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HANDBOOK OF INTERNATIONAL AUDITING, ASSURANCE, AND ETHICS PRONOUNCEMENTS

2008 EDITION

PART I

Scope of Part I of the Handbook

Part I of the handbook brings together for continuing reference background information on the International Federation of Accountants (IFAC) and the pronouncements on ethics, quality control, auditing, review, other assurance, and related services issued by IFAC as of January 1, 2008. In Part I of the handbook, the text of pronouncements that become effective at a date after January 1, 2008 has been shaded.

Part II of the handbook contains background information on the project of the International Auditing and Assurance Standards Board (IAASB) to improve the clarity of its pronouncements (Clarity project), an amended Preface for the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services and the International Standards on Auditing (ISAs) that have been redrafted in accordance with the clarity conventions. Those ISAs are effective for audits of financial statements for periods beginning on or after December 15, 2009.

How Part I of the Handbook is Arranged

The contents of Part I of the handbook are arranged by section as follows:

Changes of Substance from the 2007 Edition of the Handbook and Recent Developments 1

Background Information on the International Federation of Accountants 4

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CHANGES OF SUBSTANCE FROM THE 2007 EDITION OF THE HANDBOOK AND RECENT DEVELOPMENTS

References

Part I of this handbook contains references to the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC). As of April 1, 2002 the International Auditing and Assurance Standards Board (IAASB) of IFAC replaced the IAPC.

Part 1 of this handbook also contains references to the International Accounting Standards Committee (IASC). As of April 1, 2002 the International Financial Reporting Standards (IFRSs) (previously referred to as International Accounting Standards (IASs)) are issued by the International Accounting Standards Board (IASB). Unless otherwise indicated, references to IASs and IFRSs are to the IASs and IFRSs in effect at the date of preparing a pronouncement. Accordingly, readers are cautioned that, where a revised IAS or IFRS has been issued subsequently, reference should be made to the most recent IAS or IFRS.

In Parts I and II of this handbook, references to "country" should be read as "country or jurisdiction."

Pronouncements Issued by the International Auditing and Assurance Standards Board

This is the first year that the handbook is presented in two parts. Part I contains background information on IFAC and the pronouncements on ethics, auditing, review, other assurance, and related services issued by IFAC as of January 1, 2008.

Part II contains background information on the IAASB's project to improve the clarity of its pronouncements (Clarity project), an amended Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services and the International Standards on Auditing (ISAs) that have been redrafted in accordance with the clarity conventions. Those ISAs are effective for audits of financial statements for periods beginning on or after December 15, 2009.

Changes to Part I

Paragraph 2 of the International Standard on Review Engagements (ISRE) 2400, "Engagements to Review Financial Statements" has been amended and paragraph 3a and footnote 4 added to ISRE 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" to clarify to which engagements each ISRE respectively is to be applied. The amendments are effective.

Part II

Amendments to the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" (Preface) were approved in

December 2006 as part of the Clarity project. The amended Preface, which establishes the conventions to be used by the IAASB in drafting future ISAs, and the obligations of auditors who follow those standards, and the following ISAs, which reflect the clarity conventions, have been moved to Part II of the handbook:

- ISA 240 (Redrafted), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements;"
- ISA 300 (Redrafted), "Planning an Audit of Financial Statements;"
- ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment;" and
- ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

Minor amendments have been processed to these ISAs. To further enhance their readability, cross references to other ISAs have been moved to footnotes. (Electronic files that show the amendments in marked text can be obtained by writing to IAASBpubs@ifac.org.)

The following ISAs, which reflect the clarity conventions, have been added to Part II:

- ISA 230 (Redrafted), "Audit Documentation;"
- ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance;"
- ISA 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures;"
- ISA 600 (Revised and Redrafted), "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors);" and
- ISA 720 (Redrafted), "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements."

The redrafted standards are described as "redrafted." If further revision has been undertaken, the standard is described as "revised and redrafted." They are effective for audits of financial statements for periods beginning on or after December 15, 2009.

Small Entity Audit Considerations

For ISAs issued subsequent to March 2003, whenever necessary, small entity audit considerations are included in the body of those ISAs. Guidance contained in International Auditing Practice Statement (IAPS) 1005, "The Special Considerations in the Audit of Small Entities" is withdrawn when revisions to related ISAs become effective. Accordingly, readers are cautioned that, in addition to the guidance in IAPS 1005, reference should be made to the small entity audit considerations included in ISAs issued subsequent to March 2003.

Final Pronouncements Issued Subsequent to December 31, 2007 and Exposure Drafts

For information on recent developments and to obtain final pronouncements issued subsequent to December 31, 2007 or outstanding exposure drafts, visit the IAASB's website at http://www.iaasb.org.

Pronouncements Issued by the International Ethics Standards Board for Accountants

Changes

New paragraphs 290.14-290.26 and new or revised definitions for "firm," "network," and "network firm," which are effective for assurance reports dated on or after December 31, 2008, have been inserted in the *Code of Ethics for Professional Accountants*. Those paragraphs that follow new paragraphs 290.14-290.26 have been renumbered accordingly.

Recent Exposure Drafts

The International Ethics Standards Board for Accountants (IESBA) has issued two exposure drafts of proposed amendments to extant Section 290 *Independence—Audit and Review Engagements* and proposed new Section 291 *Independence—Other Assurance Engagements*.

For additional information on recent developments and to obtain final pronouncements issued subsequent to December 31, 2007 or outstanding exposure drafts, visit the IESBA's page on the IFAC website at http://www.ifac.org.

BACKGROUND INFORMATION ON THE INTERNATIONAL FEDERATION OF ACCOUNTANTS

The Organization

The International Federation of Accountants (IFAC) is the global organization for the accountancy profession. Founded in 1977, its mission is “to serve the public interest, IFAC will continue to strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession’s expertise is most relevant.”

IFAC’s governing bodies, staff and volunteers are committed to the values of integrity, transparency and expertise. IFAC also seeks to reinforce professional accountants’ adherence to these values, which are reflected in the IFAC *Code of Ethics for Professional Accountants.*

For additional information on IFAC and the matters and materials described below, visit IFAC’s website at http://www.ifac.org.

Primary Activities

Serving the Public Interest

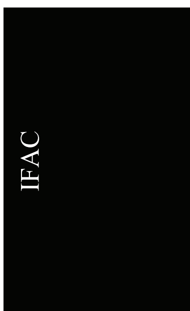
IFAC provides leadership to the worldwide accountancy profession in serving the public interest by:

- Developing, promoting and maintaining global professional standards and a *Code of Ethics for Professional Accountants* of a consistently high quality;
- Actively encouraging convergence of professional standards, particularly, auditing, assurance, ethics, education, and public and private sector financial reporting standards;
- Seeking continuous improvements in the quality of auditing and financial management;
- Promoting the values of the accountancy profession to ensure that it continually attracts high caliber entrants;
- Promoting compliance with membership obligations; and
- Assisting developing and emerging economies, in cooperation with regional accountancy bodies and others, in establishing and maintaining a profession committed to quality performance and serving the public interest.

Contributing to the Efficiency of the Global Economy

IFAC contributes to the efficient functioning of the international economy by:

- Improving confidence in the quality and reliability of financial reporting;
- Encouraging the provision of high quality performance information (financial and non-financial) within organizations;
- Promoting the provision of high quality services by all members of the worldwide accountancy profession; and
- Promoting the importance of adherence to the *Code of Ethics for Professional Accountants* by all members of the accountancy profession, including members in industry, commerce, the public sector, the not-for-profit sector, academia, and public practice.



Providing Leadership and Spokesmanship

IFAC is the primary spokesperson for the global profession and speaks out on a wide range of issues where the profession's expertise is most relevant. This is accomplished, in part, through outreach to numerous organizations that rely on or have an interest in the activities of the international accountancy profession. IFAC also issues policy positions on topics where the profession's expertise is most relevant. These are available from the IFAC website at http://www.ifac.org.

