entity to change it. If the entity refuses to make the required amendment, an emphasis of matter paragraph could be used to describe the material inconsistency.

In extreme cases (such as situations involving multiple and material uncertainties), it may be more appropriate to issue a disclaimer of opinion instead of adding an emphasis of matter paragraph.

4.4.3 Modifications to the Audit Opinion

A modified audit opinion is required where the effect of a matter in the auditor's judgment is or may be material to the financial statements:

- A limitation on the scope of the auditor's work; or
- Disagreement with management regarding:
  - The acceptability of the accounting policies selected;
  - The method of their application; or
  - The adequacy of financial statement disclosures.

When a modification is required:

- All the substantive reasons should be clearly described in the auditor's report and, unless impracticable, a quantification of the possible effect(s) on the financial statements;
- It should be set out in a separate paragraph preceding the opinion or disclaimer of opinion on the financial statements; and
- It may include a reference to a more extensive discussion, if any, in a note to the financial statements.

There are three ways in which the auditor's report can be modified as set out in the exhibit below.

Exhibit 4.4-2

Type	Nature
Qualified Opinion	When the effect is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. Expressed as being "Except for…" the effects of the matter to which the qualification relates.
Disclaimer of Opinion	When the possible effect of a limitation on scope (refer to discussion below) is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements. Expressed as "We do not express an opinion…" on the financial statements because of a limitation in the audit scope.
Adverse Opinion	When the effect of a disagreement (refer to discussion below) is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements. Expressed as "Financial statements are not presented fairly in accordance with …"

Scope Limitations

A limitation on the scope of the auditor's work could result from:

- **An imposition by the entity**
  Management may refuse to allow an audit procedure to be performed that the auditor believes is necessary. An example would be the refusal by management to allow confirmation of balances, such as accounts receivable. If this is known before the engagement is accepted, the auditor would ordinarily not accept such a limited engagement.

- **Inability to perform procedures**
  The auditor may not be able to perform procedures believed necessary due to factors such as:
  - Timing (an inability to observe the counting of physical inventories because it occurred before the auditor's appointment);
  - Damage to accounting records (such as through fire, water, theft or computer data loss);
  - Lack or restricted access to key personnel, accounting records or operating locations; or
  - The absence of adequate accounting records.

In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.

A scope limitation requires either a qualified opinion or a disclaimer of opinion. The auditor's report should:

- Describe the limitation; and
- Indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

In the report example below, all the words remain the same as the standard report (refer to Chapter 4.3) except as shown in italics.

Qualified Opinion – Limitation on Scope

Unable to Observe the Counting of Inventories

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. Except as discussed in the following paragraph, we conducted our audit in accordance with...

Opinion

We did not observe the counting of the physical inventories as of December 31, 20XX, since that date was prior to the time we were initially engaged as auditors for the Company. Owing to the nature of the Company's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures. In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a true and fair view of...

Disclaimer of Opinion – Limitation on Scope

Limitations Placed on Scope of Work

Report on the Financial Statements

We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for …

Auditor's Responsibility

(Omit the sentence stating the responsibility of the auditor.)

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope limitation as follows.)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the Company. Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements.

4.4.4 Disagreements with Management

The auditor may disagree with management about matters such as:

- The acceptability of accounting policies selected;
- The method of their application; or
- The adequacy of disclosures in the financial statements.

Where such disagreements are material to the financial statements, a qualified or an adverse opinion would be expressed.

Qualified Opinion

Disagreement on Accounting Policies – Inappropriate Accounting Method

Report on the Financial Statements

We have audited...

Management's Responsibility for the Financial Statements

Management is responsible for …

Auditor's Responsibility

Our responsibility is to …

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements, which practice, in our opinion, is not in accordance with International Financial Reporting Standards. The provision for the year ended December 31, 20XX, should be xxx based on the straight-line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly, the fixed assets should be reduced by accumulated depreciation of xxx and the loss for the year and accumulated deficit should be increased by xxx and xxx, respectively.

Opinion

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view of...

Qualified Opinion

Disagreement on Accounting Policies – Inadequate Disclosure

Report on the Financial Statements

We have audited...

Management's Responsibility for the Financial Statements

Management is responsible for …

Auditor's Responsibility

Our responsibility is to …

On January 15, 20XX, the Company issued debentures in the amount of xxx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 20XX. In our opinion, disclosure of this information is required by...

Opinion

In our opinion, except for the omission of the information included in the preceding paragraph, the financial statements give a true and fair view of...

Adverse Opinion

Disagreement on Accounting Policies – Inadequate Disclosure

Report on the Financial Statements

We have audited...

Management’s Responsibility for the Financial Statements

Management is responsible for …

Auditor’s Responsibility

Our responsibility is to …

(Insert paragraph(s) discussing the disagreement.)

Opinion

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view of (or “do not present fairly, in all material respects”) the financial position of ABC Company as of December 20, 20XX, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Qualified Opinion

Disagreement on Required Disclosures – Going Concern

Report on the Financial Statements

We have audited...

Management's Responsibility for the Financial Statements

Management is responsible for …

Auditor's Responsibility

Our responsibility is to …

The Company's financing arrangements expire and amounts outstanding are payable on March 19, 20XX. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern, and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

Opinion

In our opinion, *except for the omission of the information included in the preceding paragraph*, the financial statements give a true and fair view of (and present fairly, in all material respects) the financial position of the Company at December 31, 20XX and of its financial performance and its cash flows for the year then ended in accordance with …

Adverse Opinion

Disagreement on Required Disclosures – Going Concern

Report on the Financial Statements

We have audited...

