Hong Kong Institute of
Certified Public Accountants
香港會計師公會

November 2005

To: Members of the Hong Kong Institute of CPAs
All other interested parties

IAASB EXPOSURE DRAFT – IMPROVING THE CLARITY OF IAASB STANDARDS

- **Proposed Amendments to the Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services**
- **Proposed ISA 240 (Redrafted), The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements**
- **Proposed ISA 300 (Redrafted), Planning an Audit of Financial Statements**
- **Proposed ISA 315 (Redrafted), Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement**
- **Proposed ISA 330 (Redrafted), The Auditor's Procedures in Response to Assessed Risks**

Comments to be received by 10 February 2006

The Hong Kong Institute of Certified Public Accountants' (Institute) Auditing and Assurance Standards Committee is seeking comments on the IAASB Exposure Draft which have been posted on the Institute's website at:
www.hkicpa.org.hk/professionaltechnical/assurance/exposuredraft/.

The Explanatory Memorandum to the Exposure Draft provides background information and explanation of improvements to be made to the clarity of IAASB's International Standards and raises ten questions for commentators to respond on the significant proposals.

The IAASB is now seeking comments on four standards which have been redrafted in the proposed new style. The key elements of the new drafting style include:

- Basing the standards on objectives, as opposed to procedural considerations;
- Use of the word "shall" to identify requirements that the professional accountant is expected to follow in the vast majority of engagements;
- Eliminating the present tense to describe actions by the professional accountant, which some had regarded as ambiguous in terms of obligation; and
- Structural improvements to enhance the overall readability and understandability of the standards.

This Exposure Draft is important to all those interested in auditing standards because it sets the style and format for future auditing standards.

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In accordance with the Institute's ISA Convergence Due Process, comments are invited from any interested party and the Institute would like to hear from both those who do agree and those who do not agree with the proposals contained in the IAASB Exposure Draft. Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the IAASB Exposure Draft to be considered, they are requested to be received by the Institute on or before **10 February 2006**. Comments may be sent by mail, fax or e-mail to:

Stephen Chan
Executive Director
Hong Kong Institute of CPAs
4th Floor Tower Two, Lippo Centre
89 Queensway
Hong Kong

Fax number (+852) 2865 6776
E-mail: commentletters@hkicpa.org.hk

Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

November 2005
Exposure Draft

Response Due Date
10 February 2006

ED of Improving the Clarity of IAASB Standards

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This Exposure Draft may be filed in the "Exposure Drafts, Invitations to Comment" section of Volume III of the Institute Members' Handbook.

The Exposure Draft can also be found on the Institute's website at:
www.hkicpa.org.hk/professionaltechnical/assurance/exposuredraft/

International
Auditing
and Assurance
Standards Board

Exposure Draft
October 2005
Comments are requested by February 28, 2006

Improving the Clarity of IAASB Standards

Proposed Amendments to the Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services

Proposed ISA 240 (Redrafted), The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements

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International Federation
of Accountants

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REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB) approved the enclosed exposure drafts for publication in October 2005. The proposed redrafted International Standards on Auditing (ISAs) may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by e-mail or on computer disk, so that they will be received by **February 28, 2006**. All comments will be considered part of the public record. Comments sent in writing or on computer disk should be addressed to:

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

These exposure drafts are published in the English language. To achieve maximum exposure and feedback, the International Federation of Accountants encourages the reproduction of this publication in any format.

EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to, and an explanation of, improvements to be made to the clarity of IAASB's International Standards (Standards). It is accompanied by the first four proposed International Standards on Auditing (ISAs) redrafted to reflect such clarity improvements, which were approved for exposure by the International Auditing and Assurance Standards Board (IAASB) in October 2005.

Background

In September 2004, the IAASB issued the Exposure Draft, Proposed Policy Statement, "Clarifying Professional Requirements in International Standards Issued by the IAASB" (September 2004 Clarity ED), and the Consultation Paper, "Improving the Clarity and Structure of IAASB Standards and Related Considerations for Practice Statements" (September 2004 Clarity Consultation Paper).[1]

The September 2004 Clarity ED dealt with the language used to describe the responsibilities of the professional accountant. It contained proposals to specify and define two categories of professional requirements and to discontinue the use of the present tense in plain type paragraphs of the Standards when describing actions by the professional accountant. It sought comments on whether concern exists over a possible increase in the number of professional requirements arising from the elimination of the present tense, whether the proposals would enhance the quality and consistency of audits, and on the proposed prospective approach for implementation.

In the September 2004 Clarity Consultation Paper, the IAASB consulted on other aspects of the Standards that could affect their clarity, including their understandability, the way in which they are structured, and their applicability to the audits of both large and small-and medium-sized entities (SMEs), and related matters including possible "fundamental principles underlying an ISA audit."

Responses were received from regulators, oversight bodies, national standard setters, public accounting firms, professional accountancy organizations, and individuals. Input was also received from members of the IAASB's Consultative Advisory Group and the IFAC Small and Medium Practices and Developing Nations Permanent Task Forces. The IAASB is grateful to all who commented on the documents.

Based on those responses, the IAASB developed a proposal to improve the clarity of its Standards, designed to meet the needs of the widest range of stakeholders and users of the Standards. This was presented to an invited forum of interested parties to determine whether there was broad acceptance of the proposal, whether it was of sufficient benefit to be taken forward, and what further refinements may be needed.

On the basis of the above consultations, the IAASB is confident that the basis for improving the clarity of its Standards explained in this document is appropriate and will receive sufficiently wide acceptance.

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[1] These documents, which include background to the consultation, are available on the IAASB website at www.ifac.org/IAASB.

This memorandum presents:

- The conventions to be used by the IAASB for drafting future ISAs and other International Standards, including the authority and obligation attaching to those conventions;
- The IAASB's intended approach for implementing the new drafting conventions; and
- The basis for the IAASB's decisions, in the light of the consultations.

Proposed amendments to the Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services (Preface), and four ISA Exposure Drafts, redrafted to apply the new drafting conventions, accompany this memorandum.

The IAASB will consider the need to refine the new drafting conventions, if necessary, in light of comments on their application to the four ISA Exposure Drafts.

Questions for Respondents

The IAASB seeks comments on:

- The application of the new drafting conventions to the accompanying four ISA Exposure Drafts;
- The IAASB's intended implementation approach, including priorities and timetable; and
- The necessary changes to the Preface that describe the new drafting conventions, including the authority and obligation attaching to those conventions, and whether they are clear and understandable.

This explanatory memorandum asks for reactions on a number of matters relating to the above. These matters are set out in their appropriate context throughout this memorandum. They are summarized below, in question format, for respondents' convenience:

Restructuring Aspect of the New Drafting Convention

Q1. In the light of the separation of requirements and application material, as presented in the four ISA Exposure Drafts, do you believe there is a need to repeat the requirements at relevant points within the application material to enhance context and reference, as discussed on page 10?

Application of the New Drafting Conventions to the Four ISA Exposure Drafts

Q2. Are the objectives to be achieved by the auditor, stated at the beginning of the proposed ISAs, appropriate?

Q3. Have the guidelines identified by the IAASB for determining whether a requirement should be specified, as set out on page 6, been applied appropriately and consistently, such that the resulting requirements are at a level that promotes consistency in performance and the use of professional judgment by auditors?

Q4. Has the application material been edited in a way that makes it clearer?

Q5. Has an appropriate balance been achieved between eliminating duplicative material and retaining some repetition in the proposed ISAs to help users understand a particular ISA or how the ISAs interrelate?

Q6. Do you support the way in which special considerations in the audits of SMEs and public sector entities have been presented in the application material?

Q7. Do respondents from developing nations foresee difficulties arising from the changes in the proposed ISAs in their environment?

Q8. Do you foresee any potential translation issues?

Implementation Approach

Q9. Do you agree with the proposed implementation approach, including priorities and timetable, as discussed on pages 8 and 9 and as set out in Appendix 1?

Proposed Amendments to the Preface

Q10. Do you have any comments on the necessary changes to the Preface to reflect the new drafting conventions?

Improving the Clarity of IAASB Standards

Improvements to the Standards arising from the above consultations are described below and broadly comprise:

- Setting an objective in each Standard;
- Clarifying the obligations imposed on professional accountants by the requirements of the Standards, and the language used to communicate such requirements;
- Eliminating any possible ambiguity about the requirements a professional accountant needs to fulfill arising from the use of the present tense in current Standards; and
- Improving the overall readability and understandability of the Standards through structural and drafting improvements, including making the application material contained in the Standards clearer.

These improvements seek to make the Standards clearer, thereby improving their consistent application; and to do this in a way that will assist their adoption and facilitate international convergence while not resulting in any weakening of the Standards. These improvements also respond in a timely manner to many of the findings of the IFAC Report, "Challenges and Successes in Implementing International Standards" (Wong Report)[2] (as discussed further in the IAASB's basis for conclusions – see Appendix 2).

Objectives-based Standards

Each Standard will state the objective to be achieved by the professional accountant in relation to its subject matter.

The objective will be presented in a separate section at the beginning of each Standard.

The professional accountant will be required, in all cases, to achieve the objective stated in a Standard that is relevant in the circumstances of the engagement. The professional accountant is expected to achieve that objective by complying with the requirements of the Standard, and by

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2 The report, published in September 2004, is available on the IFAC website at www.ifac.org.

performing other procedures that, in the professional accountant's judgment, are necessary in the circumstances.

Clarifying Professional Requirements

Each Standard will specify requirements designed to assist the professional accountant in achieving the objective stated in the Standard.

The requirements, which are those actions or procedures that are of sufficient importance as to be generally required if the professional accountant is to achieve the stated objective, will be presented in a separate section within each Standard.

The requirements of a Standard are to be applied in all cases where they are relevant in the circumstances of the engagement.

Requirements will be identified by the word 'shall.'

In exceptional circumstances where the professional accountant judges it necessary to depart from a requirement in order to achieve the purpose of that requirement, the professional accountant will be required to document how the alternative procedure(s) performed achieves the purpose of the requirement, and, unless otherwise clear, the reasons for the departure. The need for the professional accountant to depart from a requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the engagement, that procedure would be ineffective.

For ISAs, the IAASB considers it important to include a description within those Standards of the obligations of the auditor with respect to the objectives and the requirements. Accordingly, a similar description to that which is proposed as an amendment to the Preface will be included also in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," when it is revised.

The IAASB will determine the requirements of a Standard as follows:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.

In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

These guidelines, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

Eliminating Ambiguity Arising from Use of the Present Tense

The present tense will no longer to be used in the Standards to describe actions or procedures by the professional accountant.

In applying the new drafting conventions to existing Standards, sentences describing the professional accountant's actions or procedures in the present tense will be redrafted either by elevating the action or procedure to the status of a requirement or by using words that make it clear that there is no intention to create a requirement. The application of the new drafting conventions to the actions or procedures described in the present tense will be made on a case-by-case basis in accordance with the guidelines above, bearing in mind the benefits and disadvantages that an increase in the extent and specificity of requirements within the Standards may have.

Improving Readability and Understandability

Structure

All Standards will contain four principal sections. In addition, a Definitions section will be included within a Standard if new terms or expressions are introduced for the first time in that Standard. The sections are:

- Introduction – the scope and effective date of the Standard;
- Objective – the objective to be achieved by the professional accountant;
- Requirements – the requirements to be complied with, together with essential explanatory material where necessary to make the section understandable by an experienced professional accountant; and
- Application Material – material, supplemented in some cases by appendices, that provides further explanation and guidance supporting proper application of the Standard. Such material may identify and describe other procedures or actions relating to the activities of the professional accountant. However, although the professional accountant has a responsibility to consider the entire text of a Standard in carrying out an engagement, the application material is not intended to impose a requirement for the professional accountant to perform the suggested procedures or actions. Rather, these procedures or actions require the professional accountant's attention and understanding; whether the professional accountant carries out such procedures or actions in the engagement will depend on the exercise of professional judgment.

Related material contained in the 'Requirements' and 'Application Material' sections will be cross-referenced.

Drafting Improvements

Drafting improvements, where appropriate, will be implemented to improve the readability and understandability of the Standards. These will include:

- Reducing or eliminating duplication within individual Standards, as appropriate, thereby improving their overall clarity through more effective presentation.
- Making use of shorter sentences and other formatting techniques such as bullet points, headings and sub-headings that improve the understandability and flow of the Standards.
- Highlighting considerations specific to small entities and public sector entities through the use of specific sub-headings within the application material of a Standard.

Drafting improvements to existing Standards to reduce or eliminate duplication are to be made only to the extent that there is no loss of understandability of a Standard. This will be determined on a case-by-case basis, in the light of what is most effective from the users' point of view. For example, the IAASB felt that it was important to retain in the proposed ISA 240 (Redrafted), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," certain material that exist in other ISAs for purposes of context and understandability of that ISA.

Implementation

The IAASB intends to apply the new drafting conventions to as many Standards as practicable in the shortest possible time, without compromising due process. The IAASB's initial focus is on ISAs, as opposed to the other International Standards, reflecting the importance that audits conducted in accordance with ISAs have to the public interest.

Appendix 1 presents a preliminary timetable for applying the new drafting conventions to the ISAs. Application to other International Standards will be determined by the IAASB at a future date.

Existing Exposure Drafts

For those proposed ISAs that are at present under revision and exposure[3], the IAASB will consider comments arising from exposure and whether changes as a result of the IAASB's deliberations thereon give rise to the need for re-exposure. Subject to the preceding steps and before the proposed revised ISAs are finalized, however, they will be redrafted to reflect the new drafting conventions and re-exposed. Comments will be sought only on changes resulting from applying the new drafting conventions and not on substantive issues addressed in the first exposure (unless the IAASB believes that changes made as a result of the original exposure warrant re-exposure). This implementation plan will result in deferring the finalization of those ISAs by approximately one year.

Exposure Drafts Approved for Issue After September 2005

The new drafting conventions are to be applied to all exposure drafts approved for issue by the IAASB after September 2005.

The IAASB's current work program includes a number of projects to revise existing Standards. Accordingly, some exposure drafts of proposed revised Standards may be issued before the completion of this consultation on the accompanying Exposure Drafts. The findings from this consultation, however, will be applied to the final drafting of exposure drafts issued in the interim period.

Existing ISAs

Recently Revised and Updated ISAs

The IAASB also plans to apply the new drafting conventions to recently issued ISAs.[4] This will be done throughout the period ending September 2007. As these ISAs have been recently updated, they will be redrafted in accordance with the new drafting conventions, but not otherwise updated.

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3 Section II of Appendix 1 lists the proposed ISAs that are presently under exposure.

4 Section I of Appendix 1 lists the recently issued ISAs to which the new drafting conventions are to be applied. The findings from the consultation on the first set of four ISA Exposure Drafts herein will be used to determine the final approach to be taken on redrafting the remaining ISAs.

Effective Date

If the preliminary timetable set out in Appendix 1 is met, the IAASB intends to set one effective date for the set of redrafted ISAs completed by September 2007. The earliest possible effective date is likely to be for periods beginning on or after December 15, 2007 in order to provide a reasonable period for translation and implementation.[5] The actual effective date, however, will depend on whether the preliminary timetable is achieved and on further discussion with those who are responsible for translation, adoption and implementation of the redrafted ISAs.

Remaining ISAs

The IAASB plans to apply the new drafting conventions to the remaining ISAs, in conjunction with their revision and updating. The priorities and schedule for this are to be determined. It is anticipated that this work would be completed by the end of 2011.

Except (as noted below) with respect to the documentation of departures from existing basic principles and essential procedures and the use of 'shall' to indicate a requirement, the existing description of the authority and conventions of the Standards contained in the Preface will remain applicable for existing Standards until they have been redrafted or revised.

Documentation of Departures

The IAASB believes that requiring the professional accountant to document a departure from a requirement responds to the public interest and is appropriate for what should be a rare occurrence. ISA 230 (Revised), "Audit Documentation," introduced this documentation requirement for departures from the basic principles and essential procedures of the ISAs effective for audits of financial information for periods beginning on or after June 15, 2006.