Membership

IFAC is comprised of 157 members and associates in 123 countries worldwide, representing more than 2.5 million accountants in public practice, industry and commerce, the public sector, and education. No other accountancy body in the world and few other professional organizations have the broad-based international support that characterizes IFAC.

IFAC's strengths derive not only from its international representation, but also from the support and involvement of its individual member bodies, which are themselves dedicated to promoting integrity, transparency, and expertise in the accountancy profession, as well as from the support of regional accountancy bodies.

Standard-Setting Initiatives

IFAC has long recognized the need for a globally harmonized framework to meet the increasingly international demands that are placed on the accountancy profession, whether from the business, the public sector or education communities. Major components of this framework are the *Code of Ethics for Professional Accountants*, International Standards on Auditing (ISAs), International Education Standards, and International Public Sector Accounting Standards (IPSASs).

IFAC's standard-setting boards, described below, follow a due process that supports the development of high quality standards in the public interest in a transparent, efficient, and effective manner. These standard-setting boards all have Consultative Advisory Groups, which provide public interest perspectives and include public members.

IFAC's Public Interest Activity Committees (PIACs) – the International Auditing and Assurance Standards Board, International Accounting Education Standards Board, International Ethics Standards Board for Accountants, and the Compliance Advisory Panel – are subject to oversight by the Public Interest Oversight Board (PIOB) (see below).

The terms of reference, due process and operating procedures of the IFAC standard-setting boards are available from the IFAC website at http://www.ifac.org.

IFAC actively supports convergence to ISAs and other standards developed by its independent standard-setting boards and the International Accounting Standards Board.

Auditing and Assurance Services

The International Auditing and Assurance Standards Board (IAASB) develops ISAs and International Standards on Review Engagements, which deal with the audit and review of historical financial information; and International Standards on Assurance Engagements, which deal with assurance engagements other than the audit or review of historical financial information. The IAASB also develops related practice statements. These standards and statements serve as the benchmark for high quality auditing and assurance standards and statements worldwide. They establish standards and provide guidance for auditors and other professional accountants, giving them the tools to cope with the increased and changing demands for reports on financial information, and provide guidance in specialized areas.

In addition, the IAASB develops quality control standards for firms and engagement teams in the practice areas of audit, assurance and related services.

Ethics

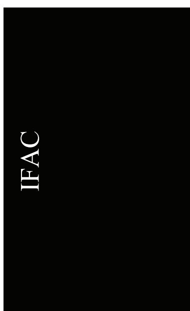
The *Code of Ethics for Professional Accountants* (the Code), developed by IFAC's International Ethics Standards Board for Accountants, establishes ethical requirements for professional accountants and provides a conceptual framework for all professional accountants to ensure compliance with the five fundamental principles of professional ethics. These principles are integrity, objectivity, professional competence and due care, confidentiality, and professional behavior. Under the framework, all professional accountants are required to identify threats to these fundamental principles and, if there are threats, apply safeguards to ensure that the principles are not compromised. A member body of IFAC or firm conducting an audit using ISAs may not apply less stringent standards than those stated in the Code.

Public Sector Financial Reporting

IFAC's International Public Sector Accounting Standards Board focuses on the development of high quality financial reporting standards for use by public sector entities around the world. It has developed a comprehensive body of IPSASs setting out the requirements for financial reporting by governments and other public sector organizations. The IPSASs represent international best practice in financial reporting by

public sector entities. In many jurisdictions, the application of the requirements of IPSASs will enhance the accountability and transparency of the financial reports prepared by governments and their agencies.

The IPSASs are contained in the 2008 edition of IFAC's *Handbook of International Public Sector Accounting Pronouncements* and are also available from the IFAC website at http://www.ifac.org. French and Spanish translations of the IPSASs are also available for download from the IFAC website.



Education

Working to advance accounting education programs worldwide, IFAC's International Accounting Education Standards Board (IAESB) develops International Education Standards, setting the benchmarks for the education of members of the accountancy profession. All member bodies are required to comply with those standards, which address the education process leading to qualification as a professional accountant as well as the ongoing continuing professional development of members of the profession. The IAESB also develops International Education Practice Statements and other guidance to assist member bodies and accounting educators in implementing and achieving best practice in accounting education.

This handbook does not contain the International Education Standards, which are available from the IFAC website at http://www.ifac.org.

Support for Professional Accountants in Business

Both IFAC and its member bodies face the challenge of meeting the needs of an increasing number of accountants employed in business and industry, the public sector, education, and the not-for-profit sector. These accountants now comprise more than 50 percent of the membership of member bodies. IFAC's Professional Accountants in Business Committee develops guidance in collaboration with member bodies to assist in addressing a wide range of professional issues, encourages and supports high quality performance by professional accountants in business, and strives to build public awareness and understanding of the work they provide.

Small- and Medium-Sized Practices

IFAC is also focused on providing support for another growing constituency: small- and medium-sized practices (SMPs). IFAC's SMP Committee develops guidance on key topics for SMPs and small- and medium-sized entities (SMEs), including implementation guidance on using ISAs in the audit of SMEs and applying International Standard on Quality Control 1. It provides input from an SMP/SME perspective on the development of international standards and on the work of the IFAC standard-setting boards. The SMP Committee also investigates ways in which IFAC, together with its member bodies, can respond to the needs of accountants operating in SMEs and SMPs and holds annual forums on SMP/SME issues.

Developing Nations

IFAC's Developing Nations Committee supports the development of the accountancy profession in all regions of the world by representing and addressing the interests of developing nations and by providing guidance to strengthen the accountancy profession worldwide. The committee also seeks resources and development assistance from the donor community on their behalf. In addition, the committee holds annual forums on addressing the needs of developing nations.

IFAC Member Body Compliance Program

As part of the Member Body Compliance Program, IFAC members and associates (mostly national professional institutes) are required to demonstrate how they have used best endeavors, subject to national laws and regulations, to implement the standards issued by IFAC and the International Accounting Standards Board. The program, which is overseen by IFAC's Compliance Advisory Panel, also seeks to determine how members and associates have met their obligations with respect to quality assurance and investigation and disciplinary programs for their members as set out in IFAC's Statements of Membership Obligations (SMOs). As part of the Compliance Program, members and associates are required to complete a self-assessment regarding the SMO requirements and, where areas for improvement are identified, to develop action plans to address those areas. The SMOs serve as the foundation of the Compliance Program and provide clear benchmarks to current and potential member bodies to assist them in ensuring high quality performance by professional accountants.

This handbook does not contain the SMOs, which are available from the IFAC website at http://www.ifac.org.

Regulatory Framework

In November 2003, IFAC, with the strong support of member bodies and international regulators, approved a series of reforms to increase confidence that the activities of IFAC are properly responsive to the public interest and will lead to the establishment of high quality standards and practices in auditing and assurance.

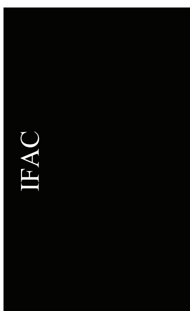
The reforms provide for the following: more transparent standard-setting processes, greater public and regulatory input into those processes, regulatory monitoring, public interest oversight, and ongoing dialogue between regulators and the accountancy profession. This is accomplished through the following structures:

Public Interest Oversight Board (PIOB)—Established in February 2005, the PIOB oversees IFAC's standard-setting activities in the areas of auditing and assurance, ethics – including independence – and education, as well as the IFAC Member Body Compliance Program. The PIOB is comprised of ten representatives nominated by international regulators and institutions.

Monitoring Group (MG)—The MG comprises international regulators and related organizations. Its role is to update the PIOB regarding significant events in the

regulatory environment. It is also the vehicle for dialogue between regulators and the international accountancy profession.

IFAC Regulatory Liaison Group (IRLG)—The IRLG includes the IFAC President, Deputy President, Chief Executive Officer, three members designated by the IFAC Board, the Chair of the Forum of Firms, and six others nominated by the Global Public Policy Committee. It works with the MG and addresses issues related to the regulation of the profession.