Management's Responsibility for the Financial Statements

Management is responsible for …

Auditor's Responsibility

Our responsibility is to …

The Company's financing arrangements expired and the amount outstanding was payable on December 31, 20XX. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern, and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

Opinion

In our opinion, *because of the omission of the information mentioned in the preceding paragraph*, the financial statements do not give a true and fair view of (or do not present fairly) the financial position of the Company as at December 31, 20XX, and of its financial performance and its cash flows for the year then ended in accordance with… (and do not comply with…)

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Appendices

Appendix A – Forms of Internal Control Documentation

Appendix Purpose
To provide guidance on the most common forms of internal control documentation (refer to Chapter 2.11 of this Guide).

The most common forms of internal control documentation are:

- Narrative descriptions or memoranda;
- Flow charts;
- A combination of flow charts and narrative descriptions; and
- Questionnaires and checklists.

A.1 Narrative Descriptions

This may be the most efficient documentation for smaller entities where accounting and internal control activities may be simple or where a particular business process is relatively straightforward. It is also commonly used for documenting the entity level and IT general controls.

It involves a narrative description of each step in the business process from start to finish (that is, initiation to the general ledger entry). Where the process is divided into a number of distinct steps, it is useful to provide paragraph headings. This enables the reader to find the relevant information fairly quickly. Narrative descriptions can also be structured so that each narrative description addresses the information in a standardized fashion.

Consider Point

Use job titles in the descriptions rather than individuals' names. This not only saves time in updating the description when someone leaves, but also avoids confusion if the person leaves or stays with the entity but assumes a quite different job description.

A.2 Flowcharts

Flowcharts take longer to prepare but, if prepared well, they provide a visual aid that enhances the reader's understanding of transaction flows and key internal controls. Flowcharts are also easily updated in subsequent years.

A flowchart should detail the entity's accounting and internal control procedures from initiation through to the general ledger or vice versa (for example, from the receipt of a sales order to the filing of the sales invoice copy and the general ledger entry). Automated accounting procedures such as computation (pricing a sales invoice) and manual procedures such as matching (completing the sales invoice on receipt of shipping order) should also be indicated on the flowchart.

Brief narrative descriptions can supplement the flowchart to describe key internal controls and other features in more detail. Software packages are often used to prepare and update charts.

Exhibit A-1

Charting Tips	**Limit the variety of chart symbols used.** Use no more than 6-8 standard flowchart symbols. Standard symbols enable audit staff and reviewers/experienced auditors to quickly familiarize themselves with charts prepared by other staff. Software often comes with hundreds of symbols, all of which could potentially be used in a chart.
	Avoid information overload. Avoid the temptation to prepare a mammoth chart that covers an entire process but takes pages to document. Assign each main activity in a process in its own chart. Start with an overview of the process and then focus on the main activities. If the process is highly complex, consider sub-activity charts. Complex charts are intimidating and therefore take much longer to understand and review.
	Highlight location and final destination of documents. Ensure the final location of documents is recorded, for example: • Permanently filed in a specific location; • Destroyed; or • Cross-referenced to another chart. This avoids time being wasted searching for certain documents, especially when they have been destroyed.

A.3 Combination Charts

Another form of systems description is the use of a combined chart and narrative. The typical page is divided into two sections as illustrated in the exhibit below. The process flow column highlights the major activities and the narrative column explains what happens or is cross-referenced to another narrative or chart explaining just that activity.

Exhibit A-2

Process Flow	Narrative or Flow Chart Reference
Initiating a sale	Orders arrive by e-mail, phone, fax, and occasionally by mail. The sales managers can also take orders. The sales department clerk enters details of the orders into the sales system. The system checks if the parts are available and whether the customer has the good credit. If everything is satisfactory, a sales order is produced.
Shipping out orders	Refer to chart xxx for details

A.4 Questionnaires and Checklists

An internal control questionnaire or checklist is another technique used to document internal control. This provides a systematic way of identifying the most common types of internal control procedures that should be present.

The danger with a questionnaire is being told by entity staff that certain internal control exists when in reality it has been changed, superseded, or is simply inactive. Internal control systems often change in reaction to new ways of delivering service, revised products and services, and even changes in personnel. Questionnaires are best used in conjunction with narrative descriptions or flow charts to identify the internal control points.

Regardless of what approach to documentation is used, the extent of documentation will increase in relation to the complexity of the entity and the extent of audit procedures to be performed.

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Appendix B – Walk-through Procedures

Appendix Purpose
To provide guidance on a walkthrough that can be used by the auditor to establish the actual design/implementation of internal control (refer to Chapter 2.11).

One of the most effective means of establishing the actual design/implementation of internal control is for the auditor to perform what is often referred to as a 'walkthrough' of the entity's significant processes. This is still part of the risk assessment procedures.

In a walkthrough, the auditor traces a transaction (from each major class of transaction) from origination to its being reported in the financial statements. This involves following the transaction through the entity's accounting and information systems and financial report preparation processes to it being reported in the financial statements. It includes inquiries of personnel, observing the application of specific internal controls and inspecting documents and reports.

B.1 Objectives of a Walkthrough

Exhibit B-1

Objectives of a Walk-through Procedure	• Confirm the auditor's understanding obtained about the process flow of transactions. • Confirm the auditor's understanding of the design of relevant internal controls identified for all five components of internal control over financial reporting, including those related to the prevention or detection of fraud. • Confirm that the auditor's understanding of the process is complete by determining whether all points in the process at which misstatements related to each relevant financial statement assertion that could occur have been identified. • Evaluate the effectiveness of the design of the internal control system. • Confirm whether the controls have been placed in operation. • Obtain audit evidence to demonstrate that the objectives were achieved.

In many instances, particularly in smaller audits, walkthroughs may be performed simultaneously with obtaining the understanding of internal control.

B.2 How to Perform a Walkthrough

In a walkthrough, the auditor traces a transaction from origination through to the entity's financial report. It includes the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and internal control procedures for each of the significant processes identified and the controls intended to address the risk of fraud.