Use of 'Shall'

The word 'shall' will replace the word 'should' in existing ISAs effective concurrently with when the enclosed redrafted ISAs become effective.

Consideration of the Body of ISAs as a Whole

The ISAs are an integrated and complete body of Standards and as such, the need for consistency both within and across ISAs and for an appropriate structure for the presentation of their content is paramount. Accordingly, the IAASB will consider whether the content (in particular, the objectives and requirements) of the set of redrafted ISAs is consistent, complete and free of overlap, as appropriate, before those ISAs are finalized.

When applying the new drafting conventions to the ISAs, the IAASB may also identify further opportunities to group or rearrange material across the ISAs that address a similar topic (for example, by creating a new ISA to deal with a topic in a single place), or to enhance the structure of the ISAs. Such changes, if deemed significant, would be exposed for comment.

[5] To assist in translation and implementation activities, redrafted ISAs would be made available at the time the IAASB finalizes them throughout 2006-2007.

Guide for Respondents

Clarity Improvements

The IAASB has considered carefully the responses to the September 2004 Clarity ED and Consultation Paper. It has concluded in principle on the general direction to be taken to improve the clarity of its Standards and is therefore not seeking further comments on this direction. Rather, the IAASB believes that further consultation is best achieved by obtaining views on the application of the new drafting conventions to the four accompanying ISA Exposure Drafts.

There is, however, one matter pertaining to the general direction on improving clarity on which views of respondents are sought. This matter deals with the relationship between the requirements and the application material. The majority of the IAASB believe that the presentation in the proposed ISAs is appropriate for purposes of distinguishing requirements from the application material, and in maintaining clarity between what is required and what is guidance. Some, however, believe that there would be an advantage in repeating the requirements at relevant points within the application material. They believe that being able to read the requirements and related application material together is essential to enable professional accountants to understand the requirements and to apply them consistently. Respondents are encouraged to submit their views on this matter.

Deadline for Comments

This consultation begins a planned series of steps in order to achieve the ambitious timetable set out in Appendix 1. Any delay in analyzing and considering the responses to this consultation will affect the ability of the IAASB to meet that timetable. Accordingly, the IAASB will consider, and proceed based on, comments on the accompanying Exposure Drafts received on or before February 28, 2006. Comments received after that date will not be considered.

Proposed Amendments to the Preface

Although the IAASB is not seeking comments on the general nature of the clarity improvements, it welcomes comments on the proposed amendments to the Preface that describe the new drafting conventions, including the authority and obligation attaching to those conventions, and whether they are clear and understandable.

The IAASB recognizes that comments on the application of the new drafting conventions may lead the IAASB to make further refinements. Accordingly, the necessary amendments to the Preface will be finalized concurrent with the finalization of the set of redrafted ISAs.

Implementation

Comments are invited on the IAASB's intended implementation approach, including priorities (particularly in relation to the relative priority of each of the existing ISAs listed in Section IV of Appendix 1) and timetable.

ISA Exposure Drafts

The accompanying ISA Exposure Drafts are redrafted solely to apply the new drafting conventions to them. Accordingly, comments are not sought on other issues that may be thought to exist and the IAASB will not consider such comments.

The IAASB is seeking comments on the changes arising from the application of the new drafting conventions to the ISAs, specifically:

- Whether the objectives to be achieved by the auditor, stated at the beginning of the proposed ISAs, are appropriate.
- Whether the guidelines identified by the IAASB for determining whether a requirement should be specified have been applied appropriately and consistently, such that the resulting requirements are at a level that promotes consistency in performance and the use of professional judgment by auditors.
- Whether the application material has been edited in a way that makes it clearer.
- Whether an appropriate balance has been achieved between eliminating duplicative material and retaining some repetition in the proposed ISAs to help users understand a particular ISA or how the ISAs interrelate.

Comments are most helpful when they refer to specific paragraphs (or identify examples to support a point), include the reasons for the comments, and, where appropriate, suggest specific changes to wording. The IAASB would also find it helpful to know when a respondent agrees with proposals in the Exposure Drafts (especially those pertaining to the proposed objectives and elevation (or not) of statements in the present tense).

Special Considerations in the Audit of Small Entities

Respondents are asked to comment on the way in which considerations in the audit of small entities have been included in the application material. Reasons should be provided, as well as any suggestions for alternative presentations.

Special Considerations in the Audit of Public Sector Entities

Special considerations in the audit of public sector entities were included in the Public Sector Perspective at the end of the current ISAs. The IAASB's current policy is to include such considerations within the body of an ISA. Accordingly, as part of redrafting of the ISAs, those special considerations have now been included at appropriate points within the application material. Respondents are asked to comment on whether, in their opinion, this presentation is effective.

Developing Nations

Many developing nations have adopted or are in the process of adopting the ISAs, and the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties arising from the changes in the proposed redrafted ISAs in their environment. Reasons should be provided, as well as suggestions for alternative treatments.

Translation

The IAASB welcomes comments on potential translation issues noted in reviewing these exposure drafts.

Supplements to the Exposure Drafts: Mapping Documents

For reference purposes, IAASB staff has prepared for each ISA Exposure Draft an analysis of the decisions that have been made by the IAASB with respect to the treatment of the present tense in the explanatory paragraphs of the extant ISAs. These analyses demonstrate how the material in the current ISAs has been reflected in the ISA Exposure Drafts. In particular, the analysis:

- Identifies existing sentences in the present tense and whether they are now treated as a requirement or as application material;
- Maps the material of each extant ISA to the redrafted ISA; and
- Identifies explanatory material that is proposed to be eliminated or repositioned as a result of redrafting.

These Staff-prepared mapping documents are available on the IAASB website at www.ifac.org/IAASB. They are for information purposes only and do not form part of the Exposure Drafts.

Comments on the mapping documents in the form of suggestions for their enhancement in assisting respondents' consideration of the future redrafting of Standards under the Clarity project are welcome.

Appendix 1

Clarity Implementation Timetable for ISAs

I. Application of the New Drafting Conventions to Recently Issued ISAs

ISA	Tentative Timetable for Issue of Final Redrafted ISA
ISA 240, The Auditor's Responsibility To Consider Fraud in an Audit of Financial Statements	July 2006
ISA 300, Planning an Audit of Financial Statements	July 2006
ISA 315, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement	July 2006
ISA 330, The Auditor's Procedures in Response to Assessed Risks	July 2006
ISA 500, Audit Evidence	June 2007
ISA 700, The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements	June 2007
ISA 200, Objective and General Principles Governing an Audit of Financial Statements	September 2007
ISA 220, Quality Control for Audits of Historical Financial Information[6]	September 2007
ISA 230, Audit Documentation	September 2007

II. Application of the New Drafting Conventions to ISAs Currently Under Exposure

Current Exposure Drafts	Tentative Timetable Plan for Issue of Final Revised and Redrafted ISA
Proposed ISA 260 (Revised), The Auditor's Communication with Those Charged with Governance	March 2007
Proposed ISA 320 (Revised), Materiality in the Identification and Evaluation of Misstatements	March 2007
Proposed ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures	March 2007
Proposed ISA 600, The Audit of Group Financial Statements	March 2007
Proposed ISA 701 and ISA 800, The Independent Auditor's Report on Other Historical Financial Information and The Independent Auditor's Report on Summary Audited Financial Statements	June 2007
Proposed ISA 705 and ISA 706, Modifications to the Opinion in the Independent Auditor's Report and Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report	June 2007

[6] When applying the new drafting conventions to ISA 220, the IAASB will consider International Standard on Quality Control 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements."

III. Application to the New Drafting Conventions to Current Projects

Current Projects	Tentative Timetable Plan for Issue of Exposure Draft (reflecting Clarity drafting conventions)
Revision of ISA 550, Related Parties	December 2005
Revision of ISA 580, Management Representations	July 2006
Revision of ISA 620, Using the Work of an Expert	September 2006

IV. Application of the New Drafting Conventions, together with Revision and Updating (as considered necessary), to the Remaining Existing ISAs [7]

ISA	Estimated Time Period
• ISA 210, Terms of Audit Engagements • 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—Specific Items • ISA 505, External Confirmations • ISA 510, Initial Engagements—Opening Balances • ISA 520, Analytical Procedures • ISA 530, Audit Sampling • ISA 545, Auditing Fair Value Measurements and Disclosures • ISA 560, Subsequent Events • ISA 570, Going Concern • ISA 610, Considering the Work of Internal Auditing • ISA 710, Comparatives • ISA 720, Other Information in Documents Containing Audited Financial Statements	2008-2011

[7] The relative priority of each of these ISAs is to be determined.

Appendix 2

Basis for Conclusions

The IAASB's review of the responses to the September 2004 Clarity ED and Consultation Paper identified, first and foremost, that many stakeholders view the current Standards as being of high quality and providing a sound basis for high quality assurance engagements, and that they should not be dismissed as in any way inadequate.

Nevertheless, the responses included a wide range of views and recommendations about how to improve the clarity of the Standards.[8] There was clear support for the project, but no clear consensus on the direction it should take.

Having studied and deliberated on these views and recommendations, and the options that could be pursued, the IAASB reached the following general conclusions:

- There is a clear need to advance the project, and to improve the clarity of the Standards, on a timely basis. Accordingly, those options that can result in improvement in the near term should be given priority.
- It may not be possible to satisfy all of the views of all respondents, and attempting to fulfill too many objectives may prevent the timely achievement of the main goals of the Clarity project. Accordingly, it is necessary to reach a compromise that will be acceptable to most stakeholders.
- The approach to improving clarity needs to include matters raised in the September 2004 Clarity Consultation Paper as well as those in the Clarity ED.
- Where possible, the selected approach should assist, rather than impede, international convergence.
- The selected approach must not result in a weakening of the existing Standards.

The following summarizes broadly the main comments received and the basis for the decisions of the IAASB in determining the way forward to improve the clarity of its Standards.

Focus on Objectives

Identifying Objectives

The majority of respondents to the September 2004 Clarity ED and Consultation Paper expressed concern over the potential for a significant increase in the number of requirements that may arise as a result of the proposals. Respondents therefore urged the IAASB to continue to follow a 'principles-based' approach in setting its Standards. Further, several respondents recommended that an 'objectives-based' approach be considered, where the focus is on the required outcome of the procedures, rather than the procedures themselves.

The IAASB considers, for all intents and purposes, 'principles-based' and 'objectives-based' standards as broadly equivalent. It believes, however, that there is merit in strengthening this

8 Responses to the September 2004 Clarity ED and Consultation Paper are available on the IAASB website at www.ifac.org/IAASB.

characteristic of its Standards by identifying the objective to be achieved by the professional accountant in following the requirements of a Standard, for the following reasons.

First, separate identification of objectives may help professional accountants better understand the purpose of the requirements. In turn, this may assist in the evaluation of whether the objectives have been met, and therefore, the objective of the engagement.

Secondly, it emphasizes the need for the professional accountant to focus on the outputs (or aims) of the engagement, rather than the inputs (procedures).

Thirdly, it may assist the IAASB in determining the requirements to be established in a Standard. This would respond, in part, to those respondents who recommended that the IAASB establish some basis for determining the extent of the requirements in the Standards.

Obligation to Achieve the Objectives

The IAASB believes that the professional accountant should be required to achieve the objective stated in a Standard that is relevant to the engagement; and to do so by both complying with the requirements of a Standard and performing other procedures that, in the professional accountant's professional judgment, are necessary in the circumstances.

The IAASB believes that the professional accountant needs to focus on the aims of the engagement, rather than on the procedures alone. Further, this approach reinforces that, while the requirements of a Standard are designed to cover substantially all relevant circumstances, they are not necessarily complete as it is neither practical nor desirable for Standards to specify requirements that address all possible circumstances. The IAASB believes that the use of professional judgment by professional accountants in designing the procedures necessary to meet the stated objectives is an essential foundation to the conduct of high quality audit and assurance engagements.

This approach promotes the establishment of requirements that are not so procedural in nature, nor so comprehensive, as to drive a compliance mentality on the part of the professional accountant to the detriment of the use of professional judgment. The IAASB regards this as the most appropriate way of achieving an appropriate balance between Standards that are clear and understandable and that promote professional judgment.

The IAASB recognizes, however, that there may be circumstances where the intention of the IAASB is that certain required procedures are the full extent of what is required to be done by the professional accountant in a certain aspect of the engagement. In such cases, the Standard will make that clear.

Presentation

The IAASB believes that setting out the objective separately within a Standard from the requirements will assist in maintaining the essential quality of the objective as the desired outcome to be achieved, and in distinguishing the objective from the requirements.

Clarifying Professional Requirements

Categories of Professional Requirements

The IAASB determined that it should not proceed with its proposal to establish two categories of professional requirements – *requirements* ('shall' statements), which were defined as requirements to be complied with in all applicable circumstances, and *presumptive requirements* ('should' statements), which were defined as requirements where there may be limited circumstances where there may be a need to depart – as set forth in the September 2004 Clarity ED. Instead, the IAASB decided to retain a single level of requirement, because of the following factors.

First were the concerns raised by some respondents that the proposed distinction between the two categories was both insufficiently significant and difficult to make. Some considered the proposed definition of *presumptive requirements* along with the proposed documentation requirement for departures would effectively put them on the same level of authority as a proposed *requirement*. Further, it was made clear that the proposals would create difficulty for certain national standard setters that intend to adopt the Standards by way of legislation; in some jurisdictions, all standards are normative and quasi-legislative, with no distinction between different requirement levels.

Similarly, the Wong Report noted concerns in relation to the difficulties in translation presented by using words such as 'shall' and 'should' and the present tense to indicate different levels of obligation. Distinguishing between *requirements* and *presumptive requirements* may create confusion and introduce complexity with only marginal benefit. The IAASB also concluded that the degree of subjectivity involved in deciding whether a requirement was to be a *requirement* or a *presumptive requirement* may make it difficult to justify the distinction.

Secondly, the IAASB became concerned, based on indications in certain respondents' comments, that internationally a more liberal view may be taken of the degree of flexibility to depart from a *presumptive requirement* (based on the proposed definition) than was originally intended. The IAASB does not support any action that may inadvertently result in a real or perceived weakening of the Standards.

Thirdly, a number of respondents believed that changing the definition of 'should' statements would create a significant degree of confusion, and potential for misapplication, particularly if the same terms were used with different definitions in both existing Standards and newly drafted ones as a result of the proposed prospective implementation approach.

Although approximately one-half of respondents generally supported the proposal for categories of requirements, the IAASB accepts that the use of a single level of requirement, with the need to document a departure, is clearer and leaves less scope for confusion and interpretation. It also simplifies the process of developing the Standards, by helping to reduce the debate as to whether a requirement is a 'should' or a 'shall', which is of lesser significance than whether something should be a requirement at all.

Language

The IAASB agreed to change the language used to indicate a requirement from 'should' to 'shall' based on the following:

- It more clearly expresses an obligation and therefore would be more in line with the high degree of obligation inherent in a requirement in the Standards.
- It would align terminology with that used in International Financial Reporting Standards.

- It is more compatible with legislative practices; although the Standards are not drafted specifically for that purpose, a change to 'shall' was seen as important to those jurisdictions that plan to adopt, or establish legal backing to, the Standards through legislation.

The IAASB also believes that there is merit in having one single term ('shall') for both the existing Standards and those that have been redrafted using the new drafting conventions. With the exception of the labels "basic principles and essential procedures" for existing Standards and "requirements" for future Standards, the same obligation in terms of compliance, basis for departure and documentation of departure will exist for the requirements of both the new and older ISAs. The IAASB therefore believes there is little basis for creating a difference in language.