IFAC Structure and Operations

Governance of IFAC rests with its Board and Council. The IFAC Council comprises one representative from each member body. The Board is a smaller group responsible for policy setting. As representatives of the worldwide accountancy profession, Board members sign a declaration to act with integrity and in the public interest.

The IFAC Nominating Committee makes recommendations on the composition of IFAC boards and committees, the IFAC Board, and candidates for the office of IFAC Deputy President. The committee is guided in its work by the principle of choosing the best person for the position. It also seeks to balance regional and professional representation on the boards and committees, as well as representation from countries with different levels of economic development.

IFAC is headquartered in New York City and is staffed by accounting and other professionals from around the world.

IFAC Publications, Copyright and Translation

IFAC makes its guidance widely available by enabling individuals to freely download all publications from its website (http://www.ifac.org) and by encouraging its members and associates, regional accountancy bodies, standard setters, regulators and others to include links from their own websites, or print materials, to the publications on IFAC's website.

IFAC also recognizes that it is important that preparers and users of financial statements, auditors, regulators, lawyers, academia, students, and other interested groups in non-English speaking countries have access to its standards in their native language. To make its standards and guidance as widely available as possible, IFAC has developed the following policy statements that address matters related to copyright and reproduction and translation:

- *Policy for Reproducing, or Translating and Reproducing, Publications Issued by the International Federation of Accountants*; and
- *Permission to State that the International Federation of Accountants has Considered a Translating Body's Process for Translating Standards and Guidance.*

This handbook does not contain these policy statements. However, the policy statements and a database of translations of IFAC publications by third parties are available on the IFAC website at http://www.ifac.org.

ETHICS

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The Code was issued in June 2005 and became effective on June 30, 2006. Paragraphs 290.1-290.13 and 290.27-290.47 are applicable to assurance engagements when the assurance report is dated on or after June 30, 2006. Paragraphs 290.14-290.26, which were issued in July 2006, apply to assurance engagements when the assurance report is dated on or after December 31, 2008.

For additional information on the International Ethics Standards Board for Accountants (IESBA), recent developments, and to obtain outstanding exposure drafts, visit the IESBA's page on the IFAC website at http://www.ifac.org.

June 2005

Revised July 2006

CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS[◆]

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PREFACE

The mission of the International Federation of Accountants (IFAC), as set out in its constitution, is "to serve the public interest, IFAC will continue to strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession's expertise is most relevant." In pursuing this mission, the IFAC Board has established the Ethics Standards Board for Accountants to develop and issue, under its own authority, high quality ethical standards and other pronouncements for professional accountants for use around the world.

This *Code of Ethics for Professional Accountants* establishes ethical requirements for professional accountants. A member body of IFAC or firm may not apply less stringent standards than those stated in this Code. However, if a member body or firm is prohibited from complying with certain parts of this Code by law or regulation, they should comply with all other parts of this Code.

Some jurisdictions may have requirements and guidance that differs from this Code. Professional accountants should be aware of those differences and comply with the more stringent requirements and guidance unless prohibited by law or regulation.

PART A—GENERAL APPLICATION OF THE CODE

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SECTION 100

Introduction and Fundamental Principles

100.1 A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a **professional accountant's*** responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest a professional accountant should observe and comply with the ethical requirements of this Code.

100.2 This Code is in three parts. Part A establishes the fundamental principles of professional ethics for professional accountants and provides a conceptual framework for applying those principles. The conceptual framework provides guidance on fundamental ethical principles. Professional accountants are required to apply this conceptual framework to identify threats to compliance with the fundamental principles, to evaluate their significance and, if such threats are other than **clearly insignificant*** to apply safeguards to eliminate them or reduce them to an acceptable level such that compliance with the fundamental principles is not compromised.

100.3 Parts B and C illustrate how the conceptual framework is to be applied in specific situations. It provides examples of safeguards that may be appropriate to address threats to compliance with the fundamental principles and also provides examples of situations where safeguards are not available to address the threats and consequently the activity or relationship creating the threats should be avoided. Part B applies to **professional accountants in public practice.*** Part C applies to **professional accountants in business.*** Professional accountants in public practice may also find the guidance in Part C relevant to their particular circumstances.

Fundamental Principles

100.4 A professional accountant is required to comply with the following fundamental principles:

(a) *Integrity*

A professional accountant should be straightforward and honest in all professional and business relationships.

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* See Definitions.

(b) *Objectivity*

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

(c) *Professional Competence and Due Care*

A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing **professional services.***

(d) *Confidentiality*

A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

(e) *Professional Behavior*

A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

Each of these fundamental principles is discussed in more detail in Sections 110 – 150.

Conceptual Framework Approach

100.5 The circumstances in which professional accountants operate may give rise to specific threats to compliance with the fundamental principles. It is impossible to define every situation that creates such threats and specify the appropriate mitigating action. In addition, the nature of engagements and work assignments may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires a professional accountant to identify, evaluate and address threats to compliance with the fundamental principles, rather than merely comply with a set of specific rules which may be arbitrary,

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* See Definitions.

is, therefore, in the public interest. This Code provides a framework to assist a professional accountant to identify, evaluate and respond to threats to compliance with the fundamental principles. If identified threats are other than clearly insignificant, a professional accountant should, where appropriate, apply safeguards to eliminate the threats or reduce them to an acceptable level, such that compliance with the fundamental principles is not compromised.

100.6 A professional accountant has an obligation to evaluate any threats to compliance with the fundamental principles when the professional accountant knows, or could reasonably be expected to know, of circumstances or relationships that may compromise compliance with the fundamental principles.

100.7 A professional accountant should take qualitative as well as quantitative factors into account when considering the significance of a threat. If a professional accountant cannot implement appropriate safeguards, the professional accountant should decline or discontinue the specific professional service involved, or where necessary resign from the client (in the case of a professional accountant in public practice) or the employing organization (in the case of a professional accountant in business).

100.8 A professional accountant may inadvertently violate a provision of this Code. Such an inadvertent violation, depending on the nature and significance of the matter, may not compromise compliance with the fundamental principles provided, once the violation is discovered, the violation is corrected promptly and any necessary safeguards are applied.

100.9 Parts B and C of this Code include examples that are intended to illustrate how the conceptual framework is to be applied. The examples are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances experienced by a professional accountant that may create threats to compliance with the fundamental principles. Consequently, it is not sufficient for a professional accountant merely to comply with the examples presented; rather, the framework should be applied to the particular circumstances encountered by the professional accountant.

Threats and Safeguards

100.10 Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

(a) Self-interest threats, which may occur as a result of the financial or other interests of a professional accountant or of an immediate or **close family*** member;

(b) Self-review threats, which may occur when a previous judgment needs to be re-evaluated by the professional accountant responsible for that judgment;

(c) Advocacy threats, which may occur when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised;

(d) Familiarity threats, which may occur when, because of a close relationship, a professional accountant becomes too sympathetic to the interests of others; and

(e) Intimidation threats, which may occur when a professional accountant may be deterred from acting objectively by threats, actual or perceived.

Parts B and C of this Code, respectively, provide examples of circumstances that may create these categories of threats for professional accountants in public practice and professional accountants in business. Professional accountants in public practice may also find the guidance in Part C relevant to their particular circumstances.

100.11 Safeguards that may eliminate or reduce such threats to an acceptable level fall into two broad categories:

(a) Safeguards created by the profession, legislation or regulation; and

(b) Safeguards in the work environment.

100.12 Safeguards created by the profession, legislation or regulation include, but are not restricted to:

- Educational, training and experience requirements for entry into the profession.
- Continuing professional development requirements.
- Corporate governance regulations.
- Professional standards.
- Professional or regulatory monitoring and disciplinary procedures.

* See Definitions.

- External review by a legally empowered third party of the reports, returns, communications or information produced by a professional accountant.

100.13 Parts B and C of this Code, respectively, discuss safeguards in the work environment for professional accountants in public practice and those in business.

100.14 Certain safeguards may increase the likelihood of identifying or deterring unethical behavior. Such safeguards, which may be created by the accounting profession, legislation, regulation or an employing organization, include, but are not restricted to:

- Effective, well publicized complaints systems operated by the employing organization, the profession or a regulator, which enable colleagues, employers and members of the public to draw attention to unprofessional or unethical behavior.
- An explicitly stated duty to report breaches of ethical requirements.