Exhibit B-3

Best Practices	Cautions
Follow the entire process Follow the process flow of actual transactions using the same documents and information technology that entity personnel use.	Do not review copies of documents supplied from a single source or purporting to be in use.
Involve the entity's staff Make inquiries of each person involved in significant aspects of the process or internal control.	Do not confine your inquiries to a single person.
Question understanding At each point at which important processing procedures or internal control activities occur, question entity personnel about: • Their understanding of what is required; and • Whether the processing procedures are performed as originally understood and on a timely (regular) basis.	Be alert for exceptions to prescribed procedures and internal control activities. Do not consider tests of controls over any procedures (such as a monthly reconciliation) that are not performed on a regular basis.
Corroborate Corroborate information at various points in the walkthrough by asking personnel to describe their understanding of the previous and succeeding processing or internal control activities and to demonstrate what they do.	Ask to be **shown** what happens rather than be **told** what happens.
Use follow-up questions Ask additional questions and obtain evidence that could help identify the abuse of internal control or indicators of fraud. For example: • What happens when you find an error? • How do you determine if an error has occurred? • What kind of errors have you found? • What happens when an error is found? • How were the errors resolved? • Have you ever been asked to override the process of internal control? If so, describe the situation, why it occurred and what happened.	If an error has never been found, evaluate if this is due to good preventive internal control or whether the individual performing the internal control procedure lacks the necessary skills to identify an error.

Best Practices	Cautions
Consider findings An improperly designed internal control may represent a material weakness in the entity's internal control. Consideration should be given to communicating findings to management and those charged with governance.	Communications should be in writing to provide audit evidence.
Documentation Sufficient appropriate documentation should be obtained to provide the evidence that the objectives of performing walk-through procedures have been met. This will include copies of documents obtained and notes on the discussions with various entity staff members.	The extent of reliance upon work performed by others should be documented with an assessment of their competence and objectivity.

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Appendix C — Risk Management Overview

Appendix Purpose
To provide an overview of the process that can be used by management to effectively identify, mitigate, track, and control business risks, particularly those that could result in the financial statements being materially misstated.

ISA 315 states:

> **76. The auditor should obtain an understanding of the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.**

Risk management has increased in popularity over the last decade as many leading entities have adopted the key principles and practices. It is now considered a best practice in entities of all sizes. It helps an entity get to where it wants to go and avoid pitfalls and surprises along the way. Smaller entities also consider risk exposures but often they do not have the structures, methodology or documentation to demonstrate that risks are being effectively managed.

This appendix provides an introduction to managing risk. It outlines a simple risk assessment process that virtually any size of entity could follow.

Auditors may wish to recommend such a risk assessment process to their clients. The advantage for the entity would be better information for decision-making and a possible saving in audit time.

Where an entity does not have its own risk assessment process, the auditor is required, through inquiries of management and observation, to identify, document, and assess the risks that could result in a material misstatement in the financial statements.

C.1 Risk Management

Once an entity sets out to do something, there is always the possibility that something may go wrong. With risk management, an entity can efficiently and effectively deploy resources in pursuit of its objectives. The purpose of risk management is to identify those risks, assess them, and then develop responsive action plans.

The exhibit below outlines some of the benefits that can be achieved from implementing a risk management process.

Exhibit C-1

Activity	Risk Management	vs.	No Risk Management
Planning	Align business strategy to risk appetite		Risk appetite not considered
Decision-making	Anticipate what can go wrong or opportunities		Continual suprises
Allocating Resources	Focus resources on what is important		Waste time
Monitoring	Track performance to risk factors		React to events as they occur

C.2 When an Entity Does not Understand its Exposure to Risk

When an entity does not understand its exposure to risk, one of two situations may occur:

- Situation 1
  The control systems in place do not anticipate events that expose the entity to risk. This could result in immediate financial loss, missed opportunities or a redirection of management time to mitigate or rectify the situation.
- Situation 2
  The controls and procedures in place may be so onerous that every conceivable risk is covered. Managers can feel constrained by rigid sets of rules and thereby miss opportunities that are worth pursuing.

Consider Point

A successful risk management process involves:

- Taking a “top-down” approach, which means relating risks and controls to the goals of the entity;
- Appointing a senior person with influence to take charge;
- Taking the time to plan and clearly articulate the benefits to be gained; and
- Communicating to staff throughout the process.

A Six Step Risk Management Process

Implementation of a risk management process often involves the following six steps:

1. Determine risk appetite and objectives;
2. Identify risks (events);
3. Assess identified risks;
4. Develop a risk response;
5. Design and implement the risk response; and

6. Monitor results.

Each of these steps is outlined below.

Step 1 — Determine risk appetite and objectives
The first step in a risk management program is to determine the entity's appetite for risk. Every entity will have differing exposures to risk and a different appetite to tolerate or absorb such risk. This can be expressed in both quantitative and qualitative terms.

Once risk appetite has been established, the next step is to consider the entity's objectives. Objectives are normally documented as part of the entity's overall business plan. The risk factors that will need managing will always flow from the desired objective. There are five major categories of objectives to consider, as outlined in the exhibit below.

Exhibit C-2

Objectives	Description
Strategic	High-level objectives that move the organization toward achieving its vision and mission.
Operational	Address the effective and efficient use of organization resources in order to achieve strategic objectives.
Safeguarding assets	Prevent loss, theft, management override, waste and inefficiency of assets and poor business decision-making.
Reporting	Assess reliability of internal and external reporting, including process for preparing the financial statements.
Compliance	Identify the implications of applicable laws and regulations and how compliance will be measured.

Where possible, objectives should include measurable targets and performance indicators so that success can be measured on an ongoing basis.

Step 2 — Identify risks (events)
This step is critical. It requires that the auditor have a good understanding of the entity and its objectives. A listing of events that would prevent the entity from achieving its stated goals is often achieved through a brainstorming session with the people directly involved. Some entities may also go a step further and identify risk factors that could benefit the entity.

Areas to address include:

- **Risks to the entity arising from its objectives and operations**
  This includes risks resulting from:
  - The nature of business operations, the regulatory environment, recent economic events and new strategic initiatives;

  - Internal risks such as the control environment, general IT controls, choice of accounting policies, and new initiatives such as system changes, reorganizations, acquisitions, etc.; and
  - Non-routine transactions and judgmental matters.