Mandatory Requirements

Some concern was voiced that the Standards with a single level of requirements would contain no truly mandatory instructions. The IAASB believes that this concern is misplaced, and that it is necessary to consider the way in which the Standards are drafted, the requirements defined, and departures therefrom permitted. The IAASB views that the combination of:

- specifying objectives together with an overriding obligation for the professional accountant to achieve them; and
- the high level of obligation in a requirement as evidenced by the departure conditions (see below),

ensures that certain requirements simply could not be replaced by the professional accountant with alternatives.

Accordingly, the IAASB concluded that there is little benefit in establishing a separate category of requirements that would declare certain requirements as specifically mandatory.

Departure from Requirements

Departure Threshold

The September 2004 Clarity ED proposed that a departure from a *presumptive requirement* (a 'should' statement) would be permitted in rare circumstances provided that the professional accountant documents why the professional accountant decided to do so and how the alternative procedure(s) performed were sufficient to achieve the objectives of the presumptive requirement.

As indicated above, the IAASB became concerned, based on indications in certain respondents' comments, that departures, based on the proposed definition, may be more frequent than the IAASB intended. It therefore considered how the present restrictive basis for departure might be amended to fit the new drafting conventions. In particular, the IAASB favored retaining the need for "exceptional circumstances" to exist, and for the professional accountant to "judge it necessary to depart" to provide the desired high hurdle for a departure to be permissible.

The IAASB reconsidered, however, whether the departure from a requirement should be considered in the context of the objective of the engagement (as per the current Preface), or the purpose of the requirement (as proposed in the September 2004 Clarity ED). The IAASB re-affirmed its view that the latter is correct on the basis that requirements, established after due process, represent actions or procedures of sufficient importance as to be generally required of the professional accountant. A decision to depart should therefore be followed by the performance of an alternative procedure(s) that can achieve the intended purpose of the requirement. Further, the IAASB believes this formulation to be consistent with:

- The IAASB's expectation that departure should be a rare occurrence.
- The IAASB's view that relevant requirements are, in effect, essentially mandatory in all circumstances, while accepting that all circumstances cannot be foreseen and that the professional accountant must be given some latitude to exercise professional judgment when a requirement would clearly not be effective in the circumstances.

A few respondents observed that setting the point of reference for a departure at the requirements-level requires the Standards to clearly explain the purpose of a requirement. The IAASB agrees in principle with this observation, but is satisfied that in most cases the purpose of a requirement will be self-evident; if it is not, further explanation will be provided.

During discussion of the appropriate conditions for a departure from a requirement, both in the context of this project and the IAASB's revision of ISA 230, "Audit Documentation," [9] the IAASB also concluded that the condition for departure should exclude reference to "more effectively" in determining whether there is a need to depart from a requirement to achieve the purpose of a requirement.[10] Further, the IAASB believes that the need to depart should only be considered in light of the circumstance of the engagement where the performance of a specific procedure would be ineffective. The proposed amendments to the Preface clarify this expectation.

Documentation

Respondents expressed mixed views over the proposed requirement for the professional accountant to document departure from a 'should' statement, which was a proposed change to the requirement in the current Preface for the professional accountant "…to be prepared to justify the departure." In addition, a number of respondents assumed that it would be necessary to document a departure even when the circumstances were such that a requirement was not applicable. Similar views were expressed by respondents to the Exposure Draft, ISA 230 (Revised) on its related proposed documentation requirement.

In finalizing the revision of ISA 230, the IAASB concluded that it is appropriate to require the documentation of a departure from a requirement, including the reasons for the departure (unless otherwise clear), and how the alternative procedure(s) achieves the purpose of the requirement. It also decided to clarify that the requirement to document departures applies only where the requirement is in fact relevant to the circumstances of the engagement.[11] The IAASB believes these decisions are equally relevant to all of its Standards, respond to the public interest and result in documentation that is appropriate, and not unduly burdensome, for what should be a rare occurrence. The decisions are therefore implemented though the revision of ISA 230 so as not to defer them until the Clarity project is completed.

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9 ISA 230 (Revised), "Audit Documentation," issued by the IAASB in September 2004 is available on the IAASB website at www.ifac.org/IAASB.

10 IAASB's basis for conclusion on this matter is set out in the document "Basis for Conclusions on Revised ISA 230, Audit Documentation," available at www.ifac.org/IAASB.

11 See footnote 10.

Eliminating Ambiguity Arising from Use of the Present Tense

Nearly all respondents supported the proposal to eliminate the perceived ambiguity arising from the use of the present tense in the Standards to describe actions by the professional accountant. The majority of respondents, however, expressed significant concern over the potential increase in the number of requirements in the Standards that may arise from doing so. In particular, respondents argued that more procedural standards might engender a compliance mentality in professional accountants, thereby affecting the quality of their conclusions when applying the Standards. Respondents therefore emphasized the need for the IAASB to continue to follow a 'principles-based approach' to standard setting, echoing the findings of the Wong Report.

Respondents were also of the view that while the decision to specify a requirement is ultimately based on the experience and judgment of the IAASB, the IAASB may need to describe how it will determine the extent and detail of the requirements of the Standards, and whether a procedure should be a requirement, or an option or consideration. Respondents' comments, however, indicated fundamentally different philosophies towards standards that contain a greater number of detailed requirements versus those that set 'higher-level' requirements.

The IAASB concluded that it is necessary to manage the risk of an unreasonable increase in requirements in a way that the quality of the work of the professional accountant – which is predicated on the proper use of professional judgment – is not diminished. To this end, the IAASB believes that it is important to communicate its general philosophy and approach (that is, the broad guidelines) that it intends to use in determining requirements.

In formulating these guidelines, the IAASB believes that a clear focus on objectives, together with requirements (including requirements to perform certain procedures), will achieve an appropriate balance that enables and supports the application of professional judgment. Further, the IAASB believes that, and as supported by many of the responses to the September 2004 Clarity ED and Consultation Paper, the requirements of the Standards should be such that they are: clear and capable of consistent application; set at a level at which they promote professional judgment in their application; and applicable to all engagements, regardless of the size and structure of the professional accountant's firm or of the entity subject to the engagement.

Accordingly, the IAASB intends to specify a requirement when it is necessary to achieve the objective, and expected to be applicable to virtually all engagements.

The IAASB also believes it important to consider whether, on balance, the resulting requirements are appropriate having regard to the importance of the subject matter of the Standard in relation to the overall objective of the engagement – that is, to consider a test of 'proportionality' in order to consider, and reflect upon, the requirements in relation to the relative importance of the matter under consideration and whether the new requirements promote the proper application of professional judgment (taking into account requirements that may exist in other ISAs).

Although the guidelines are set out in the context of determining requirements in new or revised Standards, the immediate consideration is their application to 'elevating' present tenses in existing Standards (to which the guidelines equally apply).

Improving Readability and Understandability

A majority of respondents re-emphasized the views, recognized in the September 2004 Clarity Consultation Paper, that the length of some of the more recent ISAs has affected their usefulness and understandability. They were seen as less likely to be read, and these features may pose a threat to overall audit quality, international convergence and their applicability to the audit of SMEs. It was noted that the extent of detail provided in the ISAs may be counterproductive in some jurisdictions. Further, the degree of detail has posed some challenges to implementation in audit methodologies, by professional accountants of SMEs, and in documenting compliance.

In contrast, several respondents noted that the style of recent ISAs has improved the quality of the standards by contributing to a better understanding of the issues. It was noted that additional explanatory material is often needed to deal with complex issues. In today's environment, more detail is required in standards to make them effective in achieving consistently high quality audits. Respondents were generally of the view, however, that length is an issue to the extent that it impairs the clarity of ideas being expressed.

Based on respondents' comments, the IAASB believes that measures needed to be taken to address the length and complexity of the Standards, and to assist international convergence and adoption of ISAs.

Structure

Restructuring of the Standards was seen by a majority of respondents as a possible solution to these issues. Some indicated that restructuring may make the Standards more applicable to professional accountants who serve SMEs, and that they would not support the proposals to clarify the requirements of the Standards unless some form of restructuring was carried out at the same time. A number of others made their support for elements of the proposals conditional on restructuring.

Others believed that restructuring may impair the convergence effort, and a significant minority recommended no restructuring. The principal concern was that separation of explanatory material from requirements would lead to inconsistent application and result in the loss of important context. It was also feared that restructuring may exacerbate standards overload by creating an inordinate amount of repetition, an outcome contrary to the objectives of a restructuring.

The IAASB is of the view that a restructuring of the Standards will help the professional accountant to focus on the principal things that the professional accountant needs to do and know, and is thereby likely to enhance the quality and consistency of audit and assurance engagements. The IAASB believes that restructuring offers an opportunity to reposition requirements within a Standard so that they can be read more easily: (i) in relation to the particular subject matter to which they relate; and (ii) on the whole, within the context of all of the requirements of a Standard. The importance of these aspects of clarity was underscored by reference to the likely increase in the number of requirements resulting from eliminating the present tense. The IAASB is also particularly influenced by the views of certain national standards setters who are engaged in implementing ISAs in their jurisdictions (as also reflected in the findings of the Wong Report).

Of the different restructuring options outlined in the September 2004 Clarity Consultation Paper, the IAASB concluded that restructuring of the Standards into separate sections within one document (Option B in the Consultation Paper) presents the option that was acceptable to the majority of stakeholders, based on responses received. It also responds to the strong concern expressed by several respondents about placing application material in a separate document from the requirements. By retaining both requirements and application material in a Standard, the IAASB is satisfied that there would be no weakening of the Standards resulting from restructuring – explanatory material that is retained from existing Standards will have the same status as present, and the professional accountant would be required to consider the application material as part of understanding and applying the requirements, thereby avoiding any notion that the application material may be overlooked or ignored.

Drafting Improvements

A significant majority of respondents urged the IAASB to consider additional ways to improve the readability and understandability of its Standards, and to minimize their length.

The IAASB concluded that substantial redrafting of the Standards to accommodate all concerns or some of the more fundamental recommendations would not be cost beneficial. Significant improvements may be achieved in more modest ways, however, by means such as using shorter sentences, bullet points and other formats, as suggested by some respondents.

Some respondents noted that some ISAs contain a substantial amount of material that is found [12] in other ISAs, and observed that this duplication contributes significantly to the length and complexity of ISAs. This material, of course, has been included to ensure that the ISAs provide for a comprehensive consideration of the issues and that they respond to the various comments that had been received on exposure of those ISAs.

The IAASB recognizes that duplication of material across the Standards affects their overall flow and complexity, increases the translation burden, and introduces greater room for inconsistency. However, it also recognizes that different users of the Standards have different backgrounds and needs, and that some may find some repetition helpful in understanding a particular Standard or how the Standards interrelate as a whole. Nevertheless, it believes that this duplication needs to be managed and addressed in improving overall clarity.

Accordingly, the IAASB intends to introduce redrafting improvements to reduce or eliminate duplication, but only if the understandability of a Standard is not compromised. The IAASB believes, however, that it is impracticable to develop definitive rules or guidelines, and so reducing or eliminating duplication will need to be determined case-by-case as the Standards are redrafted or revised.

A significant group of users of the Standards, in particular the ISAs, is that which provides services to smaller entities. The IAASB believes that highlighting considerations specific to these entities by use of sub-headings should assist such users in finding their way through the Standards.

Implementation

Nearly all respondents were of the view that the IAASB should make improvements to clarity on a more timely basis – in particular for the application of the new drafting conventions to the ISAs which are central to the public interest. The IAASB accepts this view and has therefore changed its intended implementation approach from the prospective approach originally proposed.

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12 A respondent referred to this as 're-telling the story'.

The initial focus on clarifying recently issued or exposed ISAs reflects the fact that these ISAs include more detailed guidance than earlier ISAs, thereby raising concerns about length and complexity. Further, it offers the advantage that the up-to-date core ISAs are addressed first, thereby creating a foundation for the revision of the remaining ISAs (to which further updating would also be necessary). It also capitalizes on the fact that these ISAs have been (or are in process of being) subject to a review of substantive issues, allowing the IAASB and stakeholders to focus on changes resulting from applying the new drafting conventions and not on other aspects of their content.

Significant support was expressed by respondents for exposing, at one time, a complete package of all ISAs, redrafted for clarity. The IAASB considers, however, that such an approach, while ideal, is not practicable within the resources of the IAASB and respondents. Further, the IAASB believes that redrafting 'older ISAs' without consideration of the need for revision is not appropriate, as such redrafting may lead some to believe that their content has been revised, which would not be the case. The alternative – to incorporate the revision of older ISAs as part of the implementation approach designed for the issue of all ISAs at one time – would unnecessarily extend the period of time before clarity improvement can be made.

Consideration of the Improvements to Clarity as a Whole

The IAASB believes that the improvements are both important individually and together produce an appropriately integrated and comprehensive response to the issue of clarity.

The IAASB also believes that the solution responds in a timely manner to many of the finding of the Wong Report. In particular:

- Translation difficulties – by retaining one convention only to indicate the requirements of a Standard (i.e., not introducing different terminology to indicate different levels of obligation), by eliminating the present tense, and by simplifying the wording of the Standards through redrafting.
- Understandability, including challenges posed by the length and complexity of the standards – by restructuring and redrafting, and by setting out objectives to be achieved by the professional accountant in each Standard.
- Challenges for SMEs and small-and medium-sized practices (SMPs) – by addressing issues of length and complexity, as noted above, and by highlighting considerations specific to smaller entities within the application material.
- Issues concerning relevance and appropriateness of the Standards to SMEs and SMPs will continue to be addressed through input by the IFAC Small and Medium Practices Permanent Task Force to the work of the IAASB.
- Frequency of changes – by a work plan that will provide users of the standards with a period during which no new or revised ISAs will become effective.
- International convergence – by establishing objectives, thereby supporting the development of Standards following a "principles-based" approach, and by restructuring that may accommodate different national strategies for the adoption of the Standards or international convergence, including legislative adoption.

Other Matters

Fundamental Principles

The September 2004 Clarity Consultation Paper asked for views on possible "fundamental principles underlying an ISA audit." Although the majority of respondents expressed support for the further development of such fundamental principles, and many believe such a project should have high priority, there were significantly divergent views on how the principles should be developed, the level at which they should be set, their status, and what they should contain.

The IAASB does not intend to proceed with the further development of the fundamental principles of auditing as part of the Clarity project. This decision was made principally on the basis that the development of the fundamental principles offers the least direct benefit in terms of clarifying the ISAs. At the same time, reaching international agreement on the principles was anticipated to be a significant and time-consuming exercise. The resulting risk of delaying progress on other elements of clarity outweighed the perceived benefits. Further, the IAASB believes that a systematic study of the principles, including the concepts that underpin auditing and assurance engagements, is needed in order for it to consider adequately the completeness and appropriateness of any proposed principles. It therefore concluded that the task of identifying, formulating and reaching consensus on the fundamental principles of auditing may better be served through a separate, properly scoped future project, rather than as part of the overall Clarity project.

Practice Statements

The September 2004 Clarity Consultation Paper asked also for views on the present description of authority of, and possible future roles of, Practice Statements. The IAASB intends to consider these matters in the near future.

PROPOSED AMENDMENTS TO THE PREFACE TO THE INTERNATIONAL STANDARDS ON QUALITY CONTROL, AUDITING, ASSURANCE AND RELATED SERVICES

[There are no proposed amendments to paragraphs 1 – 9 of the extant Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services (Preface). These paragraphs have therefore not been reproduced.]

The Authority Attaching to International Standards Issued by the International Auditing and Assurance Standards Board

10. International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information.

11. International Standards on Review Engagements (ISREs) are to be applied in the review of historical financial information.

12. International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements dealing with subject matters other than historical financial information.

13. International Standards on Related Services (ISRSs) are to be applied to compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements as specified by the IAASB.

14. ISAs, ISREs, ISAEs and ISRSs are collectively referred to as the IAASB's Engagement Standards.

15. International Standards on Quality Control (ISQCs) are to be applied for all services falling under the IAASB's Engagement Standards.