100.15 The nature of the safeguards to be applied will vary depending on the circumstances. In exercising professional judgment, a professional accountant should consider what a reasonable and informed third party, having knowledge of all relevant information, including the significance of the threat and the safeguards applied, would conclude to be unacceptable.

Ethical Conflict Resolution

100.16 In evaluating compliance with the fundamental principles, a professional accountant may be required to resolve a conflict in the application of fundamental principles.

100.17 When initiating either a formal or informal conflict resolution process, a professional accountant should consider the following, either individually or together with others, as part of the resolution process:

(a) Relevant facts;

(b) Ethical issues involved;

(c) Fundamental principles related to the matter in question;

(d) Established internal procedures; and

(e) Alternative courses of action.

Having considered these issues, a professional accountant should determine the appropriate course of action that is consistent with the fundamental principles identified. The professional accountant should also weigh the consequences of each possible course of action. If the

matter remains unresolved, the professional accountant should consult with other appropriate persons within the **firm*** or employing organization for help in obtaining resolution.

100.18 Where a matter involves a conflict with, or within, an organization, a professional accountant should also consider consulting with those charged with governance of the organization, such as the board of directors or the audit committee.

100.19 It may be in the best interests of the professional accountant to document the substance of the issue and details of any discussions held or decisions taken, concerning that issue.

100.20 If a significant conflict cannot be resolved, a professional accountant may wish to obtain professional advice from the relevant professional body or legal advisors, and thereby obtain guidance on ethical issues without breaching confidentiality. For example, a professional accountant may have encountered a fraud, the reporting of which could breach the professional accountant's responsibility to respect confidentiality. The professional accountant should consider obtaining legal advice to determine whether there is a requirement to report.

100.21 If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional accountant should, where possible, refuse to remain associated with the matter creating the conflict. The professional accountant may determine that, in the circumstances, it is appropriate to withdraw from the **engagement team*** or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.

* See Definitions.

SECTION 110

Integrity

110.1 The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in professional and business relationships. Integrity also implies fair dealing and truthfulness.

110.2 A professional accountant should not be associated with reports, returns, communications or other information where they believe that the information:

(a) Contains a materially false or misleading statement;

(b) Contains statements or information furnished recklessly; or

(c) Omits or obscures information required to be included where such omission or obscurity would be misleading.

110.3 A professional accountant will not be considered to be in breach of paragraph 110.2 if the professional accountant provides a modified report in respect of a matter contained in paragraph 110.2.

SECTION 120

Objectivity

120.1 The principle of objectivity imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.

120.2 A professional accountant may be exposed to situations that may impair objectivity. It is impracticable to define and prescribe all such situations. Relationships that bias or unduly influence the professional judgment of the professional accountant should be avoided.

SECTION 130

Professional Competence and Due Care

130.1 The principle of professional competence and due care imposes the following obligations on professional accountants:

(a) To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and

(b) To act diligently in accordance with applicable technical and professional standards when providing professional services.

130.2 Competent professional service requires the exercise of sound judgment in applying professional knowledge and skill in the performance of such service. Professional competence may be divided into two separate phases:

(a) Attainment of professional competence; and

(b) Maintenance of professional competence.

130.3 The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical professional and business developments. Continuing professional development develops and maintains the capabilities that enable a professional accountant to perform competently within the professional environments.

130.4 Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

130.5 A professional accountant should take steps to ensure that those working under the professional accountant's authority in a professional capacity have appropriate training and supervision.

130.6 Where appropriate, a professional accountant should make clients, employers or other users of the professional services aware of limitations inherent in the services to avoid the misinterpretation of an expression of opinion as an assertion of fact.

SECTION 140

Confidentiality

140.1 The principle of confidentiality imposes an obligation on professional accountants to refrain from:

(a) Disclosing outside the firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and

(b) Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

140.2 A professional accountant should maintain confidentiality even in a social environment. The professional accountant should be alert to the possibility of inadvertent disclosure, particularly in circumstances involving long association with a business associate or a close or **immediate family*** member.

140.3 A professional accountant should also maintain confidentiality of information disclosed by a prospective client or employer.

140.4 A professional accountant should also consider the need to maintain confidentiality of information within the firm or employing organization.

140.5 A professional accountant should take all reasonable steps to ensure that staff under the professional accountant's control and persons from whom advice and assistance is obtained respect the professional accountant's duty of confidentiality.

140.6 The need to comply with the principle of confidentiality continues even after the end of relationships between a professional accountant and a client or employer. When a professional accountant changes employment or acquires a new client, the professional accountant is entitled to use prior experience. The professional accountant should not, however, use or disclose any confidential information either acquired or received as a result of a professional or business relationship.

140.7 The following are circumstances where professional accountants are or may be required to disclose confidential information or when such disclosure may be appropriate:

(a) Disclosure is permitted by law and is authorized by the client or the employer;

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* See Definitions.

(b) Disclosure is required by law, for example:

(i) Production of documents or other provision of evidence in the course of legal proceedings; or

(ii) Disclosure to the appropriate public authorities of infringements of the law that come to light; and

(c) There is a professional duty or right to disclose, when not prohibited by law:

(i) To comply with the quality review of a member body or professional body;

(ii) To respond to an inquiry or investigation by a member body or regulatory body;

(iii) To protect the professional interests of a professional accountant in legal proceedings; or

(iv) To comply with technical standards and ethics requirements.

140.8 In deciding whether to disclose confidential information, professional accountants should consider the following points:

(a) Whether the interests of all parties, including third parties whose interests may be affected, could be harmed if the client or employer consents to the disclosure of information by the professional accountant;

(b) Whether all the relevant information is known and substantiated, to the extent it is practicable; when the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgment should be used in determining the type of disclosure to be made, if any; and

(c) The type of communication that is expected and to whom it is addressed; in particular, professional accountants should be satisfied that the parties to whom the communication is addressed are appropriate recipients.

SECTION 150

Professional Behavior

150.1 The principle of professional behavior imposes an obligation on professional accountants to comply with relevant laws and regulations and avoid any action that may bring discredit to the profession. This includes actions which a reasonable and informed third party, having knowledge of all relevant information, would conclude negatively affects the good reputation of the profession.

150.2 In marketing and promoting themselves and their work, professional accountants should not bring the profession into disrepute. Professional accountants should be honest and truthful and should not:

(a) Make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or

(b) Make disparaging references or unsubstantiated comparisons to the work of others.

PART B—PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICE

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SECTION 200

Introduction

200.1 This Part of the Code illustrates how the conceptual framework contained in Part A is to be applied by professional accountants in public practice. The examples in the following sections are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances experienced by a professional accountant in public practice that may create threats to compliance with the principles. Consequently, it is not sufficient for a professional accountant in public practice merely to comply with the examples presented; rather, the framework should be applied to the particular circumstances faced.

200.2 A professional accountant in public practice should not engage in any business, occupation or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the rendering of professional services.

Threats and Safeguards

200.3 Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

(a) Self-interest;

(b) Self-review;

(c) Advocacy;

(d) Familiarity; and

(e) Intimidation.

These threats are discussed further in Part A of this Code.

The nature and significance of the threats may differ depending on whether they arise in relation to the provision of services to a **financial statement audit client**,* a non-financial statement audit **assurance client*** or a non-assurance client.

200.4 Examples of circumstances that may create self-interest threats for a professional accountant in public practice include, but are not limited to:

- A **financial interest*** in a client or jointly holding a financial interest with a client.
- Undue dependence on total fees from a client.

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* See Definitions.

- Having a close business relationship with a client.
- Concern about the possibility of losing a client.
- Potential employment with a client.
- **Contingent fees*** relating to an **assurance engagement**.*
- A loan to or from an assurance client or any of its directors or officers.