- **Risks of fraud and manipulation of the financial statements**
  The possibility of management override exists in every entity and should be addressed. Identify risk factors that provide opportunity for fraud (poor corporate culture or values within entity), pressure for fraud (such as a bonus based on sales) and rationalization (such as an attitude of "I deserve this").

  Management fraud could result from overstated or understated estimates, unsupported journal entries, incorrect valuations and inappropriate transactions, such as those with related parties. Employee fraud will generally be focused on misappropriation of cash and assets. Refer to Appendix D, Nature of Fraud, for additional guidance on this subject.

Checklists such as those found in textbooks and contained in internal control frameworks are useful but auditors should only use these as a starting point for identifying areas to consider and developing their thoughts. They should not be used as a substitute for addressing the specific needs of each entity.

Step 3 — Assess identified risks
The next step in the process is to assess the identified risks. For each risk identified:

- **Ask what could go wrong as a result**
  This is the "so what?" question. For financial risks, this would relate to the potential for misstatements in the financial statements. For example, an economic slowdown may have been identified as a risk. If the transactions were properly recorded in the accounting records, it would not result in a material misstatement in the financial statements. However, the slowdown could result in receivables (due to customers' inability to pay) or inventory (due to slow-moving goods) being overvalued.

- **Assess the likelihood (probability of the event occurring) and the impact (potential financial impact)**
  Financial impact will be based on the entity's risk appetite or a materiality threshold. A common approach is to assess likelihood and impact on a scale such as 1 to 10 or 1 to 5. The results can be multiplied together to come up with a combined or overall assessment of risk. A typical worksheet is outlined below.

Exhibit C-3

Risk Register

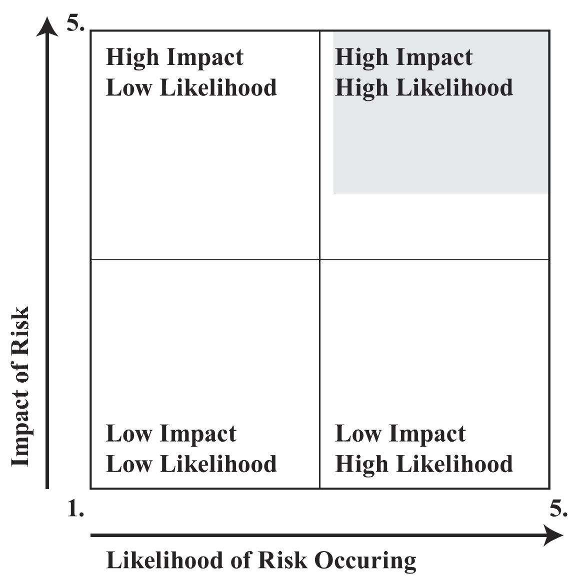
Materiality overall ______________________________

Risks Identified	What could go wrong in the F/S as a result?	FSA Impact — CEAV			Risk assessment			Signif't risk? Y/N	Mgmt response		Audit Re-sponse (audit plan)	
		Assets	Liab's	Inc.[1]	Lideli'd to occur	$ Impact	Comb'd Score			W/P		W/P

[1] Inc. = Income Statement

The results of the risk assessment can also be plotted in a graph.

Exhibit C-4

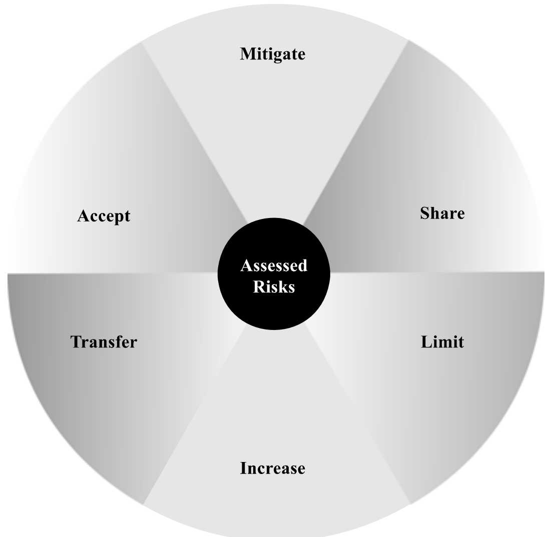


Step 4 — Develop a risk response

The outcome of Steps 1 to 3 is a listing of risks that have been assessed. The next step is to determine an appropriate response to the risks. Risks in the high impact and high likelihood range will normally be mitigated first. This step requires a balance to be struck between the cost of further action to mitigate the risk and the potential impact of the residual risk. In some cases, current control processes may be found to be disproportionately costly or onerous compared to the risk they address.

There are a number of possible risk responses, such as those illustrated in the exhibit below.

Exhibit C-5



Risks can be:

- **Mitigated**
  This is the most common risk response and often takes the form of control activities. Other risk mitigation could include revised policies and procedures, organizational change, hiring additional staff and investment in new technology.
- **Shared**
  Risk can be shared with others such as by forming a joint venture.
- **Limited**
  This can be achieved by reducing or stopping the activity or seeking alternative ways to achieve the desired outcome.
- **Increased**
  This applies to risks with an outcome that is highly desirable. These risks need to be exploited – not controlled. The response will be how to maximize the benefits should these opportunities arise.
- **Transferred**
  This includes outsourcing or other contractual arrangements with third parties and buying an insurance policy.
- **Accepted**
  This involves doing nothing. These risks are considered acceptable in relation to the entity's risk tolerance.

Step 5 — Design and implement the risk response

A plan of action should be developed to ensure action is taken as required to respond appropriately to the assessed risks. Some consideration points include:

- The plan should articulate what is required, who will do the work and by when;
- Do not try to address each specific risk in isolation. Think about how the assessed risks interact with each other and develop responses on the basis of general areas or sets of risk;
- Assign ongoing responsibility for risk mitigation within the entity;
- Obtain input from external advisors and auditors as required; and
- Obtain formal approval for the plan from those charged with governance of the entity (if different from management).