International Standards [Issued/Effective] Before [Date]

16. International ~~The IAASB's~~ Standards [issued/effective] before [date] contain basic principles and essential procedures (identified in bold type lettering and by the word "shall") together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. It is therefore necessary to consider the entire ~~whole~~ text of a Standard to understand and apply the basic principles and essential procedures.

17. The basic principles and essential procedures of a Standard are to be applied in all cases where they are relevant in the circumstances of the engagement. ~~The nature of the IAASB's Standards requires professional accountants to exercise professional judgment in applying them.~~ In exceptional circumstances, however, a professional accountant may judge it necessary to depart from a basic principle or essential procedure ~~of an Engagement Standard in order~~ to achieve ~~more effectively~~ the purpose ~~objective~~ of that~~e~~ basic principle or essential procedure~~engagement~~. When such a situation arises, the professional accountant is required to document how the alternative procedure(s) performed achieves the purpose of the basic principle or essential procedure, and, unless otherwise clear, the reasons for the departure ~~should be prepared to justify the departure~~.

International Standards [Issued/Effective] After [Date]

18. International Standards [issued/effective] after [date] contain objectives and requirements together with related guidance in the form of application material, including appendices. The professional accountant is required to consider the entire text of a Standard in carrying out work on an engagement.

19. The professional accountant must achieve the objective stated at the beginning of each Standard that is relevant in the circumstances of the engagement. The professional accountant achieves the objective by complying with the requirements of the Standard, and by performing other procedures that, in the professional accountant's professional judgment, are necessary in the circumstances.

20. The requirements are contained in a separate section of each Standard. They are identified by the word "shall." If a Standard provides that a procedure or action is one that the professional accountant "shall consider," the consideration of the procedure or action is required, while carrying out the procedure or action is not. The requirements are to be understood and applied in the context of the stated objective and the application material that provides guidance for their application.

21. The requirements of a Standard are to be applied in all cases where they are relevant in the circumstances of the engagement. In exceptional circumstances, however, the professional accountant may judge it necessary to depart from a requirement in order to achieve the purpose of that requirement. When such a situation arises, the professional accountant is required to document how the alternative procedure(s) performed achieves the purpose of the requirement, and, unless otherwise clear, the reasons for the departure. The need for the professional accountant to depart from a requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the engagement, that procedures would be ineffective.

22. The application material contained in a Standard is intended to provide further explanation and guidance on the requirements, and may identify and describe other procedures or actions relating to the activities of the professional accountant. While the professional accountant has a responsibility to consider the whole text of a Standard in carrying out an engagement, such guidance is not intended to impose a requirement for the professional accountant to perform the suggested procedures or actions. Rather, these procedures or actions require the professional accountant's attention and understanding; whether the professional accountant carries out such procedures or actions in the engagement will depend on the exercise of professional judgment in the circumstances consistent with the objective stated in the Standard.

23. Appendices, which form part of the application material, are an integral part of a Standard. The purpose and intended use of an appendix are clearly explained in the body of the related Standard or within the title and introduction of the appendix itself.

Applicability of the International Standards

24~~18~~. The nature of the International Standards requires the professional accountant to exercise professional judgment in applying them. Any limitation of the applicability of a specific International Standard is made clear in the S~~s~~tandard.

25~~19~~. International Standards are applicable to engagements in the public sector. ~~In circumstances where specific International Standards or guidance contained in an International Standard are not applicable in a public sector environment, or w~~When additional guidance is appropriate for the public sector~~in such an environment~~, such guidance is included within the body of an International Standard. International Standards issued prior to January 2005 provided additional guidance for the public sector by means of a ~~IFAC's Public Sector Committee~~[1] ~~so states in a~~ Public Sector Perspective (PSP), where considered necessary, appearing at the end of the International Standard. ~~When no PSP is added, the International Standard is to be applied as written to engagements in the public sector.~~

The Authority Attaching to Practice Statements Issued by the International Auditing and Assurance Standards Board

26~~20~~. International Auditing Practice Statements (IAPSs) are issued to provide interpretive guidance and practical assistance to professional accountants in implementing ISAs and to promote good practice. International Review Engagement Practice Statements (IREPSs), International Assurance Engagement Practice Statements (IAEPSs) and International Related Services Practice Statements (IRSPSs) are issued to serve the same purpose for implementation of ISREs, ISAEs and ISRSs respectively.

27~~21~~. Professional accountants should be aware of and consider Practice Statements applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Practice Statement should be prepared to explain how:

- the basic principles and essential procedures in the IAASB's Engagement Standard(s), for those [issued/effective] before [date]; or
- the requirements in the IAASB's Engagement Standards, for those [issued/effective] after [date]

addressed by the Practice Statement have been complied with.

[Except for renumbering, there are no proposed amendments to paragraphs 22 – 29 of the extant Preface. These paragraphs have therefore not been reproduced.]

~~[1] In November 2004 the Public Sector Committee's name was changed to the International Public Sector Accounting Standards Board.~~

PROPOSED INTERNATIONAL STANDARD ON AUDITING 240 (REDRAFTED)

THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

CONTENTS

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to consider fraud, and to design and perform procedures to detect material misstatement due to fraud, in an audit of financial statements.

2. This ISA expands on how ISA 315 (Redrafted), "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," and ISA 330 (Redrafted), "The Auditor's Procedures in Response to Assessed Risks," are to be applied in relation to the risk of material misstatement due to fraud, and deals specifically with procedures that the auditor is required to perform in relation to fraud and the auditor's responses to material misstatement of the financial statements resulting from identified or suspected fraud.

Fraud in the Context of an Audit of Financial Statements

3. The following paragraphs emphasize aspects of responsibilities and audit evidence that are important in considering fraud in the context of an audit of financial statements. Further explanation is provided in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," and ISA 500, "Audit Evidence."

4. Misstatements in the financial statements can arise from fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Fraud may involve one or more members of management or those charged with governance (management fraud) or may involve only employees of the entity (employee fraud). In either case, there may be collusion within the entity or with third parties outside of the entity. Although fraud is a broad legal concept, for the purposes of the ISAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor— misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. (Ref: Para. A1-A5)

5. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. This involves establishing and maintaining a culture of honesty and ethical behavior and internal controls pertaining to the preparation of the entity's financial statements, and managing risks that may give rise to material misstatements in those financial statements. (Ref: Para. A6-A8)

6. An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the audit evidence available is persuasive rather than conclusive. (Ref: Para. A9)

7. An audit performed in accordance with ISAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. Unless the auditor has reason to believe the contrary, for example if conditions identified

during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified, the auditor may accept records and documents as genuine.

8. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with ISAs. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud may involve sophisticated and carefully organized schemes to conceal it, such attempts at concealment made even more difficult to detect when accompanied by collusion. Further, the risk of not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or to override control procedures designed to prevent similar frauds by other employees. (Ref: Para. A10-A11)

9. The subsequent discovery of a material misstatement of the financial statements resulting from fraud does not, in and of itself, indicate a failure to comply with ISAs. Whether the auditor has performed an audit in accordance with ISAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence. (Ref: Para. A12)

Effective Date

10. This ISA is effective for audits of financial statements for periods beginning on or after [date].

Objective to be Achieved

11. In relation to this ISA, the objective of the auditor is to:

    (a) Consider fraud when identifying and assessing the risks of material misstatement of the financial statements, by maintaining an attitude of professional skepticism and recognizing the possibility that a material misstatement due to fraud could exist;

    (b) Respond to the assessed risks of material misstatement of the financial statements due to fraud, including the risks of management override of controls, by designing and performing procedures to detect material misstatement due to fraud; and

    (c) Respond appropriately to identified or suspected fraud.

Definitions

12. The following terms are introduced in this ISA:

    (a) Fraud – 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. Auditors do not make legal determinations of whether fraud has actually occurred.

(b) Fraud risk factors – Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

(c) Fraudulent financial reporting – Intentional misstatements, including omissions of amounts or disclosures in financial statements to deceive financial statement users.

(d) Misappropriation of assets – The theft of an entity's assets, which is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

Requirements

Professional Skepticism

13. In accordance with ISA 200, the auditor shall 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 of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A13)

14. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's attitude of professional skepticism is particularly important in considering the risks of material misstatement due to fraud because of the characteristics of fraud and the potential for management override of controls, and because there may have been changes in circumstances.

15. Maintaining an attitude of professional skepticism includes considering the reliability of the information to be used as audit evidence, including consideration of controls over its preparation and maintenance where relevant. Although the auditor may accept records and documents as genuine, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified, the auditor shall investigate further. (Ref: Para. A14)

Discussion Among the Engagement Team

16. The discussion amongst the members of the engagement team required by ISA 315 (Redrafted) shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A15-A16)

Risk Assessment Procedures and Related Activities

17. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment required by ISA 315 (Redrafted), the auditor shall perform the following procedures to obtain information for use in identifying the risks of material misstatement due to fraud:

    (a) Make inquiries of management regarding:

(i) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A17-A18)

(ii) 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; (Ref: Para. A19)

(iii) Management's process for responding to internal or external allegations of fraud affecting the entity;

(iv) 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

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

(b) Make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A20-A22)

(c) For those entities that have an internal audit function, make inquiries of internal audit regarding:

(i) Their knowledge of any actual, suspected or alleged fraud affecting the entity;

(ii) Their views about the risks of fraud; and

(iii) Procedures performed, if any, by the internal auditors during the year to detect fraud, and whether management has satisfactorily responded to any findings resulting from those procedures.

(d) 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. Such an understanding may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of such internal control and the competency and integrity of management. (Ref: Para. A23-A25)

(e) Make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

(f) Consider unusual or unexpected relationships that have been identified in performing analytical procedures as risk assessment procedures that may indicate risks of material misstatement due to fraud, including those relationships identified from analytical procedures related to revenue accounts that may indicate fraudulent financial reporting.

(g) Consider whether other information obtained indicates risks of material misstatement due to fraud. (Ref: Para. A26)

18. The auditor shall consider whether the information obtained from the risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred. (Ref: Para. A27-A31)

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

19. In accordance with ISA 315 (Redrafted), the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. The auditor shall treat those assessed risks that could result in a material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall understand the entity's related controls, including relevant control activities. (Ref: Para. A32-A33)

20. Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues or an understatement of revenues and, therefore, the auditor shall presume that there are risks of fraud in revenue recognition. The auditor shall identify which types of revenue, revenue transactions or assertions may give rise to such risks. The auditor shall treat those assessed risks of material misstatement due to fraud related to revenue recognition as significant risks. If the auditor has not identified, in a particular circumstance, revenue recognition as a risk of material misstatement due to fraud, the auditor shall document the reasons supporting the auditor's conclusion as required by paragraph 39. (Ref: Para. A34)

Responses to the Risks of Material Misstatement Due to Fraud

Overall Responses

21. In accordance with ISA 330 (Redrafted), the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. (Ref: Para. A35)

22. In determining overall responses to address the risks of material misstatement due to fraud at the financial statement level, the auditor shall:

    (a) Consider the assignment and supervision of personnel, including whether the knowledge, skill and ability of the individuals assigned significant engagement responsibilities are commensurate with the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A36-A37)

    (b) Consider the accounting policies used by the entity, particularly those related to subjective measurements and complex transactions, and whether the selection and application of accounting policies may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and

    (c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. An element of unpredictability is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. (Ref: Para. A38)

Audit Procedures Responsive to Risks of Material Misstatement Due to Fraud at the Assertion Level

23. In accordance with ISA 330 (Redrafted), the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks due to fraud at the assertion level. (Ref: Para. A39-A42)

Audit Procedures Responsive to Risks Related to Management Override of Controls

24. Management is in a unique position to perpetrate fraud because of management's ability directly or indirectly to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a significant risk of material misstatement due to fraud.

25. Accordingly, the auditor shall design and perform audit procedures to respond to the risk of management override of controls to:

    (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries throughout the year or at period end, or making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments and reclassifications. Accordingly, in designing and performing audit procedures to test the appropriateness of journal entries and other adjustments made in the preparation of the financial statements, the auditor shall:

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

        (ii) Select journal entries and other adjustments made at the end of a reporting period, and consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A43-A45)

    (b) Review accounting estimates for biases and evaluate whether the circumstances producing such a bias represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:

        (i) Consider whether differences between estimates best supported by audit evidence and the estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management, in which case the auditor shall reconsider the estimates taken as a whole; and

        (ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. (Ref: Para. A46-A47)

(c) Obtain an understanding of the business rationale of significant transactions of which the auditor becomes aware that:

- Are outside the normal course of business for the entity, or
- Otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit.

In doing so, the auditor shall evaluate whether the rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A48)

26. The auditor shall consider whether, in order to respond to the risks of management override of controls, the auditor needs to perform procedures in addition to those specifically referred to above.

Evaluation of Audit Evidence (Ref: Para. A49-A53)

27. The auditor shall consider whether analytical procedures that are performed 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 knowledge of the business indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A50)

28. When the auditor identifies a misstatement, whether material or not, the auditor shall consider whether such a misstatement may be indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. A51-A53)

29. If the auditor believes that a misstatement, whether material or not, is or may be the result of fraud and the matter involves higher-level management, the auditor shall reevaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.

30. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit, including the effect on the auditor's report.

Auditor Unable to Continue the Engagement (Ref: Para. A54-A57)

31. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) Consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider the possibility of withdrawing from the engagement; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Management Representations (Ref: Para. A58-A59)

32. The auditor shall obtain written representations from management that:

(a) It acknowledges its responsibility for the design and implementation of internal control to prevent and detect fraud;

(b) It has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;

(c) It has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:

(i) Management;

(ii) Employees who have significant roles in internal control, or

(iii) Others where the fraud could have a material effect on the financial statements; and

(d) It has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

Communications With Management and Those Charged With Governance

33. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters as soon as practicable to the appropriate level of management. Those with primary responsibility for the prevention and detection of fraud are thereby informed of matters relevant to their responsibilities. (Ref: Para. A60)

34. If the auditor has identified fraud involving

(a) Management;

(b) Employees who have significant roles in internal control; or

(c) Others where the fraud results in a material misstatement in the financial statements,

the auditor shall communicate these matters to those charged with governance as soon as practicable. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (Ref: Para. A61-A62)

35. The auditor shall consider whether there are any other matters related to fraud to be discussed with those charged with governance of the entity. (Ref: Para. A63)

Communications to Regulatory and Enforcement Authorities

36. The auditor shall determine whether there is a responsibility to report the occurrence of fraud to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. A64-A66)

Documentation

37. In addition to the documentation requirements of ISA 315 (Redrafted) and ISA 330 (Redrafted), the auditor shall document the results of the audit procedures designed to address the risk of management override of controls.

38. The auditor shall document communications about fraud made to management, those charged with governance, regulators and others.

39. When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall document the reasons for that conclusion.

* * *

Application Material

Fraud in the Context of an Audit of Financial Statements (Ref: Para. 3-9)

A1. Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in internal control. Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

Intentional Misstatements Relevant to the Auditor

Fraudulent Financial Reporting

A2. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.

- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

A3. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives;
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances;
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period;
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements;
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity; and
- Altering records and terms related to significant and unusual transactions.

A4. Fraudulent financial reporting can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some other entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

Misappropriation of Assets

A5. Individuals may have an incentive to misappropriate assets for example, because they are living beyond their means. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts);
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment);
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees); and

- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

Responsibilities of Those Charged with Governance and of Management

A6. It is important that management, with the oversight of those charged with governance, place a strong emphasis on: fraud prevention, which may reduce opportunities for fraud to take place; and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a culture of honesty and ethical behavior.

A7. Those charged with governance of the entity are responsible to ensure, through oversight of management, that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Active oversight by those charged with governance can help reinforce management's commitment to create a culture of honesty and ethical behavior. In exercising oversight responsibility, those charged with governance consider the potential for management override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

A8. Management, with oversight from those charged with governance, is responsible to establish a control environment and to establish and maintain controls pertaining to the preparation of the entity's financial statements and managing risks that may give rise to material misstatements in those financial statements. Such controls reduce but do not eliminate the risks of misstatement. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

Responsibilities of the Auditor for Detecting Material Misstatement Due to Fraud

A9. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be appropriate in the context of an identified risk of material misstatement due to fraud.