200.5 Examples of circumstances that may create self-review threats include, but are not limited to:

- The discovery of a significant error during a re-evaluation of the work of the professional accountant in public practice.
- Reporting on the operation of financial systems after being involved in their design or implementation.
- Having prepared the original data used to generate records that are the subject matter of the engagement.
- A member of the **assurance team*** being, or having recently been, a **director or officer*** of that client.
- A member of the assurance team being, or having recently been, employed by the client in a position to exert direct and significant influence over the subject matter of the engagement.
- Performing a service for a client that directly affects the subject matter of the assurance engagement.

200.6 Examples of circumstances that may create advocacy threats include, but are not limited to:

- Promoting shares in a **listed entity*** when that entity is a financial statement audit client.
- Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.

200.7 Examples of circumstances that may create familiarity threats include, but are not limited to:

- A member of the engagement team having a close or immediate family relationship with a director or officer of the client.
- A member of the engagement team having a close or immediate family relationship with an employee of the client who is in a

* See Definitions.

position to exert direct and significant influence over the subject matter of the engagement.

- A former partner of the firm being a director or officer of the client or an employee in a position to exert direct and significant influence over the subject matter of the engagement.
- Accepting gifts or preferential treatment from a client, unless the value is clearly insignificant.
- Long association of senior personnel with the assurance client.

200.8 Examples of circumstances that may create intimidation threats include, but are not limited to:

- Being threatened with dismissal or replacement in relation to a client engagement.
- Being threatened with litigation.
- Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

200.9 A professional accountant in public practice may also find that specific circumstances give rise to unique threats to compliance with one or more of the fundamental principles. Such unique threats obviously cannot be categorized. In either professional or business relationships, a professional accountant in public practice should always be on the alert for such circumstances and threats.

200.10 Safeguards that may eliminate or reduce threats to an acceptable level fall into two broad categories:

(a) Safeguards created by the profession, legislation or regulation; and

(b) Safeguards in the work environment.

Examples of safeguards created by the profession, legislation or regulation are described in paragraph 100.12 of Part A of this Code.

200.11 In the work environment, the relevant safeguards will vary depending on the circumstances. Work environment safeguards comprise firm-wide safeguards and engagement specific safeguards. A professional accountant in public practice should exercise judgment to determine how to best deal with an identified threat. In exercising this judgment a professional accountant in public practice should consider what a reasonable and informed third party, having knowledge of all relevant information, including the significance of the threat and the safeguards applied, would reasonably conclude to be acceptable. This consideration will be affected by matters such as the significance of the threat, the nature of the engagement and the structure of the firm.

200.12 Firm-wide safeguards in the work environment may include:

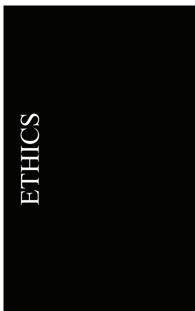
- Leadership of the firm that stresses the importance of compliance with the fundamental principles.
- Leadership of the firm that establishes the expectation that members of an assurance team will act in the public interest.
- Policies and procedures to implement and monitor quality control of engagements.
- Documented policies regarding the identification of threats to compliance with the fundamental principles, the evaluation of the significance of these threats and the identification and the application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant, to an acceptable level.
- For firms that perform assurance engagements, documented **independence**[*] policies regarding the identification of threats to independence, the evaluation of the significance of these threats and the evaluation and application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant, to an acceptable level.
- Documented internal policies and procedures requiring compliance with the fundamental principles.
- Policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients.
- Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single client.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client.
- Policies and procedures to prohibit individuals who are not members of an engagement team from inappropriately influencing the outcome of the engagement.
- Timely communication of a firm's policies and procedures, including any changes to them, to all partners and professional staff, and appropriate training and education on such policies and procedures.

[*] See Definitions.

- Designating a member of senior management to be responsible for overseeing the adequate functioning of the firm's quality control system.
- Advising partners and professional staff of those assurance clients and related entities from which they must be independent.
- A disciplinary mechanism to promote compliance with policies and procedures.
- Published policies and procedures to encourage and empower staff to communicate to senior levels within the firm any issue relating to compliance with the fundamental principles that concerns them.

200.13 Engagement-specific safeguards in the work environment may include:

- Involving an additional professional accountant to review the work done or otherwise advise as necessary.
- Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant.
- Discussing ethical issues with those charged with governance of the client.
- Disclosing to those charged with governance of the client the nature of services provided and extent of fees charged.
- Involving another firm to perform or re-perform part of the engagement.
- Rotating senior assurance team personnel.



200.14 Depending on the nature of the engagement, a professional accountant in public practice may also be able to rely on safeguards that the client has implemented. However it is not possible to rely solely on such safeguards to reduce threats to an acceptable level.

200.15 Safeguards within the client's systems and procedures may include:

- When a client appoints a firm in public practice to perform an engagement, persons other than management ratify or approve the appointment.
- The client has competent employees with experience and seniority to make managerial decisions.
- The client has implemented internal procedures that ensure objective choices in commissioning non-assurance engagements.

- The client has a corporate governance structure that provides appropriate oversight and communications regarding the firm's services.

SECTION 210

Professional Appointment

Client Acceptance

210.1 Before accepting a new client relationship, a professional accountant in public practice should consider whether acceptance would create any threats to compliance with the fundamental principles. Potential threats to integrity or professional behavior may be created from, for example, questionable issues associated with the client (its owners, management and activities).

210.2 Client issues that, if known, could threaten compliance with the fundamental principles include, for example, client involvement in illegal activities (such as money laundering), dishonesty or questionable financial reporting practices.

210.3 The significance of any threats should be evaluated. If identified threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level.

210.4 Appropriate safeguards may include obtaining knowledge and understanding of the client, its owners, managers and those responsible for its governance and business activities, or securing the client's commitment to improve corporate governance practices or internal controls.

210.5 Where it is not possible to reduce the threats to an acceptable level, a professional accountant in public practice should decline to enter into the client relationship.

210.6 Acceptance decisions should be periodically reviewed for recurring client engagements.

Engagement Acceptance

210.7 A professional accountant in public practice should agree to provide only those services that the professional accountant in public practice is competent to perform. Before accepting a specific client engagement, a professional accountant in public practice should consider whether acceptance would create any threats to compliance with the fundamental principles. For example, a self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly carry out the engagement.

210.8 A professional accountant in public practice should evaluate the significance of identified threats and, if they are other than clearly insignificant, safeguards should be applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include:

- Acquiring an appropriate understanding of the nature of the client's business, the complexity of its operations, the specific requirements of the engagement and the purpose, nature and scope of the work to be performed.
- Acquiring knowledge of relevant industries or subject matters.
- Possessing or obtaining experience with relevant regulatory or reporting requirements.
- Assigning sufficient staff with the necessary competencies.
- Using experts where necessary.
- Agreeing on a realistic time frame for the performance of the engagement.
- Complying with quality control policies and procedures designed to provide reasonable assurance that specific engagements are accepted only when they can be performed competently.

210.9 When a professional accountant in public practice intends to rely on the advice or work of an expert, the professional accountant in public practice should evaluate whether such reliance is warranted. The professional accountant in public practice should consider factors such as reputation, expertise, resources available and applicable professional and ethical standards. Such information may be gained from prior association with the expert or from consulting others.

Changes in a Professional Appointment

210.10 A professional accountant in public practice who is asked to replace another professional accountant in public practice, or who is considering tendering for an engagement currently held by another professional accountant in public practice, should determine whether there are any reasons, professional or other, for not accepting the engagement, such as circumstances that threaten compliance with the fundamental principles. For example, there may be a threat to professional competence and due care if a professional accountant in public practice accepts the engagement before knowing all the pertinent facts.

210.11 The significance of the threats should be evaluated. Depending on the nature of the engagement, this may require direct communication with the

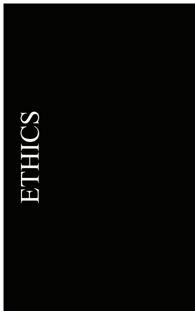
existing accountant* to establish the facts and circumstances behind the proposed change so that the professional accountant in public practice can decide whether it would be appropriate to accept the engagement. For example, the apparent reasons for the change in appointment may not fully reflect the facts and may indicate disagreements with the existing accountant that may influence the decision as to whether to accept the appointment.