Step 6 — Monitor results

Risk management should not be viewed as a one-time event. Risk registers should be updated on a regular basis such as annually. New risks will arise and existing control activities may need to be changed. In addition, consider how the effectiveness of the risk response can be monitored on an ongoing basis.

Some monitoring activities could include:

- Key performance indicators;
- Comparison of production, stock, quality measures, sales and other information of day-to-day performance to budget or plan;
- Performance against predetermined tolerances for risk; and
- Specific data related to achievement of entity objectives.

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Appendix D — Nature of Fraud

Appendix Purpose
To provide an outline of some of the factors leading to financial statement fraud and misappropriation of assets.

Misstatements in financial statements can arise from either fraud or error. What distinguishes fraud from error is whether the underlying action is intentional or unintentional.

Fraud is always intentional and involves deliberate concealment of the facts. It can take the form of misappropriation of assets or the manipulation of financial statements. Manipulation also occurs when there are omissions or false statements in the notes and/or other disclosures.

D.1 Misappropriation

"Management fraud" refers to fraud involving one or more members of management or those charged with oversight. Fraud involving other non-management employees is referred to as "employee fraud".

Manipulation of financial statements occurs when a higher or lower level of earnings is reported than that which actually occurred. It could also take the form of omissions (failure to disclose certain matters) or false statements in the notes and/or other disclosures. The motive may be to raise finances, reach a bonus threshold, inflate the value of the business or simply minimize taxes.

Exhibit D-1

Types of Fraud	**Management Fraud**		**Employee Fraud**
Nature	Manipulation of financial statements Reporting a higher/lower level of earnings than actually occurred	⟷	Misappropriation of assets Conversion of entity assets for personal use
Method	Management override of functioning internal control		Exploiting weakness in internal control
Amount involved	Could be highly significant		Anywhere from small to significant

Misappropriation by External Forces

Fraud can also be committed against an entity by external forces such as suppliers and customers. Suppliers may submit false or duplicate invoices, or overcharge for services performed or goods delivered. Customers may deduct false credits to reduce debtors.

The most serious types of fraud usually involve management. This is because management has the most opportunity. Unlike employees, who may be able to misappropriate small amounts of money by exploiting weaknesses in internal control, management is well placed to override or bypass an otherwise good system of internal control. This results from the fact that management is primarily responsible for the design and implementation of internal control in the first place. The potential for this "management override" exists in virtually every entity, no matter what the size.

The characteristics of misappropriation of assets or the manipulation of financial statements are summarized in the exhibit below.

Exhibit D-2

	Misappropriation of Assets (converting assets to personal use)		Manipulation of F/S (reporting a higher/lower level of earnings than actually occurred)	
Who?	Management	Employees	Management	Employees
Pressures	Personal benefit	Personal benefit	Personal benefit such as saving taxes, selling business at an inflated price or justifying a bonus	Personal benefit such as meeting a performance-based threshold for a bonus
Opportunities	Override of functioning internal control (IC) Exploit weakness in internal control	Exploit weakness in internal control	Override of functioning internal controls Exploit weakness in internal control (IC)	Exploit weakness in internal control (IC)
Amounts Involved	Tend to be large due to position in entitiy and knowledge of IC	Often small but could potentially be large	Tend to be large due to position in entity and knowledge of IC	Size would be relative to benefit (bonus) paid

D.2 Integrity, Ethics, and Competence

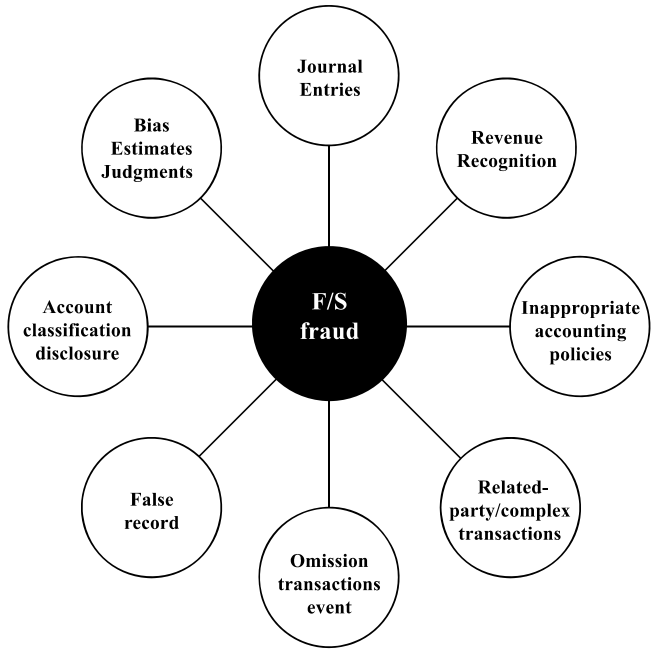
Although fraud can take place in any organization, it is much more prevalent in entities with poor governance, poor culture (dubious ethical values), a poor attitude toward internal control, and less than competent people holding key positions. Employees tend to follow the practices of their leader. For example, if senior management regularly inflate their expense accounts, it is highly likely that other employees do likewise.

Surveys have indicated that the best deterrent to fraud is a healthy "tone from the top". This includes the corporate values articulated by those charged with governance and the control procedures designed to address management override.

Some of the more common techniques used to perpetrate fraud are illustrated in the exhibit below.