Inherent Limitations of an Audit in the Context of Fraud

A10. As described in ISA 200, 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.

A11. Fraud, however, may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor, and collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

A12. The subsequent discovery of a material misstatement resulting from fraud does not, in and of itself, indicate a failure to comply with ISAs, particularly in the case of certain kinds of intentional misstatements. This is because audit procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or that involves falsified documentation.

Professional Skepticism (Ref: Para. 13-15)

A13. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist.

A14. When the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified, possible procedures to investigate further may include confirming directly with the third party or using the work of an expert to assess the document's authenticity.

Discussion Among the Engagement Team (Ref: Para. 16)

A15. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud. It enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures. It also permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention. An attitude of professional skepticism is particularly important when discussing the susceptibility of the entity's financial statements to material misstatement due to fraud.

A16. The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.

- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatements due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

Risk Assessment Procedures and Related Activities

Inquiries of Management

Management's Assessment of the Risk of Fraud (Ref: Para. 17(a)(i))

A17. Management is responsible for the entity's internal control and for the preparation of the financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less formal and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

A18. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 17(a)(ii))

A19. In the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

Inquiry of Management and Others Within the Entity (Ref: Para. 17(b))

A20. The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.

A21. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

(a) Operating personnel not directly involved in the financial reporting process;

(b) Employees with different levels of authority;

(c) Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees;

(d) In-house legal counsel;

(e) Chief ethics officer or equivalent person; and

(f) The person or persons charged with dealing with allegations of fraud.

A22. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Obtaining an Understanding of Oversight Exercised by Those Charged With Governance (Ref: Para. 17(d))

A23. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity and by country, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.[1]

A24. The auditor may obtain an understanding of how those charged with governance exercise this oversight in a number of ways, such as attending meetings where such discussions take place, reading the minutes from such meetings or by making inquiries of those charged with governance.

Considerations Specific to Smaller Entities

A25. In some cases, all of those charged with governance are involved in managing the entity, such as may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

Consideration of Other Information (Ref: Para. 17(g))

A26. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members described below may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

Consideration of Fraud Risk Factors (Ref: Para. 18)

A27. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- An ineffective control environment may create an opportunity to commit fraud.

A28. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

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[1] ISA 260, "Communication of Audit Matters With Those Charged With Governance," discusses with whom the auditor communicates when the entity's governance structure is not well defined.

A29. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists: an incentive or pressure to commit fraud; a perceived opportunity to commit fraud; and an ability to rationalize the fraudulent action. Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

A30. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as effective oversight by those charged with governance, an effective internal audit function or the existence and enforcement of a formal code of conduct. Furthermore, fraud risk factors considered at a business segment operating level may provide different insights than the consideration thereof at an entity-wide level.

Considerations Specific to Smaller Entities

A31. In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise weak controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential weakness since there is an opportunity for management override of controls.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

Identifying and Assessing the Risks of Material Misstatements Due to Fraud and Understanding the Entity's Related Controls (Ref: Para. 19)

A32. As explained in ISA 315 (Redrafted), management may make informed judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. It is therefore important for the auditor to obtain an understanding of the controls that management has designed and implemented to prevent and detect fraud. In doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

Considerations Specific to Smaller Entities

A33. It may often be the case in small entities that management chooses to accept the risks associated with a lack of segregation of duties, where the owner provides day-to-day supervision of operations.

Risks of Fraud in Revenue Recognition (Ref: Para. 20)

A34. Material misstatements due to fraudulent financial reporting relating to revenue recognition may result from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period. Appendix 3 includes examples of responses to the auditor's assessment of the risk of material misstatement due to fraudulent financial reporting resulting from revenue recognition.

Responses to the Risks of Material Misstatement Due to Fraud

Overall Responses (Ref: Para. 21)

A35. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example through increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions or increased recognition of the need to corroborate management explanations or representations concerning material matters. It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 22, which are discussed below.

Consideration of the Assignment and Supervision of Personnel (Ref: Para. 22(a))

A36. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.

A37. The extent of supervision reflects the auditor's assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work.

Unpredictability in the Selection of Audit Procedures (Ref: Para. 22(c))

A38. Incorporating an element of unpredictability in the selection of the nature, extent and timing of audit procedures to be performed can be achieved by, for example:

- Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.
- Adjusting the timing of audit procedures from that otherwise expected.
- Using different sampling methods.
- Performing audit procedures at different locations or at locations on an unannounced basis.

Audit Procedures Responsive to Risks of Material misstatement due to Fraud at the Assertion Level (Ref: Para. 23)

A39. The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:

- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. Physical observation or inspection of certain assets may become more important or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files. In addition, the auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.
- The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement—for example, a misstatement involving improper revenue recognition—may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.
- The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A40. If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help to identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all locations on the same date.

A41. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions, including asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

A42. Examples of possible audit procedures, including those that illustrate the incorporation of an element of unpredictability, to address the assessed risks of material misstatement due to fraud are presented in Appendix 2. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

Audit Procedures Responsive to Risks Related to Management Override of Controls

Journal Entries and Other Adjustments (Ref: Para. 25(a))

A43. The auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

A44. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- *The assessment of the risks of material misstatement due to fraud* – the presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.
- *Controls that have been implemented over journal entries and other adjustments* – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.
- *The entity's financial reporting process and the nature of evidence that can be obtained* – for many entities routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and

controls. When information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.

- *The characteristics of fraudulent journal entries or other adjustments* – inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.
- *The nature and complexity of the accounts* – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.
- *Journal entries or other adjustments processed outside the normal course of business* – non standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

A45. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. Because fraudulent journal entries and other adjustments are often made at the end of a reporting period, the auditor ordinarily selects the journal entries and other adjustments made at that time. However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, it is important to consider whether there is also a need to test journal entries and other adjustments throughout the period.

Accounting Estimates (Ref: Para. 25(b))

A46. In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

A47. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

Business Rationale for Significant Transactions (Ref: Para. 25(c))

A48. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include :

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed nor approved by those charged with governance of the entity.
- 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.

Evaluation of Audit Evidence (Ref: Para. 27-30)

A49. ISA 330 (Redrafted) requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate. This evaluation is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

Analytical Procedures Performed in the Overall Review at or Near the End of the Audit (Ref: Para. 27)

A50. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.

Consideration of Identified Misstatements (Ref: Para. 28-30)

A51. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud may not be an isolated occurrence.

Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

A52. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves higher-level management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

A53. ISA 320, "Audit Materiality" and ISA 700, "The Auditor's Report" provide standards and guidance on the evaluation and disposition of misstatements and the effect on the auditor's report.

Auditor Unable to Continue the Engagement (Ref: Para. 31)

A54. Examples of exceptional circumstances that may arise and that may bring into question the auditor's ability to continue performing the audit include:

(a) The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;

(b) The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or

(c) The auditor has significant concern about the competence or integrity of management or those charged with governance.

A55. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

A56. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary by country. In some countries, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others.[2]

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[2] The "IFAC Code of Ethics for Professional Accountants" provides guidance on communications with a proposed successor auditor.

Considerations Specific to Public Sector Entities

A57. In many cases in the public sector, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the mandate or public interest considerations.

Management Representations (Ref: Para. 32)

A58. ISA 580, "Management Representations," provides standards and guidance on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that, irrespective of the size of the entity, management acknowledges its responsibility for internal control designed and implemented to prevent and detect fraud.

A59. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtains a written representation from management confirming that it has disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud and its knowledge of actual, suspected or alleged fraud affecting the entity.

Communications With Management and Those Charged With Governance

Communication With Management (Ref: Para. 33)

A60. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

Communication With Those Charged With Governance (Ref: Para. 34)

A61. The auditor's communication with those charged with governance may be made orally or in writing. ISA 260 identifies factors the auditor considers in determining whether to communicate orally or in writing. Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters as soon as practicable and may consider it necessary to also report such matters in writing.

A62. In some cases, the auditor may consider it appropriate to communicate with those charged with governance about those circumstances when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.

Other Matters Related to Fraud (Ref: Para. 35)

A63. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified material weaknesses in internal control, or to appropriately respond to an identified fraud.
- The auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

Communications to Regulatory and Enforcement Authorities (Ref: Para. 36)

A64. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the auditor's legal responsibilities vary by country and in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. In some countries, the auditor of a financial institution has a statutory duty to report the occurrence of fraud to supervisory authorities. Also, in some countries the auditor has a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action.

A65. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the objective of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud.

Considerations Specific to Public Sector Entities

A66. In the public sector, requirements for reporting fraud, whether or not discovered through the audit process, often may be subject to specific provisions of the audit mandate or related legislation or regulation.

Appendix 1

(Ref: Para. A29)

Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration—that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (*a*) incentives/pressures, (*b*) opportunities, and (*c*) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins.
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
- New accounting, statutory, or regulatory requirements.

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.

- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow[3].
- Personal guarantees of debts of the entity.

There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

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3 Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

There is ineffective monitoring of management as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Ineffective oversight by those charged with governance over the financial reporting process and internal control.

There is a complex or unstable organizational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff.
- Ineffective accounting and information systems, including situations involving material weaknesses in internal control.

Attitudes/Rationalizations

- Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to correct known material weaknesses in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.

- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
  - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
  - Unreasonable demands on the auditor, such as 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 access to people or information or the ability to communicate effectively with those charged with governance.
  - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Arising From Misstatements Arising From Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other re-imbursements.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

Appendix 2

(Ref: Para. A42)

Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the account balances, classes of transactions and assertions they may affect.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.
- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the risk of material misstatement due to fraud resulting from transactions and activities among these components.

- If the work of an expert becomes particularly significant with respect to a financial statement item for which the risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific responses—Misstatement Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risk of material misstatements due to fraudulent financial reporting are as follows:

Revenue recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.
- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.
- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts—for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

Management estimates

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

Specific Responses—Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to a risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analyzing recoveries of written-off accounts.
- Analyzing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.

- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analyzing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

Appendix 3

(Ref: Para. A49)

Examples of Circumstances that Indicate the Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy
- Unsupported or unauthorized balances or transactions
- Last-minute adjustments that significantly affect financial results
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties
- Tips or complaints to the auditor about alleged fraud

Conflicting or missing evidence, including:

- Missing documents
- Documents that appear to have been altered
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist
- Significant unexplained items on reconciliations
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships – for example receivables growing faster than revenues,
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures
- Unusual discrepancies between the entity's records and confirmation replies
- Large numbers of credit entries and other adjustments made to accounts receivable records
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement
- Missing inventory or physical assets of significant magnitude
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated

- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought
- Undue time pressures imposed by management to resolve complex or contentious issues
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management
- Unusual delays by the entity in providing requested information
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable
- An unwillingness to address identified weaknesses in internal control on a timely basis

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance
- Accounting policies that appear to be at variance with industry norms
- Frequent changes in accounting estimates that do not appear to result from changes circumstances
- Tolerance of violations of the entity's Code of Conduct

PROPOSED INTERNATIONAL STANDARD ON AUDITING 300 (REDRAFTED)

PLANNING AN AUDIT OF FINANCIAL STATEMENTS

CONTENTS

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with planning an audit of financial statements. This ISA is framed in the context of recurring audits but also applies to initial audit engagements.

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after [date].

Objective to be Achieved

3. In relation to this ISA, the objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Requirements

Involvement of Key Engagement Team Members

4. The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members.[1] (Ref: Para. A1-A2)

Preliminary Engagement Activities

5. The auditor shall perform the following activities at the beginning of the current audit engagement:

   (a) Performing procedures required by ISA 220, "Quality Control for Audits of Historical Financial Information," regarding the continuance of the client relationship and the specific audit engagement.

   (b) Evaluating compliance with ethical requirements, including independence, as required by ISA 220.

   (c) Establishing an understanding of the terms of the engagement, as required by ISA 210, "Terms of Audit Engagements." (Ref: Para. A3-A5)

   Performing these activities at the beginning of the audit assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level.

[1] ISA 315 (Redrafted), "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," provides guidance on the engagement team's discussion of the susceptibility of the entity to material misstatements of the financial statements. ISA 240 (Redrafted), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," provides guidance on the emphasis given during this discussion to the susceptibility of the entity's financial statements to material misstatement due to fraud.

Planning Activities

The Overall Audit Strategy and Audit Plan

6. The auditor shall establish the overall audit strategy for the audit that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. (Ref: Para. A7-A8)

7. In establishing the overall audit strategy, the auditor shall:

    (a) Determine the characteristics of the engagement that define its scope.

    (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.

    (c) Consider the important factors that will determine the focus of the engagement team's efforts.

    (d) Consider the results of preliminary engagement activities, experience gained on other engagements performed for the entity, where practicable, and other matters relevant to planning the engagement.

    (e) Ascertain the resources necessary to perform the engagement. (Ref: Appendix, Para. A6)

8. The auditor shall develop an audit plan for the audit that includes:

    - A description of the nature, timing and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement, as determined under ISA 315 (Redrafted), "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements."
    - A description of the nature, timing and extent of planned further audit procedures at the assertion level for each material class of transactions, account balance, and disclosure, as determined under ISA 330 (Redrafted), "The Auditor's Procedures in Response to Assessed Risks."
    - Such other audit procedures required to be carried out for the engagement to comply with ISAs. (Ref: Para. A9)

9. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A10)

Direction, Supervision and Review

10. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and review of their work. (Ref: Para. A11-A12)

Documentation

11. The auditor shall document:

    (a) The overall audit strategy.

    (b) The audit plan.

    (c) Any significant changes to the overall audit strategy or the audit plan, the reasons for such changes made during the audit engagement, and the auditor's response to the circumstances that resulted in such changes. (Ref: Para. A13-A15)

Additional Considerations in Initial Audit Engagements

12. The auditor shall perform the following activities prior to starting an initial audit:

    (a) Performing procedures regarding the acceptance of the client relationship and the specific audit engagement (see ISA 220 for additional guidance).

    (b) Communicating with the previous auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A16)

***

Application Material

Involvement of Key Engagement Team Members (Ref: Para. 4)

A1. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan, in order to reduce audit risk to an acceptably low level. The involvement by the engagement partner and other key members of the engagement team in planning the audit assists in bringing to bear their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process. Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.
- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the proper assignment of work to engagement team members.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components and experts.

The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement.

A2. 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. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning addresses the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement and the auditor's performance of further audit procedures at the assertion level that are responsive to those risks, such matters as:

- The analytical procedures to be applied as risk assessment procedures.
- The obtaining of a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework

- The determination of materiality.
- The involvement of experts
- The performance of other risk assessment procedures.

Preliminary Engagement Activities (Ref: Para. 5)

A3. The auditor's consideration of client continuance and ethical requirements, including independence, occurs throughout the performance of the audit engagement as conditions and changes in circumstances occur. Performance of initial procedures on both client continuance and evaluation of ethical requirements (including independence) at the beginning of the current audit engagement means that they are performed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.

A4. Performing these preliminary engagement activities enables the auditor to plan an audit engagement for which:

- The auditor maintains the necessary independence and ability to perform the engagement.
- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
- There is no misunderstanding with the client as to the terms of the engagement.

Considerations Specific to Public Sector Entities

A5. In the public sector, the auditor's mandate may create an obligation to accept, and the inability to withdraw from an engagement. In such a case, some of the preliminary engagement activities set out in Paragraph 5 of the ISA would not be applicable. With respect to the requirement to establish an understanding of the terms of the engagement, the use of engagement letters in the public sector is not widespread practice. Nevertheless, both the auditor and the entity might find such an activity helpful.