210.12 An existing accountant is bound by confidentiality. The extent to which the professional accountant in public practice can and should discuss the affairs of a client with a proposed accountant will depend on the nature of the engagement and on:

(a) Whether the client's permission to do so has been obtained; or

(b) The legal or ethical requirements relating to such communications and disclosure, which may vary by jurisdiction.

210.13 In the absence of specific instructions by the client, an existing accountant should not ordinarily volunteer information about the client's affairs. Circumstances where it may be appropriate to disclose confidential information are set out in Section 140 of Part A of this Code.



210.14 If identified threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level.

210.15 Such safeguards may include:

- Discussing the client's affairs fully and freely with the existing accountant.
- Asking the existing accountant to provide known information on any facts or circumstances that, in the existing accountant's opinion, the proposed accountant should be aware of before deciding whether to accept the engagement.
- When replying to requests to submit tenders, stating in the tender that, before accepting the engagement, contact with the existing accountant will be requested so that inquiries may be made as to whether there are any professional or other reasons why the appointment should not be accepted.

210.16 A professional accountant in public practice will ordinarily need to obtain the client's permission, preferably in writing, to initiate discussion with an existing accountant. Once that permission is obtained, the existing accountant should comply with relevant legal and other regulations

* See Definitions.

governing such requests. Where the existing accountant provides information, it should be provided honestly and unambiguously. If the proposed accountant is unable to communicate with the existing accountant, the proposed accountant should try to obtain information about any possible threats by other means such as through inquiries of third parties or background investigations on senior management or those charged with governance of the client.

210.17 Where the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in public practice should, unless there is satisfaction as to necessary facts by other means, decline the engagement.

210.18 A professional accountant in public practice may be asked to undertake work that is complementary or additional to the work of the existing accountant. Such circumstances may give rise to potential threats to professional competence and due care resulting from, for example, a lack of or incomplete information. Safeguards against such threats include notifying the existing accountant of the proposed work, which would give the existing accountant the opportunity to provide any relevant information needed for the proper conduct of the work.

SECTION 220

Conflicts of Interest

220.1 A professional accountant in public practice should take reasonable steps to identify circumstances that could pose a conflict of interest. Such circumstances may give rise to threats to compliance with the fundamental principles. For example, a threat to objectivity may be created when a professional accountant in public practice competes directly with a client or has a joint venture or similar arrangement with a major competitor of a client. A threat to objectivity or confidentiality may also be created when a professional accountant in public practice performs services for clients whose interests are in conflict or the clients are in dispute with each other in relation to the matter or transaction in question.

220.2 A professional accountant in public practice should evaluate the significance of any threats. Evaluation includes considering, before accepting or continuing a client relationship or specific engagement, whether the professional accountant in public practice has any business interests, or relationships with the client or a third party that could give rise to threats. If threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level.

220.3 Depending upon the circumstances giving rise to the conflict, safeguards should ordinarily include the professional accountant in public practice:

(a) Notifying the client of the firm's business interest or activities that may represent a conflict of interest, and obtaining their consent to act in such circumstances; or

(b) Notifying all known relevant parties that the professional accountant in public practice is acting for two or more parties in respect of a matter where their respective interests are in conflict, and obtaining their consent to so act; or

(c) Notifying the client that the professional accountant in public practice does not act exclusively for any one client in the provision of proposed services (for example, in a particular market sector or with respect to a specific service) and obtaining their consent to so act.

220.4 The following additional safeguards should also be considered:

(a) The use of separate engagement teams; and

(b) Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing); and

(c) Clear guidelines for members of the engagement team on issues of security and confidentiality; and

(d) The use of confidentiality agreements signed by employees and partners of the firm; and

(e) Regular review of the application of safeguards by a senior individual not involved with relevant client engagements.

220.5 Where a conflict of interest poses a threat to one or more of the fundamental principles, including objectivity, confidentiality or professional behavior, that cannot be eliminated or reduced to an acceptable level through the application of safeguards, the professional accountant in public practice should conclude that it is not appropriate to accept a specific engagement or that resignation from one or more conflicting engagements is required.

220.6 Where a professional accountant in public practice has requested consent from a client to act for another party (which may or may not be an existing client) in respect of a matter where the respective interests are in conflict and that consent has been refused by the client, then the professional accountant in public practice must not continue to act for one of the parties in the matter giving rise to the conflict of interest.

SECTION 230

Second Opinions

230.1 Situations where a professional accountant in public practice is asked to provide a second opinion on the application of accounting, auditing, reporting or other standards or principles to specific circumstances or transactions by or on behalf of a company or an entity that is not an existing client may give rise to threats to compliance with the fundamental principles. For example, there may be a threat to professional competence and due care in circumstances where the second opinion is not based on the same set of facts that were made available to the existing accountant, or is based on inadequate evidence. The significance of the threat will depend on the circumstances of the request and all the other available facts and assumptions relevant to the expression of a professional judgment.

230.2 When asked to provide such an opinion, a professional accountant in public practice should evaluate the significance of the threats and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include seeking client permission to contact the existing accountant, describing the limitations surrounding any opinion in communications with the client and providing the existing accountant with a copy of the opinion.

230.3 If the company or entity seeking the opinion will not permit communication with the existing accountant, a professional accountant in public practice should consider whether, taking all the circumstances into account, it is appropriate to provide the opinion sought.

SECTION 240

Fees and Other Types of Remuneration

240.1 When entering into negotiations regarding professional services, a professional accountant in public practice may quote whatever fee deemed to be appropriate. The fact that one professional accountant in public practice may quote a fee lower than another is not in itself unethical. Nevertheless, there may be threats to compliance with the fundamental principles arising from the level of fees quoted. For example, a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.

240.2 The significance of such threats will depend on factors such as the level of fee quoted and the services to which it applies. In view of these potential threats, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Safeguards which may be adopted include:

- Making the client aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee.
- Assigning appropriate time and qualified staff to the task.

240.3 Contingent fees are widely used for certain types of non-assurance engagements.[1] They may, however, give rise to threats to compliance with the fundamental principles in certain circumstances. They may give rise to a self-interest threat to objectivity. The significance of such threats will depend on factors including:

- The nature of the engagement.
- The range of possible fee amounts.
- The basis for determining the fee.
- Whether the outcome or result of the transaction is to be reviewed by an independent third party.

240.4 The significance of such threats should be evaluated and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate or reduce them to an acceptable level. Such safeguards may include:

[1] Contingent fees for non-assurance services provided to assurance clients are discussed in Section 290 of this part of the Code.

- An advance written agreement with the client as to the basis of remuneration.
- Disclosure to intended users of the work performed by the professional accountant in public practice and the basis of remuneration.
- Quality control policies and procedures.
- Review by an objective third party of the work performed by the professional accountant in public practice.

240.5 In certain circumstances, a professional accountant in public practice may receive a referral fee or commission relating to a client. For example, where the professional accountant in public practice does not provide the specific service required, a fee may be received for referring a continuing client to another professional accountant in public practice or other expert. A professional accountant in public practice may receive a commission from a third party (e.g., a software vendor) in connection with the sale of goods or services to a client. Accepting such a referral fee or commission may give rise to self-interest threats to objectivity and professional competence and due care.

240.6 A professional accountant in public practice may also pay a referral fee to obtain a client, for example, where the client continues as a client of another professional accountant in public practice but requires specialist services not offered by the existing accountant. The payment of such a referral fee may also create a self-interest threat to objectivity and professional competence and due care.

240.7 A professional accountant in public practice should not pay or receive a referral fee or commission, unless the professional accountant in public practice has established safeguards to eliminate the threats or reduce them to an acceptable level. Such safeguards may include:

- Disclosing to the client any arrangements to pay a referral fee to another professional accountant for the work referred.
- Disclosing to the client any arrangements to receive a referral fee for referring the client to another professional accountant in public practice.
- Obtaining advance agreement from the client for commission arrangements in connection with the sale by a third party of goods or services to the client.