Exhibit D-3

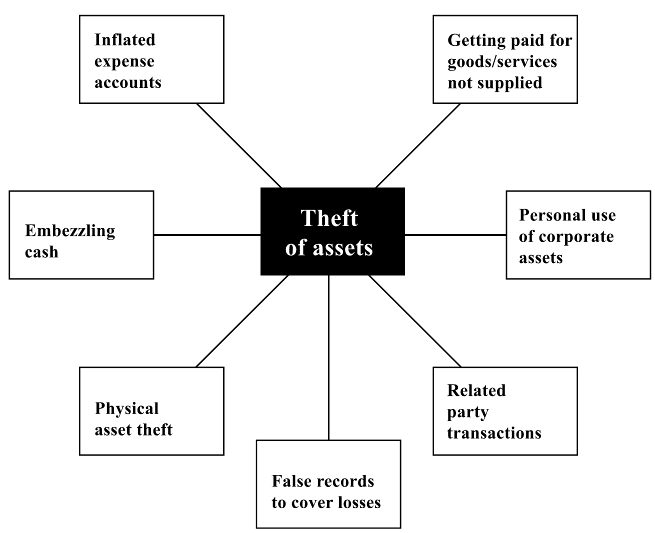
Fraudulent Financial Reporting



Journal entries and estimates are popular ways to manipulate financial statements. This is because they provide a high degree of deniability by management if discovered. A bias in estimates can be attributed to excessive conservatism or optimism. An unsupported journal entry, if discovered, can be characterized as a simple mistake. This differs from strategies such as falsified records that, if discovered by the auditor, would be quite difficult for management to deny.

Exhibit D-4

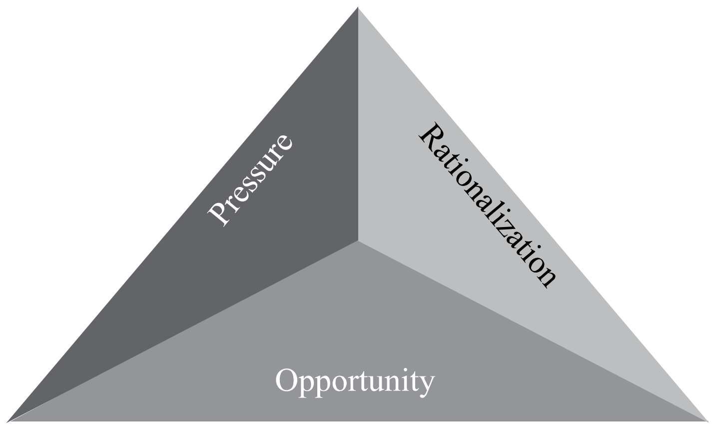
Misappropriation of Assets



D.3 The Fraud Triangle

When fuel, oxygen, and heat are brought together, there is a high probability of fire. The same is true for fraud. Fraud is most likely to occur when three key factors are present. These factors are illustrated below in what is often called the fraud triangle.

Exhibit D-5



Opportunity (Perceived or Real)

Opportunity pertains to an individual's perception that he or she can get away with fraud. This often emanates from a poor corporate culture or where a person feels they can take advantage of the trust placed in him or her.

Fraud perpetrators believe that they will not be detected or, if they are caught, the repercussions will not be serious. This is why the policy of always making a public example of people who steal is one of the most effective anti-fraud controls available. Potential perpetrators who think they might be detected and charged with a criminal offence rarely commit fraud.

Pressure

Pressure is usually generated by an immediate need that is difficult to share with others. Examples of these pressures include:

- Meeting analyst's or bank's expectations for profit;
- Inflating the purchase price of the business;
- Meeting the threshold for a performance bonus;
- Having significant personal debts or poor credit;
- Trying to cover financial losses;
- Being greedy or involved in gambling, drugs, and/or affairs;
- Being under undue peer or family pressure to succeed; and
- Living beyond one's means.

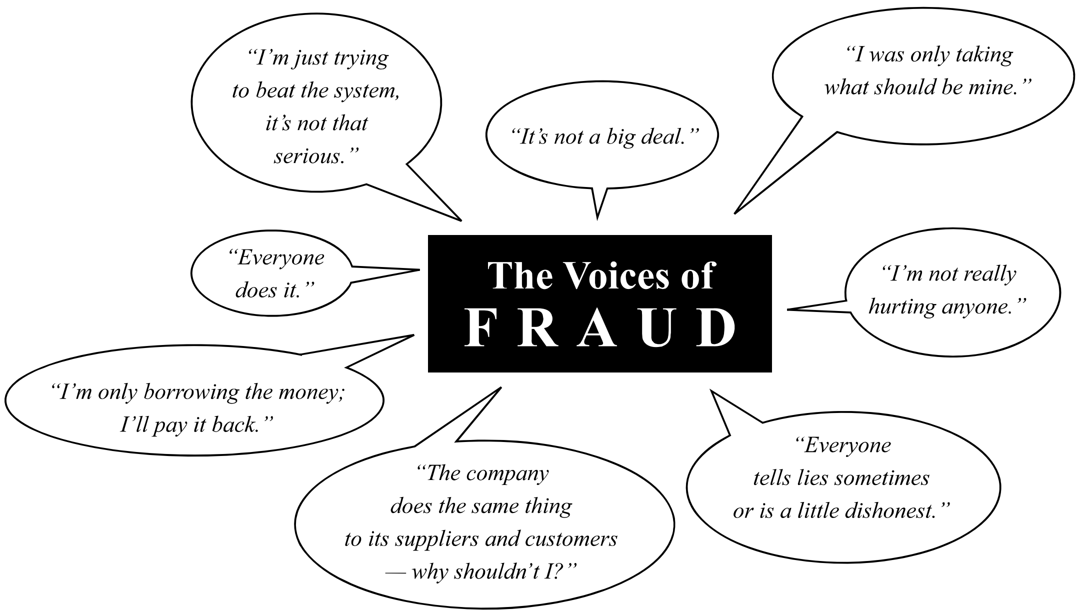
Other situations or characteristics, not necessarily financial in nature, include:

- Enjoying the challenge of beating the system;
- Fearing personal loss of pride, position or status such as when a company is doing poorly;
- Being dissatisfied with a job or wanting revenge against an employer; and
- Being emotionally unstable.