Planning Activities

The Overall Audit Strategy (Ref: Para. 6-7)

A6. The process of developing the overall audit strategy helps the auditor to ascertain the nature, timing and extent of resources necessary to perform the engagement, in particular, subject to the completion of the auditor's risk assessment procedures:

- The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters.
- The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;

- When these resources are deployed, such as whether at an interim audit stage or at key cut-off dates; and
- How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

A7. Once the overall audit strategy has been established, an audit plan can be developed to address 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 is ordinarily established before the detailed audit plan, the two planning activities are not necessarily discrete or sequential processes but are closely inter-related since changes in one may result in consequential changes to the other.

Considerations Specific to Smaller Entities

A8. In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, co-ordination and communication between team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity and the complexity of the audit. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner-manager, can serve as the basis for planning the current audit engagement.

The Audit Plan (Ref: Para. 8)

A9. The audit plan is more detailed than the overall audit strategy in that it includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures ordinarily occurs early in the audit process. However, planning of the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before completing the audit plan of all remaining further audit procedures.

Changes to Planning Decisions During the Course of the Audit (Ref: Para. 9)

A10. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan, based on the revised consideration of assessed risks at the assertion level for all or some of the classes of transactions, account balances or disclosures, and thereby the resulting planned nature, timing and extent of further audit procedures. This may be the case when, for example, information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures, such as when audit evidence obtained through the performance of substantive procedures contradicts the audit evidence obtained with respect to the testing of the operating effectiveness of controls.

Direction, Supervision and Review (Ref: Para. 10)

A11. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

- The size and complexity of the entity.
- The area of the audit.
- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work).
- The capabilities and competence of the individual team members performing the audit work.

ISA 220 contains further guidance on the direction, supervision and review of audit work.

Considerations Specific to Smaller Entities

A12. When an audit is carried out entirely by the engagement partner, questions of direction and supervision of engagement team members and review of their work do not arise. In such cases, the engagement partner, having personally conducted all aspects of the work, will be aware of all material issues. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performed the entire audit. When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to plan to consult with other suitably-experienced auditors or the auditor's professional body.

Documentation (Ref: Para. 11)

A13. The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

A14. The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures, and further audit procedures at the assertion level for each material class of transaction, account balance, and disclosure in response to the assessed risks. It also serves as a record of the proper planning and performance of the audit procedures that can be reviewed and approved prior to the performance of further audit procedures. The auditor may use standard audit programs or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A15. A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains (a) why the significant changes were made, and (b) the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Additional Considerations in Initial Audit Engagements (Ref: Para. 12)

A16. The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For initial audits, additional matters the auditor may consider in developing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the previous auditor, for example, to review the previous auditor's working papers.
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditors, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The planned audit procedures to obtain sufficient appropriate audit evidence regarding opening balances (see ISA 510, "Initial Engagements—Opening Balances").
- The assignment of firm personnel with appropriate levels of capabilities and competence to respond to anticipated significant risks.
- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

Appendix

Examples of Matters the Auditor may Consider in Establishing the Overall Audit Strategy

This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters will also influence the auditor's detailed audit plan.

Characteristics of the Engagement that Define its Scope

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in prior audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- The availability of client personnel and data.

Reporting Objectives, Timing of the Audit and Nature of Communications Required

- The entity's timetable for reporting, such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, extent and timing of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement and the expected deliverables resulting from the audit procedures.
- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Matters that Determine the Focus of the Engagement Team's Effort and Direction of the Audit

- The determination of appropriate materiality levels, including:
  - Setting materiality for planning purposes.
  - Setting and communicating materiality for auditors of components.
  - Reconsidering materiality as audit procedures are performed during the course of the audit.
  - Identifying the material components and account balances.
- Audit areas where there is a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.

- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified weaknesses and action taken to address them.
- Evidence of management's commitment to the design and operation of sound internal control, including evidence of appropriate documentation of such internal control.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

PROPOSED INTERNATIONAL STANDARD ON AUDITING 315 (REDRAFTED)

UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

CONTENTS

Introduction

Scope of this ISA

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

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after [date].

Objective to be Achieved

3. In relation to this ISA, the objective of the auditor is to obtain an understanding of the entity, including its internal control, and its environment 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.

Definitions

4. The following terms are introduced in this ISA:

   (a) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

   (b) Internal control – The process designed and effected by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Internal control consists of the following components: (i) the control environment; (ii) the entity's risk assessment process; (iii) the information system, including the related business processes, relevant to financial reporting, and communication; (iv) control activities; and (v) monitoring controls. The term "controls" refers to one or more of the components, or any aspect thereof.

   (c) Material weakness – A weakness in internal control that could have a material effect on the financial statements.

   (d) Risk assessment procedures – The audit procedures performed to obtain an understanding of the entity, including its internal control, and its environment to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

   (e) Significant risk – The term used in ISAs to refer to an identified and assessed risk of material misstatement that is determined to be, in the auditor's judgment, one that requires special audit consideration.

Requirements

Risk Assessment Procedures and Related Activities

5. The purpose of performing risk assessment procedures is to provide a satisfactory basis, supported by audit evidence, for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1-A4)

6. The auditor shall perform risk assessment procedures that include the following:

   (a) Inquiries of management and others within the entity who may have information that helps in identifying risks of material misstatement due to fraud or error. (Ref: Para. A5)

   (b) Analytical procedures. (Ref: Para. A6-A7)

   (c) Observation and inspection. (Ref: Para. A8)

7. Although the auditor is required to perform all the risk assessment procedures described above in the course of obtaining the required understanding of the entity, including its internal control, and its environment (paragraphs 12-17), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. (Ref: Para. A9)

8. The auditor shall consider information obtained from the auditor's client acceptance or continuance process or from experience gained on other engagements performed for the entity that may be helpful in identifying risks of material misstatement.

9. For continuing engagements, some of the information used to gain an understanding of the entity and its environment may be obtained from the auditor's previous experience with the entity and audit procedures performed in previous audits. When the auditor intends to use such information, the auditor shall determine whether changes have occurred that may affect its relevance to the current audit. (Ref: Para. A10-A11)

10. The engagement partner and other key members of the engagement team shall discuss the susceptibility of the entity's financial statements to material misstatements, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to members of the engagement team not involved in the discussion. Throughout the audit, engagement team members shall continue to communicate and share information obtained that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks. (Ref: Para. A12-A14)

11. The discussion assists members of the engagement team to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures.

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

The Entity and Its Environment

12. The auditor shall obtain an understanding of the following:

    (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A15-A20)

    (b) The nature of the entity, including the following aspects, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements:

    - The entity's operations.
    - The entity's ownership and governance.
    - The types of investments that the entity is making and plans to make.
    - The way that the entity is structured and how it is financed. (Ref: Para. A21-A23)

    (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall consider whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A24)

    (d) The entity's objectives and strategies, and the related business risks that may result in a material misstatement of the financial statements. An understanding of business risks increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks as not all business risks give rise to risks of material misstatement. (Ref: Para. A25-A31)

    (e) The measurement and review of the entity's financial performance. An understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets result in management actions that may have increased the risks of material misstatement.[1] (Ref: Para. A32-A37)

[1] Note to readers of the Exposure Draft: Paragraph 39 of extant ISA 315 deals with the circumstances where the auditor intends to make use of information produced by the entity's information system, including data used for reviewing the entity's performance, for purposes of the audit. Similar guidance on the auditor's use of information produced for monitor activities is contained in paragraph 99 of extant ISA 315. The IAASB believes that the actions by the auditor described in the present tense in the last sentences of those paragraphs represent requirements. However, it believes that such requirements would best be presented as an amplification of the existing basic principle and essential procedure in paragraph 11 of existing ISA 500, "Audit Evidence," rather than within ISA 315 (Redrafted). This position will be reflected in ISA 500 when it is redrafted in accordance with the new drafting conventions.

The Entity's Internal Control

13. The auditor shall obtain an understanding of internal control relevant to the audit. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing, and extent of further audit procedures. (Ref: Para. A38-A54)

Controls Relevant to the Audit

14. Ordinarily, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements for external purposes and the management of risk that may give rise to a material misstatement in those financial statements. Relevant controls may exist in any of the components of internal control. The auditor's primary consideration is whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures, and their related assertions. (Ref: Para. A55-A60)

Depth of Understanding of Internal Control

15. In obtaining an understanding of internal control, the auditor shall evaluate the design of relevant controls and determine whether they have been implemented. The auditor shall obtain the understanding by performing procedures in addition to inquiry of the entity's personnel, as inquiry alone is not sufficient for such purposes. (Ref: Para. A61-A64)

16. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it.

Components of Internal Control

17. In understanding the entity's internal control relevant to the audit, the auditor shall obtain an understanding of the following components of internal control:

    (a) The control environment, which sets the tone of an organization and is the foundation for effective internal control, providing discipline and structure. The understanding shall include how management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior, and whether the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and are not undermined by control environment weaknesses.

    For this purpose, the auditor shall obtain an understanding of the following elements of the control environment and how they have been incorporated into the entity's processes:

    (i) Communication and enforcement of integrity and ethical values.

    (ii) Commitment to competence.

    (iii) Participation by those charged with governance.

    (iv) Management's philosophy and operating style.

(v) Organizational structure.

(vi) Assignment of authority and responsibility.

(vii) Human resource policies and practices. (Ref: Para. A65-A72)

(b) The entity's process, whether formal or informal, for:

(i) identifying business risks relevant to financial reporting objectives;

(ii) estimating the significance of the risks;

(iii) assessing the likelihood of their occurrence; and

(iv) deciding about actions to address those risks;

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

In obtaining this understanding, the auditor shall inquire about business risks that management has identified and consider whether they may result in material misstatement. Where the auditor identifies risks of material misstatement that management failed to identify, the auditor shall consider whether there was an underlying risk of a kind that should have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall consider why that process failed to identify it and whether the process is appropriate to its circumstances. If, as a result, the auditor judges that there is a material weakness in the entity's risk assessment process, the auditor shall communicate it to those charged with governance as required by paragraph 26. (Ref: Para. A73)

(c) The information system, including the related business processes, relevant to financial reporting, and communication, as follows:

(i) The auditor's understanding of the information system relevant to financial reporting, which shall be obtained by performing risk assessment procedures that include tracing transactions through the information system, shall include the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- The procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements.
- The related accounting records, supporting information and specific accounts in the financial statements in respect of initiating, recording, processing and reporting transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form.

- How the information system captures events and conditions, other than 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.
- Controls surrounding non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A74-A78)

(ii) The auditor shall understand how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including communications between management and those charged with governance as well as external communications, such as those with regulatory authorities. (Ref: Para. A79-A80)

(d) Control activities relevant to the audit, i.e., those the auditor considers necessary to sufficiently understand in order to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from information technology (IT) or manual systems.

An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. The auditor's emphasis is on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that material misstatements are more likely to occur. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. (Ref: Para. A81-A86)

(e) 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. The auditor shall obtain an understanding of the sources of the information related to the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose.[2] (Ref: Para. A87-A90)

Identifying and Assessing the Risks of Material Misstatement

18. The auditor shall 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, in order to provide a basis for designing and performing further audit procedures.

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2 See footnote 1.

19. For this purpose, the auditor shall:

- Identify risks throughout the process of obtaining an understanding of the entity, including its relevant controls that relate to the risks, and its environment; this includes considering the classes of transactions, account balances, and disclosures in the financial statements;
- Relate the identified risks to what can go wrong at the assertion level;
- Consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements, including the possibility that the risks might give rise to multiple misstatements; and
- Consider the likelihood that the risks could result in a material misstatement of the financial statements. (Ref: Para. A91-A97)

Risks that Require Special Audit Consideration

20. As part of the risk assessment as described in paragraph 18, the auditor shall 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").

21. The determination of significant risks, which arise on most audits, is a matter for the auditor's professional judgment. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

22. In determining which risks are significant risks, the auditor shall consider the following:

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

Ordinarily, routine, non-complex transactions that are subject to systemic processing are less likely to give rise to significant risks. (Ref: Para. A98-A102)

23. For significant risks, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to such risks. Management ought to be aware of significant risks; however, those risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, although management may have other responses intended to deal with such risks. (Ref: Para. A103-A105)

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

24. In respect of some risks, the auditor may judge that it is not possible or practicable to reduce audit risk at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, as part of the risk assessment described in paragraph 18, the auditor shall obtain an understanding of the entity's controls, including relevant control activities, over those risks. (Ref: Para. A106-A107)

Revision of Risk Assessment

25. The auditor's assessment of the risks of material misstatement at the assertion level is based on available audit evidence and may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures that tends to contradict the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A108)

Communicating With Those Charged With Governance and Management

26. The auditor shall as soon as practicable make those charged with governance and management, at an appropriate level of responsibility, aware of material weaknesses in the design or implementation of internal control which have come to the auditor's attention. Such controls may include those to prevent, or detect and correct, error, or those to prevent and detect fraud. The auditor shall include within material weaknesses the following:

    - Risks of material misstatement that the auditor identifies and which the entity has either not controlled, or for which the relevant control is inadequate.
    - A weakness in the entity's risk assessment process that the auditor identifies as material. (Ref: Para. A109)

Documentation

27. The auditor shall document:

    (a) The discussion among the engagement team required by paragraph 10, and the significant decisions reached;

    (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment identified in paragraph 12 and each of the internal control components identified in paragraph 17; 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 18; and

    (d) The risks identified and related controls about which the auditor has obtained an understanding as a result of the requirements in paragraphs 23 and 24. (Ref: Para. A110)

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Application Material

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

A1. Obtaining an understanding of the entity, including its internal control, and its environment(referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing risks of material misstatement of the financial statements, whether due to fraud or error (referred to hereafter as "risks of material misstatement"), and responding to those risks throughout the audit, for example when:

- Establishing materiality and evaluating whether the judgment about materiality remains appropriate as the audit progresses;
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Designing and performing further audit procedures to reduce audit risk to an acceptably low level; and
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

A2. Information obtained by performing risk assessment procedures and activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this ISA. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this ISA. However, the significance of fraud is such that further requirements and guidance are included in ISA 240 (Redrafted), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" in relation to risk assessment procedures and activities to obtain information that is used to identify the risks of material misstatement due to fraud.

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

A5. Much of the information obtained by the auditor by inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. The auditor's consideration of what information may be obtained that helps the auditor in identifying risks of material misstatement assists the auditor in determining to whom inquiries may be directed and the extent of those inquiries. For example:

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- Inquiries directed toward internal audit personnel may relate to their activities concerning the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from these activities.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor in evaluating the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward in-house legal counsel may relate to such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- Inquiries directed towards marketing or sales personnel may relate to changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

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

A6. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

A7. However, when such analytical procedures use data aggregated at a high level (which may often be the situation when performing analytical procedures as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information gathered in identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures. See ISA 520, "Analytical Procedures" for standards and guidance on the use of analytical procedures.

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

A8. Observation and inspection may support inquiries of management and others, and also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

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

Other Audit Procedures (Ref: Para. 7)

A9. Other audit procedures may be useful in obtaining information about the entity and its environment and in identifying risks of material misstatement. Examples of such procedures include:

- Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.
- Reviewing information obtained from external sources such as reports by analysts, banks, or rating agencies; trade and economic journals; or regulatory or financial publications.

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

A10. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as past misstatements and whether they were corrected on a timely basis, as well as with information about the nature of the entity, including its internal control, and its environment. In addition, identifying significant changes in any of the aspects of the entity from prior periods may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

A11. Paragraph 9 requires the auditor to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for purposes of the current audit. Changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of systems.

Discussion Among the Engagement Team (Ref: Para. 10-11)

A12. The discussion provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity. It also allows the team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error. ISA 240 (Redrafted) provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.