240.8 A professional accountant in public practice may purchase all or part of another firm on the basis that payments will be made to individuals formerly owning the firm or to their heirs or estates. Such payments are

not regarded as commissions or referral fees for the purpose of paragraph 240.5–240.7 above.

SECTION 250

Marketing Professional Services

250.1 When a professional accountant in public practice solicits new work through **advertising*** or other forms of marketing, there may be potential threats to compliance with the fundamental principles. For example, a self-interest threat to compliance with the principle of professional behavior is created if services, achievements or products are marketed in a way that is inconsistent with that principle.

250.2 A professional accountant in public practice should not bring the profession into disrepute when marketing professional services. The professional accountant in public practice should be honest and truthful and should not:

- Make exaggerated claims for services offered, qualifications possessed or experience gained; or
- Make disparaging references to unsubstantiated comparisons to the work of another.

If the professional accountant in public practice is in doubt whether a proposed form of advertising or marketing is appropriate, the professional accountant in public practice should consult with the relevant professional body.

* See Definitions.

SECTION 260

Gifts and Hospitality

260.1 A professional accountant in public practice, or an immediate or close family member, may be offered gifts and hospitality from a client. Such an offer ordinarily gives rise to threats to compliance with the fundamental principles. For example, self-interest threats to objectivity may be created if a gift from a client is accepted; intimidation threats to objectivity may result from the possibility of such offers being made public.

260.2 The significance of such threats will depend on the nature, value and intent behind the offer. Where gifts or hospitality which a reasonable and informed third party, having knowledge of all relevant information, would consider clearly insignificant are made a professional accountant in public practice may conclude that the offer is made in the normal course of business without the specific intent to influence decision making or to obtain information. In such cases, the professional accountant in public practice may generally conclude that there is no significant threat to compliance with the fundamental principles.

260.3 If evaluated threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. When the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in public practice should not accept such an offer.

SECTION 270

Custody of Client Assets

270.1 A professional accountant in public practice should not assume custody of client monies or other assets unless permitted to do so by law and, if so, in compliance with any additional legal duties imposed on a professional accountant in public practice holding such assets.

270.2 The holding of client assets creates threats to compliance with the fundamental principles; for example, there is a self-interest threat to professional behavior and may be a self interest threat to objectivity arising from holding client assets. To safeguard against such threats, a professional accountant in public practice entrusted with money (or other assets) belonging to others should:

(a) Keep such assets separately from personal or firm assets; and

(b) Use such assets only for the purpose for which they are intended; and

(c) At all times, be ready to account for those assets, and any income, dividends or gains generated, to any persons entitled to such accounting; and

(d) Comply with all relevant laws and regulations relevant to the holding of and accounting for such assets.

270.3 In addition, professional accountants in public practice should be aware of threats to compliance with the fundamental principles through association with such assets, for example, if the assets were found to derive from illegal activities, such as money laundering. As part of client and engagement acceptance procedures for such services, professional accountants in public practice should make appropriate inquiries about the source of such assets and should consider their legal and regulatory obligations. They may also consider seeking legal advice.

SECTION 280

Objectivity—All Services

280.1 A professional accountant in public practice should consider when providing any professional service whether there are threats to compliance with the fundamental principle of objectivity resulting from having interests in, or relationships with, a client or directors, officers or employees. For example, a familiarity threat to objectivity may be created from a family or close personal or business relationship.

280.2 A professional accountant in public practice who provides an assurance service is required to be independent of the assurance client. Independence of mind and in appearance is necessary to enable the professional accountant in public practice to express a conclusion, and be seen to express a conclusion, without bias, conflict of interest or undue influence of others. Section 290 provides specific guidance on independence requirements for professional accountants in public practice when performing an assurance engagement.

280.3 The existence of threats to objectivity when providing any professional service will depend upon the particular circumstances of the engagement and the nature of the work that the professional accountant in public practice is performing.

280.4 A professional accountant in public practice should evaluate the significance of identified threats and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include:

- Withdrawing from the engagement team.
- Supervisory procedures.
- Terminating the financial or business relationship giving rise to the threat.
- Discussing the issue with higher levels of management within the firm.
- Discussing the issue with those charged with governance of the client.

SECTION 290

Independence—Assurance Engagements

290.1 In the case of an assurance engagement it is in the public interest and, therefore, required by this Code of Ethics, that members of **assurance teams**,* firms and, when applicable, **network firms*** be independent of assurance clients.

290.2 Assurance engagements are designed to enhance intended users' degree of confidence about the outcome of the evaluation or measurement of a subject matter against criteria. The International Framework for Assurance Engagements (the Assurance Framework) issued by the International Auditing and Assurance Standards Board describes the elements and objectives of an assurance engagement, and identifies engagements to which International Standards on Auditing (ISAs), International Standards on Review Engagements (ISREs) and International Standards on Assurance Engagements (ISAEs) apply. For a description of the elements and objectives of an assurance engagement reference should be made to the Assurance Framework.

290.3 As further explained in the Assurance Framework, in an assurance engagement the professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

290.4 The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. The term "subject matter information" is used to mean the outcome of the evaluation or measurement of subject matter. For example:

- The recognition, measurement, presentation and disclosure represented in the **financial statements*** (subject matter information) result from applying a financial reporting framework for recognition, measurement, presentation and disclosure, such as International Financial Reporting Standards, (criteria) to an entity's financial position, financial performance and cash flows (subject matter).
- An assertion about the effectiveness of internal control (subject matter information) results from applying a framework for evaluating the effectiveness of internal control, such as COSO or CoCo, (criteria) to internal control, a process (subject matter).

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* See Definitions.

290.5 Assurance engagements may be assertion-based or direct reporting. In either case they involve three separate parties: a public accountant in public practice, a responsible party and intended users.

290.6 In an assertion-based assurance engagement, which includes a **financial statement audit engagement**,* the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.

290.7 In a direct reporting assurance engagement the professional accountant in public practice either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report.

290.8 Independence requires:

Independence of Mind

The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

Independence in Appearance

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

290.9 The use of the word "independence" on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

290.10 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating

* See Definitions.

action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules which may be arbitrary, is, therefore, in the public interest.

A Conceptual Approach to Independence

290.11 Members of assurance teams, firms and network firms are required to apply the conceptual framework contained in Section 100 to the particular circumstances under consideration. In addition to identifying relationships between the firm, network firms, members of the assurance team and the assurance client, consideration should be given to whether relationships between individuals outside of the assurance team and the assurance client create threats to independence.

290.12 The examples presented in this section are intended to illustrate the application of the conceptual framework and are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances that may create threats to independence. Consequently, it is not sufficient for a member of an assurance team, a firm or a network firm merely to comply with the examples presented, rather they should apply the framework to the particular circumstances they face.

290.13 The nature of the threats to independence and the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level differ depending on the characteristics of the individual assurance engagement: whether it is a financial statement audit engagement or another type of assurance engagement; and in the latter case, the purpose, subject matter information and intended users of the report. A firm should, therefore, evaluate the relevant circumstances, the nature of the assurance engagement and the threats to independence in deciding whether it is appropriate to accept or continue an engagement, as well as the nature of the safeguards required and whether a particular individual should be a member of the assurance team.

Networks and Network Firms[2]

290.14 An entity that belongs to a network might be a firm, which is defined in this Code as a sole practitioner, partnership or corporation of professional accountants and an entity that controls or is controlled by such parties, or the entity might be another type of entity, such as a consulting practice or

2 Paragraphs 290.14-290.26, which were issued in July 2006, apply to assurance engagements when the assurance report is dated on or after December 31, 2008.

a professional law practice. The independence requirements in this section that apply to a network firm apply to any entity that meets the definition of a network firm irrespective of whether the entity itself meets the definition of a firm.

290.15 If a firm is considered to be a network firm, the firm is required to be independent of the financial statement audit clients of the other firms within the network. In addition, for assurance clients that are not financial statement audit clients, consideration should be given to any threats the firm has reason to believe may be created by financial interests in the client held by other entities in the network or by relationships between the client and other entities in the network.