Some of these pressures can easily be identified (such as performance incentive plans). Others are more difficult to identify (such as family or peer pressure, living beyond one's means or having a gambling problem).

Rationalization
Rationalization is the belief, in one's own mind, that a crime has not been committed. Common rationalizations for fraud include being dissatisfied with pay or feeling underappreciated (such as not getting an expected promotion). Some other rationalizations include:

Exhibit D-6



Management Override
Every entity is exposed to the danger of management overriding what might be otherwise effective controls. This threat results from management's position in the entity and their responsibility for the design, implementation and maintenance of internal control. If the managing director or owner-manager asks for an accounting entry to be made, it is unlikely that a staff member will say no.

Some of the areas to consider when addressing the risk of fraud include:

- The leadership provided by management and the corporate culture and values being established;
- The extent of compensation packages based on results. Such incentives might motivate management or employees to engage in dishonest, illegal or unethical behaviour;
- Evaluating whether transactions make sense in the context of legitimate business purposes;

- Unnecessary complexity in rules regulations and policies; and
- Obtaining input from key employees on matters affecting the financial reporting process including significant estimates, fraud risks, key controls, and other related matters.

For a discussion on the role of the auditor with respect to fraud risk, refer to Chapter 2.8 of this Guide.

D.4 Discovering Fraud

Because fraud is intentional, nobody (including the auditor) is meant to find it. As a result the discovery of fraud is not easy. Even when fraud is suspected, it often involves a lot of detailed work to find out what happened. Forensic accountants look to patterns, oddities or exceptions in seemingly insignificant matters for clues that something may be amiss. For example, to verify inventory, an independent auditor would attend an inventory count to ensure actual quantities agree with the company's records. To find inventory fraud, a forensic accountant might look for unusual buying patterns, read complaint letters from customers or employees' e-mails and check whether any addresses on supplier invoices match those of an employee.

Consider Point

Do not ignore small matters.

The way to discover fraudulent activity is to identify warning signs (such as patterns, oddities and exceptions) and then follow the trail. An immaterial amount (such as an inflated expense claim) should not be ignored. It may well be indicative of a larger issue, such as a lack of management integrity.

D.5 Anti-fraud Controls

Management and those charged with governance should be actively addressing the risk of fraud. This is particularly important in relation to management override.

Anti-fraud controls can be designed to discourage fraud in any size of entity. While the disincentive of anti-fraud controls may not stop management override altogether, it will slow it down by causing the perpetrator to think carefully about the repercussions of their actions. For example, a policy that journal entries must be supported by some explanation and a signature for approval will empower the accountant to always ask the manager for the explanation and approval. This simple step could also deter someone in senior management from making an unauthorized entry.

A useful anti-fraud control in smaller entities is to ensure some job rotation for key positions such as the accountant or bookkeeper. This person is often in a trusted position and has a lot of opportunity to commit fraud. A simple policy to deter this behaviour is to hire someone to take over this job for at least one week per year who would check to see nothing is amiss. This could be timed to coincide with the employee's regular holiday.

Consider Point

Use professional skepticism.

Avoid the temptation to place a lot of trust in management, particularly when the entity has been a client for many years. When this occurs, the fact that someone has committed fraud comes as a complete surprise. Unfortunately, fraud and management override can be perpetrated in any size of entity at any time. Professional skepticism assumes neither management's total honesty nor their dishonesty, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management or those charged with governance. It recognizes that fraud is always possible and that management is in the best position to commit fraud.

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Appendix E — Making Audit Inquiries

Appendix Purpose
To provide practical guidance on how to make audit inquiries.

Making inquiries is a fundamental part of performing any audit engagement. Risk assessment procedures suggest that auditors make inquiries of all key employees in the entity to help them identify potential risk factors. Where applicable, auditors should also talk with those charged with governance.

The skill of inquiry involves taking the time to craft meaningful questions, listening to what is being said and responding with appropriate supplementary questions. It also involves the skill of picking up on other clues in an interview such as hesitation, nervousness, and body language.

This appendix provides some general guidance for auditors in making inquiries.

E.1 Prepare for the Interview

Good preparation sets the tone for a purposeful and effective interview.

Establish Objectives
Determine the objective of the interview, the information required, and who can best provide it. Some typical interview objectives include:

- Explore or obtain an understanding of how things work;
- Verify or corroborate information already obtained;
- Investigate a potential fraud, illegal act or other risk factor;
- Obtain answers to unexpected results or contradictory information;
- Seek a different perspective on a particular matter;
- Seek assistance in obtaining additional information; and
- Obtain a management response to control weaknesses or identified misstatements in the financial statements.

Understand the Entity and the Interviewee
First consider the entity's culture and control environment. If they are strong, it may be possible to rely on the information provided without needing to verify it with supporting evidence. Conversely, a poor attitude toward control will mean less reliability can be placed on the information and representations provided.

Gather some information about the person you plan to interview. Consider their background, roles and responsibilities, skills, reputation and how their performance is measured and compensated. This will provide a basis for developing appropriately-worded questions and understanding the type of information the interviewee can/should be able to provide.

Develop a Strategy

Think through the interview and identify the most likely problems you might encounter. This is best done by putting yourself in the interviewee's shoes and thinking about how they might react to your questions. Problems could range from lack of time by the interviewee, unexpected responses to questions, inability to produce the required information or provision of new information that will need to be followed up, such as an indication of a fraud risk factor.

Develop an outline for the conduct of the interview. Ensure the progression through the interview is logical and straightforward.

- Develop an introductory statement that explains the purpose of the interview so that when you arrive, you can set the correct tone. This is important as it will build rapport with the interviewee and set them at ease.
- Prepare open-ended questions that move from the general to the specific. Open-ended questions cannot be answered with a simple yes or no. Yes/no answers are quick, but they may prevent you from learning about the person, the issues they face, and obtaining information that you may not otherwise have known about. You will learn a great deal more about the subject matter when the interviewee can express it in his or her own words.