A13. It is not always necessary or practical for the discussion among members of the engagement team to include all members in a single discussion, nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team, including specialists and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Considerations Specific to Smaller Entities

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

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

The Entity and Its Environment

Industry, Regulatory and Other External Factors (Ref: Para. 12(a))

Industry Factors

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

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

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

Regulatory Factors

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

- Accounting principles and industry specific practices.
- Regulatory framework for a regulated industry.
- Legislation and regulation that significantly affect the entity's operations, such as regulatory requirements and direct supervisory activities.

- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

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

Considerations specific to public sector entities

A19. For the audits of public sector entities, there may be legislative frameworks and other relevant regulations, ordinances or ministerial directives that affect the audit mandate and any other special auditing requirements. Therefore, obtaining an understanding of the regulatory framework includes obtaining an understanding of the legislation and proper authority governing the operation of an entity.

Other External Factors

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

Nature of the Entity (Ref: Para.12(b))

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

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

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

- *Business operations* – such as:
  - Nature of revenue sources, and products or services and markets, including involvement in electronic commerce such as Internet sales and marketing activities
  - Conduct of operations (for example, stages and methods of production)
  - Alliances, joint ventures, and outsourcing activities
  - Geographic dispersion and industry segmentation

  - Location of production facilities, warehouses, and offices, and location and quantities of inventories
  - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters)
  - Research and development activities and expenditures
  - Transactions with related parties.
- *Investments and investment activities* – such as:
  - Planned or recently executed acquisitions or divestitures
  - Investments and dispositions of securities and loans
  - Capital investment activities
  - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
- *Financing and financing activities* – such as:
  - Major subsidiaries and associated entities, including consolidated and non-consolidated structures
  - Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements
  - Beneficial owners (local, foreign, business reputation and experience) and related parties
  - Use of derivative financial instruments.
- *Financial reporting* – such as:
  - Accounting principles and industry specific practices, including industry-specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals)
  - Revenue recognition practices
  - Accounting for fair values
  - Foreign currency assets, liabilities and transactions
  - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

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

The Entity's Selection and Application of Accounting Policies (Ref: Para.12(c))

A24. An understanding of the entity's selection and application of accounting policies encompasses such matters as:

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

Objectives and Strategies and Related Business Risks (Ref. Para.12(d))

A25. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's strategies and objectives may change over time.

A26. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk particularly may arise from change or complexity, though a failure to recognize the need for change may also give rise to risk. Change may arise, for example, from the development of new products that may fail; from an inadequate market, even if successfully developed; or from flaws that may result in liabilities and reputational risk.

A27. Examples of matters that auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a material misstatement of the financial statements include:

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

A28. A business risk may have an immediate consequence for the risk of misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in Appendix 2.

A29. Usually management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 17(b) and paragraph A73.

Considerations Specific to Public Sector Entities

A30. For the audits of public sector entities, "management objectives" may be influenced by concerns regarding public accountability and may include objectives which have their source in legislation, regulations, government ordinances, and ministerial directives.

Considerations Specific to Smaller Entities

A31. Smaller entities often do not set their objectives and strategies, or manage the related business risks, through formal plans or processes. In many cases there may be no documentation of such matters. In such entities, the auditor's understanding is ordinarily obtained through inquiries of management and observation of how the entity responds to such matters.

Measurement and Review of the Entity's Financial Performance (Ref: Para.12(e))

A32. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements.

A33. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A87-A90), though their purposes may overlap. Monitoring of controls is specifically concerned with the effective operation of internal control through consideration of information about the control. The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties). In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.

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

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics
- Period-on-period financial performance analysis

- Budgets, forecasts, variance analysis, segment information and divisional, departmental or other level performance reports
- Employee performance measures and incentive compensation policies
- Comparisons of an entity's performance with that of competitors.

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

A36. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor a risk of misstatement of related financial statement information. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations Specific to Smaller Entities

A37. Smaller entities often do not have formal processes to measure and review the entity's financial performance. Management nevertheless may rely on certain key indicators which their knowledge and experience of the business suggest are reliable bases for evaluating financial performance and taking appropriate action.

The Entity's Internal Control

A38. The following application material on internal control is presented in three sections, as follows:

- General Nature and Characteristics of Internal Control
- Extent of Understanding of Internal Control
- The Components of Internal Control

General Nature and Characteristics of Internal Control (Ref: Para. 13)

Purpose of Internal Control

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

- Reliability of financial reporting;
- Effectiveness and efficiency of operations; and
- Compliance with applicable laws and regulations.

A40. Internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives. The way in which internal control is designed and implemented varies with an entity's size and complexity.

Considerations specific to smaller entities

A41. Smaller entities may use less formal means and simpler processes and procedures to achieve their objectives. For example, smaller entities with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures or detailed written policies. In addition, the owner-manager[3] may be in charge of more than one process or component of internal control. Therefore, such processes or components may not appear to be clearly distinguished within smaller entities. Their underlying purposes, however, are equally valid.

Limitations of Internal Control

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

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

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

Considerations specific to smaller entities

A45. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, for key areas, even in a very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. For example, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties. On the other hand, the owner-manager may be more able to override controls because of the informal system of internal control. This is taken into account by the auditor when

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

identifying the risks of material misstatement due to fraud. The potential for override of controls by the owner-manager depends to a great extent on the control environment and the owner-manager's attitudes about the importance of internal control.

Division of Internal Control into Components

A46. The division of internal control into the five components, as described in paragraphs 4(b) and 17, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. The division does not necessarily reflect how an entity considers and implements internal control, or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this ISA, provided all the components described in this ISA are addressed.

A47. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A65-A90 below. Appendix 1 provides further explanation of these components of internal control.

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

A48. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A49. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

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

An entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT.

A50. Generally, IT benefits an entity's internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- Enhance the timeliness, availability, and accuracy of information;

- Facilitate the additional analysis of information;
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

A51. IT also poses specific risks to an entity's internal control, including the following:

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

A52. Manual controls may be more suitable where judgment and discretion are required such as for the following circumstances:

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

A53. Manual controls pose specific risks to the entity's internal control. Manual controls may be less reliable than automated controls because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual systems may be less suitable for the following:

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

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

A54. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or manual systems by establishing effective controls in light of the characteristics of the entity's information system.

Extent of Understanding of Internal Control

Controls Relevant to the Audit (Ref: Para. 14)

A55. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

A56. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. Factors relevant to that judgment may include such matters as the following:

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

A57. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. Controls relating to operations and compliance objectives may also be relevant to an audit if they pertain to data the auditor evaluates or uses in applying audit procedures.

A58. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting.

A59. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

Considerations specific to public sector entities

A60. Public sector auditors often have additional responsibilities with respect to internal controls, for example to report on compliance with an established Code of Practice. Public sector auditors can also have responsibilities to report on the compliance with legislative authorities. Their review of internal controls may be broader and more detailed.

Depth of Understanding of Internal Control (Ref: Para. 15)

A61. Paragraph 15 requires that an understanding of internal control involve evaluating the design of a control and determining whether it has been implemented. There is little point in assessing the implementation of an ineffective control, and so the design of a control is considered first. An improperly designed control may represent a material weakness in the entity's internal control.

A62. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

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

A63. In obtaining this understanding, the auditor may learn for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

A64. Obtaining an understanding of an entity's controls is not sufficient to serve as testing the operating effectiveness of controls, unless there is some automation that provides for the consistent operation of the control. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A50), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in ISA 330 (Redrafted), "The Auditor's Procedures in Response to Assessed Risks."

Components of Internal Control—Control Environment (Ref: Para. 17(a))

A65. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A66. Because of the importance of the entity's control environment to the effectiveness of internal controls, paragraph 17(a) requires the auditor to obtain an understanding of the following elements of the control environment:

(a) *Communication and enforcement of integrity and ethical values* – Essential elements which influence the effectiveness of the design, administration and monitoring of controls.

(b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) *Participation by those charged with governance* – Attributes of those charged with governance such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(d) *Management's philosophy and operating style* – Characteristics such as management's:

- Approach to taking and managing business risks.
- Attitudes and actions toward financial reporting.
- Attitudes toward information processing and accounting functions and personnel.

(e) *Organizational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(f) *Assignment of authority and responsibility* - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.

(g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counseling, promotion, compensation, and remedial actions.

Audit Evidence for Elements of the Control Environment

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

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

A68. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, where one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as their independence from management and their ability to evaluate the actions of management, and whether those charged with governance understand the entity's business transactions and evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework. In addition, for example, owner-manager controls may mitigate a lack of segregation of duties in a small business, or an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.

A69. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. In particular, it may help reduce the risk of fraud, although a satisfactory control environment is not an absolute deterrent to fraud. Conversely, weaknesses in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or by allowing unauthorized transactions to be processed. As explained in ISA 330 (Redrafted), the control environment also influences the nature, timing, and extent of the auditor's further procedures.

A70. The control environment in itself does not prevent, or detect and correct, a material misstatement; the effect of other components (for example, the monitoring of controls and the operation of specific control activities) together with the control environment affect the risks of material misstatement.

Considerations Specific to Smaller Entities

A71. Small entities may implement the control environment elements differently from larger entities. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Similarly, those charged with governance in small entities may not include an independent or outside member, or the role of governance may be undertaken by the owner-manager where there are no other owners.

A72. Consequently, the owner-manager's attitudes, awareness and actions are of particular importance in the design of a smaller entity's control environment.

Components of Internal Control—The Entity's Risk Assessment Process (Ref: Para. 17(b))

Considerations Specific to Smaller Entities

A73. The basic concepts of the entity's risk assessment process are relevant to every entity, regardless of size. However, the risk assessment process is likely to be less formal and less structured in small entities than in larger ones. In a smaller entity, management may not have a formal risk assessment process as identified in paragraph 17(b). Management nevertheless may be aware of risks without the use of a formal process but through direct personal involvement with employees and outside parties. Accordingly, even if the entity has no formal process, it does not mean that management has not identified and considered the implication of business risks; accordingly, inquiry about identified risks is still relevant in such circumstances.

Components of Internal Control—The Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication (Ref: Para. 17(c))

The Information System, Including Related Business Processes, Relevant to Financial Reporting (Ref: Para. 17(c)(i))

A74. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

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

Journal entries

A75. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions such as sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A76. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

Related business processes

A77. An entity's business processes are the activities designed to develop, purchase, produce, sell and distribute an entity's products and services; ensure compliance with laws and regulations; and record information, including accounting and financial reporting information. Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, including how transactions originate therein, assists in obtaining an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

Considerations specific to smaller entities

A78. Information systems and related business processes relevant to financial reporting in small entities are likely to be less formal than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies.

Communication (Ref: Para. 17(c)(ii))

A79. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A80. Communication may be less formal and easier to achieve in a small entity than in a larger entity due to the small entity's size and fewer levels as well as management's greater visibility and availability.

Components of Internal Control—Control Activities (Ref: Para. 17(d))

A81. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:

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

Considerations Specific to Smaller Entities

A82. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate varies. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's retention of authority for approving credit sales, significant purchases, and draw-downs on lines of credit can provide strong control over those activities, lessening or removing the need for more detailed control activities.

A83. An appropriate segregation of duties often appears to present difficulties in small entities. Even companies that have only a few employees, however, may be able to assign their responsibilities to achieve appropriate segregation. Alternatively, if that is not possible, management oversight of the incompatible activities may achieve control objectives.

Risks Arising From IT

A84. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT-controls and application controls.

A85. General IT-controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data center and network operations.
- System software acquisition, change and maintenance.
- Program change.
- Access security.
- Application system acquisition, development, and maintenance.

They are generally implemented to deal with the risks referred to in paragraph A51 above.

A86. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

Components of Internal Control—Monitoring of Controls (Ref: Para. 17(e))

A87. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A88. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. See ISA 610, "Considering the Work of Internal Auditing" for additional guidance. Management's monitoring activities may also include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

A89. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors may exist in the information, potentially leading management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of the sources of the information related to the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose, is important to the auditor's evaluation of the design of the entity's monitoring activities as a component of internal control

Considerations Specific to Smaller Entities

A90. Management's monitoring of control is often accomplished by the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the control.

Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 18-19)

A91. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

A92. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement.

Controls and the Assessment of Risks of Material Misstatement at the Assertion Level

A93. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A94. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

A95. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Assessment of Risks of Material Misstatement at the Financial Statement Level

A96. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions. The latter risks (risks at the financial statement level) may derive in particular from a weak control environment. For example, weaknesses such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A97. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. Also, concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements. See [extant] ISA 701 for requirements and guidance in determining whether there is a need for the auditor to consider a qualification or disclaimer of opinion or, as may be required in some cases, to withdraw from the engagement.

Risks that Require Special Audit Consideration (Ref: Para. 20-23)

Identifying Risks that Require Special Audit Consideration

A98. Significant risks often relate to significant non-routine transactions and judgmental matters. Non-routine transactions are transactions that are unusual, either due to size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.

A99. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.

- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

A100. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

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

A101. ISA 330 (Redrafted) describes the consequences for further audit procedures of identifying a risk as significant.

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

A102. ISA 240 (Redrafted) provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.

Understanding Internal Controls Related to Significant Risks (Ref: Para. 23)

A103. The auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

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

A104. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A105. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. This may indicate a material weakness in the entity's internal control.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para. 24)

A106. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risk may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported electronically such as in an integrated system. In such cases, audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed or reported only in electronic form and appropriate controls are not operating effectively.

A107. The consequences for further audit procedures of identifying such risks are described in ISA 330 (Redrafted).

Revision of Risk Assessment (Ref: Para. 25)

A108. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatement. See ISA 330 (Redrafted) for further guidance.

Communicating With Those Charged With Governance and Management (Ref: Para. 26)

Considerations Specific to Public Sector Entities

A109. In the audit of public sector entities, there may be additional communication or reporting requirements for public sector auditors. For example, internal control weaknesses may have to be reported to the legislature or other governing body.

Documentation (Ref: Para. 27)

A110. The manner in which the requirements of paragraph 27 are documented is for the auditor to determine using professional judgment. In particular, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures (see ISA 330 (Redrafted) for additional guidance). The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit. Ordinarily, the more complex the entity and the more extensive the audit procedures performed by the auditor, the more extensive the auditor's documentation will be.

Appendix 1

(Ref: Paras. 4(b), 17 and A65-A90)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(b), 17 and A65-A90, as they relate to a financial statement audit.

Control Environment

2. The control environment encompasses the following elements:

   (a) *Communication and enforcement of integrity and ethical values*. The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.

   (b) *Commitment to competence*. Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.

   (c) *Participation by those charged with governance*. An entity's control consciousness is influenced significantly by those charged with governance. The importance of responsibilities of those charged with governance is recognized in codes of practice and other regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.

   (d) *Management's philosophy and operating style*. Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.

   (e) *Organizational structure*. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.

   (f) *Assignment of authority and responsibility*. The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

(g) *Human resource policies and practices*. Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Entity's Risk Assessment Process

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements that give a true and fair view (or are presented fairly, in all material respects) in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.

4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment*. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel*. New personnel may have a different focus on or understanding of internal control.
- *New or revamped information systems*. Significant and rapid changes in information systems can change the risk relating to internal control.
- *Rapid growth*. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology*. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities*. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.

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

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

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

Control Activities

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:
   - *Performance reviews*. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.

- *Information processing*. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are polices and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

- *Physical controls*. Controls that encompass:

    ◦ The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.

    ◦ The authorization for access to computer programs and data files.

    ◦ The periodic counting and comparison with amounts shown on control records (for example comparing the results of cash, security and inventory counts with accounting records).

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

- *Segregation of duties*. Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

10. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, non-routine transactions such as major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

Monitoring of Controls

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies.

Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the design and operation of internal control, and communicate information about strengths and weaknesses and recommendations for improving internal control.

13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Appendix 2

(Ref: Para. A28 and A92)

Conditions and Events that may Indicate Risks of Material Misstatement

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

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

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

PROPOSED INTERNATIONAL STANDARD ON AUDITING 330 (REDRAFTED)

THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS

CONTENTS

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's response to the assessed risks of material misstatement in a financial statement audit.

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after [date].

Objective to be Achieved

3. In relation to this ISA, the objective of the auditor is to:
   (a) Determine and implement overall responses to assessed risks at the financial statement level;
   (b) Design and perform further audit procedures to respond to assessed risks at the assertion level; and
   (c) Evaluate whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level.

Definitions

4. The following terms are introduced in this ISA:
   (a) Substantive procedure – An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:
      (i) Tests of details (of classes of transactions, account balances, and disclosures), and
      (ii) Substantive analytical procedures.
   (b) Test of controls – An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Requirements

Overall Responses

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

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

6. The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and responsive to the assessed risks of material misstatement at the assertion level. The purpose is to provide a clear linkage between the nature, timing and extent of the auditor's further audit procedures and the risk assessment.
7. In determining the further audit procedures to be performed, the auditor shall:
   (a) Consider the reasons for the assessment of the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

(i) The particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risks); and

(ii) Whether the relevant risk assessment takes account of the entity's controls (i.e., the control risk), including the nature of the specific controls used by the entity and whether they are manual or automated, and whether the auditor expects to obtain evidence to determine if the controls are effective; and

(b) Seek more persuasive audit evidence the higher the auditor's assessment of risk. More persuasive audit evidence may be obtained by increasing the quantity of the evidence, or obtaining evidence that is more relevant or reliable. The nature of the audit procedures is, however, of most importance in responding to the assessed risks. (Ref: Para. A4-A17)

Tests of Controls

8. The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively, or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A18-A22)

Nature of Tests of Controls

9. In designing and performing tests of controls, the auditor shall:

(a) Perform other audit procedures in combination with inquiry to test the operating effectiveness of the controls. (Ref: Para. A23-A25)

(b) Obtain audit evidence about the operating effectiveness of the controls, including:

(i) How the controls were applied at relevant times during the period under audit.

(ii) The consistency with which they were applied.

(iii) By whom or by what means they were applied.

(c) If the controls to be tested depend upon other controls (indirect controls), consider whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A26-27)

Timing of Tests of Controls

10. The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs 11 and 14 below. The purpose of this requirement and those in paragraphs 11 and 14, is to provide an appropriate basis for the auditor's intended reliance at relevant times during the period under audit. (Ref: Para. A28)

Using audit evidence obtained during an interim period

11. When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

(a) Obtain audit evidence about changes to those controls subsequent to the interim period; and

(b) Determine what additional audit evidence should be obtained for the remaining period. (Ref: Para. A29-A30)

Using audit evidence obtained in previous audits

12. In considering whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

- The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process.
- The risks arising from the characteristics of the control, including whether controls are manual or automated.
- The effectiveness of general IT-controls.
- The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control.
- Whether the lack of a change in a particular control poses a risk due to changing circumstances.
- The risk of material misstatement and the extent of reliance on the control. (Ref: Para. A31)

13. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain audit evidence about whether such changes have occurred by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

(a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the operating effectiveness of the controls in the current audit. (Ref: Para. A32)

(b) If there have not been such changes, the auditor shall test the operating effectiveness of the controls at least once in every third audit.

However, when there are a number of controls for which the auditor determines that it is appropriate to use audit evidence obtained in previous audits, the auditor shall test the operating effectiveness of some controls each audit. The purpose of this requirement is to avoid the possibility that the auditor might test controls in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A33-35)

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

Extent of Tests of Controls

15. The auditor shall increase the extent of tests of controls the more the auditor relies on their operating effectiveness in the assessment of risk. (Ref: Para. A36-A37)

Evaluating the Operating Effectiveness of Controls

16. When evaluating the operating effectiveness of relevant controls, the auditor shall consider misstatements that have been detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A38)

17. When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

    (a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;

    (b) Additional tests of controls are necessary; or

    (c) The potential risks of misstatement need to be addressed using substantive procedures. (Ref: Para. A39)

Substantive Procedures

18. Irrespective of the assessed risk of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. This requirement reflects the facts that: (i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and (ii) there are inherent limitations to internal control, including management override. (Ref: Para. A40-A44)

19. When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedure, those procedures shall include tests of details. (Ref: Para. A45)

20. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

    (a) Agreeing the financial statements to the underlying accounting records; and

    (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements.

    The nature and extent of the auditor's examination of journal entries and other adjustments depends on the nature and complexity of the entity's financial reporting process and the associated risks of material misstatement.

Timing of Substantive Procedures

Using audit evidence obtained during an interim period

21. When substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:

    (a) Substantive procedures combined with tests of controls; or

    (b) If the auditor considers it sufficient, further substantive procedures only,

    that provide a reasonable basis for extending the audit conclusions from the interim date to the period end.

22. If misstatements are detected at an interim date, the auditor shall modify the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period. This may include extending or repeating such procedures at the period end.

23. When the auditor plans to perform substantive analytical procedures with respect to the intervening period between the interim date and the period end, the auditor shall consider whether:

    (a) The period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.

    (b) The entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.

    (c) The information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:

        (i) Significant unusual transactions or entries (including those at or near period end),

        (ii) Other causes of significant fluctuations, or expected fluctuations that did not occur, and

        (iii) Changes in the composition of the classes of transactions or account balances. (Ref: Para. A46-47)

Using audit evidence obtained in previous audits

24. The auditor shall only use audit evidence obtained in previous audits as substantive audit evidence in the current period if the audit evidence and the related subject matter have not fundamentally changed. If the auditor plans to use such evidence, the auditor shall perform audit procedures during the current period to establish its continuing relevance. (Ref: Para. A48)

Adequacy of Presentation and Disclosure

25. The auditor shall 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. (Ref: Para. A49)

Evaluating the Sufficiency and Appropriateness of Audit Evidence

26. Based on the audit procedures performed and the audit evidence obtained, including consideration of how the detection of a misstatement may affect the risks of misstatement, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate.

27. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

28. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or a disclaimer of opinion. (Ref: Para. A50-52)

Documentation

29. The auditor shall document:

    (a) The overall responses to address the assessed risks of material misstatement, identifying separately those due to fraud, at the financial statement level and the nature, timing, and extent of the further audit procedures;

    (b) The linkage of those procedures with the assessed risks at the assertion level; and

    (c) The results of the audit procedures.

30. If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall document the conclusions reached about relying on such controls that were tested in a previous audit.

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Application Material

Overall Responses (Ref: Para. 5)

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

- Emphasizing to the audit team the need to maintain professional skepticism.
- Assigning more experienced staff or those with special skills or using experts.[1]
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.

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[1] The assignment of engagement personnel to the particular engagement reflects the auditor's risk assessment, which is based on the auditor's understanding of the entity, including its internal control, and its environment.

- Making general changes to the nature, timing, or extent of audit procedures, for example: performing substantive procedures at period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at period end. Weaknesses in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by conducting more audit procedures as of the period end rather than at an interim date, seeking more extensive audit evidence from substantive procedures, or increasing the number of locations to be included in the audit scope.

A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

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

The Nature, Timing, and Extent of Further Audit Procedures (Ref: Paras. 6-7)

A4. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, in some cases (as appropriate and notwithstanding the requirements of this ISA[2]), the auditor may determine that:

- Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion.
- Performing only substantive procedures is appropriate for specific assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient.
- A combined approach using both tests of controls and substantive procedures is an effective approach.

Considerations Specific to Public Sector Entities

A5. For the audits of public sector entities, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.

Considerations Specific to Smaller Entities

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

A6. In the case of very small entities, there may not be many control activities that could be identified by the auditor. For this reason, the auditor's further audit procedures are likely to be primarily substantive procedures. In some rare cases, however, the absence of controls may make it impossible to obtain sufficient appropriate audit evidence.

Nature

A7. The nature of an audit procedure refers to its purpose (i.e., test of controls or substantive procedure) and its type (i.e., inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure).

A8. The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, the auditor may confirm the completeness of the terms of a contract with a third party, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

A9. The reasons for the assessment of a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

Timing

A10. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.

A11. The auditor may perform tests of controls or substantive procedures at an interim date or at period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, given the risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from interim date to the period end would not be effective.

A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.

A13. In addition, certain audit procedures can be performed only at or after period end, for example:

- Agreeing the financial statements to the accounting records,
- Examining adjustments made during the course of preparing the financial statements, and
- Procedures to respond to a risk that, at period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized.

A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.

Extent

A15. Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.

A16. The extent of an audit procedure is determined by the judgment of the auditor after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single objective is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increased sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

A17. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

Tests of Controls

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

A18. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

A19. Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

A20. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included inquiries about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to the investigation of variances between budgeted and actual amounts. These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

A21. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the objective of a test of controls is different from the objective of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each objective of the test separately.

A22. In some cases, as discussed in ISA 315 (Redrafted), "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level. For example, when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, the auditor is required by paragraph 8(b) of this ISA to perform tests of relevant controls.

Nature of Tests of Controls

Other audit procedures in combination with inquiry (Ref: Para. 9(a))

A23. A higher level of assurance is ordinarily sought about controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

A24. Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, it is necessary to perform other audit procedures in combination with inquiry. In this regard, inquiry combined with inspection or reperformance ordinarily provides more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

A25. The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

Testing of indirect controls (Ref: Para. 9(c))

A26. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls. For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the auditor may also need to consider the effectiveness of controls related to the accuracy of the information in those reports (for example, the general IT-controls). The user review and related follow up is the control that is directly of relevance to the auditor; the controls over the accuracy of the information in the reports are described as 'indirect' controls.

A27. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.

Timing of Tests of Controls

Intended period of reliance (Ref: Para. 10)

A28. Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity's monitoring of controls.

Using audit evidence obtained during an interim period (Ref: Para. 11)

A29. Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period.
- The degree to which audit evidence about the operating effectiveness of those controls was obtained.
- The length of the remaining period.
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.

- The control environment.

A30. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the entity's monitoring of controls.

Using audit evidence obtained in previous audits (Ref: Para. 12)

A31. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

Controls that have changed from previous audits (Ref: Para. 13(a))

A32. Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 13(b))

A33. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

(a) have not changed since they were last tested; and

(b) are not controls that mitigate a significant risk,

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but cannot exceed two years.

A34. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A weak control environment.
- Weak monitoring of controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Weak general IT-controls.

A35. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides collateral evidence about the continuing effectiveness of the control environment and therefore contributes to the decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

Extent of Tests of Controls (Ref: Para. 15)

A36. The more the auditor relies on a control, the greater the testing of the control. Other matters the auditor may consider in determining the extent of the auditor's tests of controls include the following:

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

ISA 530, "Audit Sampling and Other Means of Testing" contains further guidance on the extent of testing.

A37. Because of the inherent consistency of IT processing, the auditor may not need to increase the extent of testing of an automated control. An automated control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests might include determining that:

- Changes to the program are not made without being subject to the appropriate program change controls,
- The authorized version of the program is used for processing transactions, and
- Other relevant general controls are effective.

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

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

A38. A material misstatement detected by the auditor's procedures ordinarily indicates the existence of a material weakness in internal control.

A39. The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce audit risk at the assertion level to that assessed by the auditor.

Substantive Procedures

Nature and Extent of Substantive Procedures (Ref: Para. 18)

A40. The greater the risk of material misstatement, the greater the extent of substantive procedures. Because the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

A41. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures may be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

A42. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. ISA 520, "Analytical Procedures" contains standards and guidance on the application of analytical procedures during an audit.

A43. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion involve selecting from items that likely should be included in the relevant financial statement amount and investigating whether they are included.

A44. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. See ISA 530 for additional guidance.

Substantive Procedures Responsive to Significant Risks (Ref: Para. 19)

A45. The auditor is required by paragraph 19 of this ISA to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

Timing of Substantive Procedures

Using audit evidence obtained during an interim period (Ref: Para. 21-23)

A46. In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to:

(a) Identify amounts that appear unusual,

(b) Investigate any such amounts, and

(c) Perform substantive analytical procedures or tests of details to test the intervening period.

A47 Performing substantive procedures at an interim date increases the risk that misstatements that may exist at the period end are not detected by the auditor. This risk increases as the remaining period is lengthened. Factors such as the following influence whether to perform substantive procedures at an interim date:

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

Using audit evidence obtained in previous audits (Ref: Para. 24)

A48. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. There are, however, exceptions, e.g., a legal opinion obtained in a previous audit related to the structure of a securitization to which no changes have occurred, may be relevant in the current period.

Adequacy of Presentation and Disclosure (Ref: Para. 25)

A49. Evaluating presentation and disclosure relates to the assessed risk of material misstatement at the assertion level regarding the form, arrangement, and content of the financial statements and their appended notes. This includes, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. See ISA 500, "Audit Evidence," for a description of the assertions related to presentation and disclosure.

Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: Para.26-28)

A50. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example,

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

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

A51. The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

A52. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

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

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IAASB Issues Exposure Drafts to Enhance the Clarity of International Standards

(New York/October 31, 2005) -- As part of its comprehensive program to improve the clarity of international standards, the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) has issued exposure drafts (EDs) of four proposed standards in a new drafting style. It has also issued an exposure draft of Proposed Amendments to the *Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services* and an Explanatory Memorandum to accompany the EDs. The release of these documents marks the beginning of the IAASB's ambitious 18-month program to re-draft standards and to develop new standards using the new style.

The IAASB developed its new drafting style based on responses to its 2004 Proposed Policy Statement and Consultation Paper on Clarity. The proposals were discussed at a forum of interested parties in July 2005 and refined as a result. Key elements of the new drafting style include: basing the standards on objectives, as opposed to procedural considerations; use of the word "shall" to identify requirements that the professional accountant is expected to follow in the vast majority of engagements; eliminating the present tense to describe actions by the professional accountant, which some had regarded as ambiguous in terms of obligation; and structural improvements to enhance the overall readability and understandability of the standards.

"The Clarity Project was undertaken primarily to deal with our use of the present tense, which it had been suggested was ambiguous in effect. We have also taken the opportunity to make changes to improve our drafting conventions to ensure that IAASB standards are understandable and capable of being translated and to facilitate international convergence," explains IAASB Chairman John Kellas. "Through consultation with regulators, the IAASB's Consultative Advisory Group, other standard setters and users of the standards, we developed this drafting style which we believe will clarify the requirements in the standards and make the standards easier to understand and to adopt."

The following four proposed standards have been re-drafted in the new style:

- International Standard on Auditing (ISA) 240 (Redrafted), *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*;
- ISA 300 (Redrafted), *Planning an Audit of Financial Statements*;
- ISA 315 (Redrafted), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; and
- ISA 330 (Redrafted), *The Auditor's Procedures in Response to Assessed Risks*.

The enhancements contained in the re-drafted standards also respond to the findings of the 2004 IFAC report, *Challenges and Successes In Implementing International Standards: Achieving Convergence To IFRSs and ISAs*, which identified such issues as the length and complexity of international standards as major challenges to convergence for such constituents as accountants in developing nations and small and medium practices and entities.

How to Comment
Comments on the exposure drafts are requested by February 28, 2006. The EDs may be viewed by going to http://www.ifac.org/EDs. Comments may be submitted by email to EDComments@ifac.org. They can also be faxed to the attention of the IAASB

Technical Director at +1 (212) 286-9570 or mailed to IFAC, 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA. All comments will be considered a matter of public record and will ultimately be posted on IFAC's website.

About the IAASB and IFAC
The objective of the IAASB, an independent standard-setting board within IFAC, is to serve the public interest by setting high quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The international Public Interest Oversight Board oversees the activities of the IAASB and, as one element of that oversight, establishes the criteria for its due process and working procedures.

IFAC is the worldwide organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. Its current membership consists of over 160 professional accountancy bodies in 119 countries, representing more than 2.5 million accountants in public practice, education, government service, industry and commerce. In addition to setting international auditing and assurance standards through the IAASB, IFAC sets ethics, education, and public sector accounting standards and develops guidance to encourage high quality performance by professional accountants in business.

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