Prepare Some Basic Questions

Be sure the questions are tailored for the particular interviewee and do not use terminology that the person may misunderstand. This clarity will help speed up the interview process and ensure you obtain the desired information.

A good interviewer knows there is enormous power in a question. A good question will often elicit information that the interviewee has not really planned to provide. A poor question has the opposite effect. It shows the interviewer was not prepared. This could empower the interviewee to provide less than complete information or even incorrect or misleading responses, if so inclined.

While it may be tempting to use questions from a form or to write them out word for word, it is better and more natural for conversation to simply make a list of the key points/areas you hope to cover.

Listing key points gives you flexibility to frame your questions naturally and pick up from previous responses. If your questions are verbatim, the interviewee will think you are simply going through the motions and filling in a form. It may be assumed that you are only interested in a quick superficial response that allows you to move to the next question and hasten the end of the interview. If all you need are answers to certain specific questions, it may be better to submit them to the interviewee in advance and then discuss the responses at the meeting.

Exhibit E-1

Checklist for Interview Preparation	
✓	Establish clear objectives.
✓	Do your homework – understand the entity and the interviewee.
✓	Develop a strategy. This includes the approach to take and how obstacles will be handled.
✓	Prepare to be flexible in your questioning.

E.2 Conduct the Interview

Where possible, interviews should be conducted in private. Use a meeting room if necessary. When you first meet, use simple manners to set a tone that is formal, friendly, and non-threatening.

Get the Interview Off to a Good Start

Sometimes, your introductory remarks can be the most challenging part of the interview. The goal is to create the proper impression, ask for cooperation and explain the nature of the interview. If your interviewee feels uncomfortable, it will be more difficult to gather the facts. Be sure to smile, exchange greetings, shake hands and introduce yourself.

Keep the opening statement simple, such as "I'm here today to ask some questions about the company's accounting policies and procedures." Keep the interviewee at ease and gain his or her cooperation with a simple, agreeable statement such as "do you mind taking a few minutes to help me?"

Begin Questioning

Structure the questions from the general ("tell me about…") to the specific ("who told you about…"), which will help you to build rapport. As the interviewee speaks, lean in slightly to show you are interested.

Begin with non-threatening questions – even if you already know the answer – before proceeding to more possibly contentious questions. Be sure to ask for the basis of any conclusions/assertions the interviewee expresses.

Professional skepticism requires us to be on alert for indications of deception intended to mislead us. As the questions become more focused, look for any changes in your interviewee's behaviour that may signal a suspicious or sensitive topic.

One strategy for detecting misleading answers is to compare them with information you were anticipating. Consider:

- Are the answers consistent with expectations?
- Are there anomalies?

- Are answers unnecessarily jargon-laced or full of unfamiliar terms?
- Does the answer address the question asked? Is the interviewee providing irrelevant information instead of a direct answer?

It is important to probe further if you sense the answers could be misleading. Consider what the interviewee's motivations or ulterior motives might be and ask to see evidence of the representations made.

Some tips when asking questions:

- Observe reactions. Look at how the interviewee is responding. Listen with both your ears and your eyes. Are the answers truthful? Do verbal responses and body language conflict? Anti-fraud investigators call this process "calibration" and it is vital when interviewing someone who could be inclined to withhold information or where honesty is an issue.
- Use silence. Long periods of silence between questions create a vacuum that interviewers are tempted to fill. Avoid that temptation. The tension of silence may provoke a subject to reveal information or provide cues that he or she is lying or withholding information. Quiet periods also give the interviewer an opportunity to assess the progress of the interview and change an upcoming question as needed.
- Listen more than you talk. Remember that you have two ears and one mouth. The goal is to listen more than talk. Try not to be speaking more than a quarter of the time.
- Stay on track. Keep your personal thoughts or suspicions to yourself unless expressing them is intentionally part of your interview plan. Above all, keep the interview on track.

Draw out Details
Ask supplementary questions to draw out additional details and more detailed responses. Ask questions such as:

- "And then what happens?"
- "What caused that situation to occur?"
- "Could you give me an example of that?"
- "Could you show me the relevant documents?"
- "Who else should I be speaking to about this?", etc.

Document the Answers
Develop a consistent pattern of note-taking throughout the interview. A sudden change in note-taking style during the interview may distract the interviewee and could even affect his or her answers. These notes should be legible and contain enough detail so that minutes of the meeting can be prepared later. If you anticipate obtaining a lot of detailed information, consider tape-recording the interview. Always obtain permission from the interviewee before recording an interview.

Make a Closing Statement
At the end of the interview, confirm your understanding of points raised, reiterate key facts, agree on any information that the interviewee will supply and determine any next steps. Also ask for

suggestions about others to interview if more information is needed. Follow your pre-interview strategy and ensure you have met your objectives.

Exhibit E-2

	Checklist for Conducting Successful Interviews
✓	Set the right tone.
✓	Design your questions to move logically from the general to the specific.
✓	Observe any changes in your interviewee's behaviour.
✓	Don't speak more than a quarter of the time.
✓	Keep the interview on track.
✓	Get additional details by asking supplemental (probing) questions based on previous answers.
✓	Keep a consistent pattern of note-taking.
✓	Confirm key answers and information before you leave.

E.3 Evaluate the Results

Once the interview is completed, write a memo to file (as soon as possible) to document the findings. If the subject matter is contentious or subject to potential litigation, consider keeping your handwritten notes to corroborate the formal memo to file.

Spend a few minutes to reflect on the interview and the information obtained. Consider factors such as:

- Any surprises. This could be information that invalidates previously-held assumptions or contradicts other evidence.
- Any themes, patterns or oddities that may indicate a potential risk. This could include weak internal control, potential management override, possible fraudulent activities, or other risks of material misstatement.

Finally, document your findings and consider whether new risks have been identified (that should then be assessed) or that further audit procedures should be expanded.

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