290.16 To enhance their ability to provide professional services, firms frequently form larger structures with other firms and entities. Whether these larger structures create a network depends upon the particular facts and circumstances and does not depend on whether the firms and entities are legally separate and distinct. For example, a larger structure may be aimed only at facilitating the referral of work, which in itself does not meet the criteria necessary to constitute a network. Alternatively, a larger structure might be such that it is aimed at co-operation and the firms share a common brand name, a common system of quality control, or significant professional resources and consequently is considered to be a network.

290.17 The judgment as to whether the larger structure is a network should be made in light of whether a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that the entities are associated in such a way that a network exists. This judgment should be applied consistently throughout the network.

290.18 Where the larger structure is aimed at co-operation and it is clearly aimed at profit or cost sharing among the entities within the structure, it is considered to be a network. However, the sharing of immaterial costs would not in itself create a network. In addition, if the sharing of costs is limited only to those costs related to the development of audit methodologies, manuals, or training courses, this would not in itself create a network. Further, an association between a firm and an otherwise unrelated entity to jointly provide a service or develop a product would not in itself create a network.

290.19 Where the larger structure is aimed at cooperation and the entities within the structure share common ownership, control or management, it is considered to be a network. This could be achieved by contract or other means.

290.20 Where the larger structure is aimed at co-operation and the entities within the structure share common quality control policies and procedures, it is considered to be a network. For this purpose common quality control

policies and procedures would be those designed, implemented and monitored across the larger structure.

290.21 Where the larger structure is aimed at co-operation and the entities within the structure share a common business strategy, it is considered to be a network. Sharing a common business strategy involves an agreement by the entities to achieve common strategic objectives. An entity is not considered to be a network firm merely because it co-operates with another entity solely to respond jointly to a request for a proposal for the provision of a professional service.

290.22 Where the larger structure is aimed at co-operation and the entities within the structure share the use of a common brand name, it is considered to be a network. A common brand name includes common initials or a common name. A firm is considered to be using a common brand name if it includes, for example, the common brand name as part of, or along with, its firm name, when a partner of the firm signs an assurance report.

290.23 Even though a firm does not belong to a network and does not use a common brand name as part of its firm name, it may give the appearance that it belongs to a network if it makes reference in its stationery or promotional materials to being a member of an association of firms. Accordingly, a firm should carefully consider how it describes any such memberships in order to avoid the perception that it belongs to a network.

290.24 If a firm sells a component of its practice, the sales agreement sometimes provides that, for a limited period of time, the component may continue to use the name of the firm, or an element of the name, even though it is no longer connected to the firm. In such circumstances, while the two entities may be practicing under a common name, the facts are such that they do not belong to a larger structure aimed at co-operation and are, therefore, not network firms. Those entities should carefully consider how to disclose that they are not network firms when presenting themselves to outside parties.

290.25 Where the larger structure is aimed at co-operation and the entities within the structure share a significant part of professional resources, it is considered to be a network. Professional resources include:

- Common systems that enable firms to exchange information such as client data, billing, and time records;
- Partners and staff;
- Technical departments to consult on technical or industry specific issues, transactions or events for assurance engagements;
- Audit methodology or audit manuals; and
- Training courses and facilities.

290.26 The determination of whether the professional resources shared are significant, and therefore the firms are network firms, should be made based on the relevant facts and circumstances. Where the shared resources are limited to common audit methodology or audit manuals, with no exchange of personnel or client or market information, it is unlikely that the shared resources would be considered to be significant. The same applies to a common training endeavor. Where, however, the shared resources involve the exchange of people or information, such as where staff are drawn from a shared pool, or a common technical department is created within the larger structure to provide participating firms with technical advice that the firms are required to follow, a reasonable and informed third party is more likely to conclude that the shared resources are significant.

Assertion-Based Assurance Engagements

Financial Statement Audit Engagements

290.27 Financial statement audit engagements are relevant to a wide range of potential users; consequently, in addition to independence of mind, independence in appearance is of particular significance. Accordingly, for financial statement audit clients, the members of the assurance team, the firm and network firms are required to be independent of the financial statement audit client. Such independence requirements include prohibitions regarding certain relationships between members of the assurance team and directors, officers and employees of the client in a position to exert direct and significant influence over the subject matter information (the financial statements). Also, consideration should be given to whether threats to independence are created by relationships with employees of the client in a position to exert direct and significant influence over the subject matter (the financial position, financial performance and cash flows).

Other Assertion-Based Assurance Engagements

290.28 In an assertion-based assurance engagement where the client is not a financial statement audit client, the members of the assurance team and the firm are required to be independent of the assurance client (the responsible party, which is responsible for the subject matter information and may be responsible for the subject matter). Such independence requirements include prohibitions regarding certain relationships between members of the assurance team and directors, officers and employees of the client in a position to exert direct and significant influence over the subject matter information. Also, consideration should be given to whether threats to independence are created by relationships with employees of the client in a position to exert direct and significant influence over the subject matter of the engagement. Consideration

should also be given to any threats that the firm has reason to believe may be created by network firm interests and relationships.

290.29 In the majority of assertion-based assurance engagements, that are not financial statement audit engagements, the responsible party is responsible for the subject matter information and the subject matter. However, in some engagements the responsible party may not be responsible for the subject matter. For example, when a professional accountant in public practice is engaged to perform an assurance engagement regarding a report that an environmental consultant has prepared about a company's sustainability practices, for distribution to intended users, the environmental consultant is the responsible party for the subject matter information but the company is responsible for the subject matter (the sustainability practices).

290.30 In those assertion-based assurance engagements that are not financial statement audit engagements, where the responsible party is responsible for the subject matter information but not the subject matter the members of the assurance team and the firm are required to be independent of the party responsible for the subject matter information (the assurance client). In addition, consideration should be given to any threats the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter.

Direct Reporting Assurance Engagements

290.31 In a direct reporting assurance engagement the members of the assurance team and the firm are required to be independent of the assurance client (the party responsible for the subject matter).

Restricted Use Reports

290.32 In the case of an assurance report in respect of a non-financial statement audit client expressly restricted for use by identified users, the users of the report are considered to be knowledgeable as to the purpose, subject matter information and limitations of the report through their participation in establishing the nature and scope of the firm's instructions to deliver the services, including the criteria against which the subject matter are to be evaluated or measured. This knowledge and the enhanced ability of the firm to communicate about safeguards with all users of the report increase the effectiveness of safeguards to independence in appearance. These circumstances may be taken into account by the firm in evaluating the threats to independence and considering the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level. At a minimum, it will be necessary to apply the provisions of this section in evaluating the independence of members of

the assurance team and their immediate and close family. Further, if the firm had a material financial interest, whether direct or indirect, in the assurance client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Limited consideration of any threats created by network firm interests and relationships may be sufficient.

Multiple Responsible Parties

290.33 In some assurance engagements, whether assertion-based or direct reporting, that are not financial statement audit engagements, there might be several responsible parties. In such engagements, in determining whether it is necessary to apply the provisions in this section to each responsible party, the firm may take into account whether an interest or relationship between the firm, or a member of the assurance team, and a particular responsible party would create a threat to independence that is other than clearly insignificant in the context of the subject matter information. This will take into account factors such as:

- The materiality of the subject matter information (or the subject matter) for which the particular responsible party is responsible; and
- The degree of public interest associated with the engagement.

If the firm determines that the threat to independence created by any such interest or relationship with a particular responsible party would be clearly insignificant it may not be necessary to apply all of the provisions of this section to that responsible party.

Other Considerations

290.34 The threats and safeguards identified in this section are generally discussed in the context of interests or relationships between the firm, network firms, members of the assurance team and the assurance client. In the case of a financial statement audit client that is a listed entity, the firm and any network firms are required to consider the interests and relationships that involve that client's related entities. Ideally those entities and the interests and relationships should be identified in advance. For all other assurance clients, when the assurance team has reason to believe that a **related entity*** of such an assurance client is relevant to the evaluation of the firm's independence of the client, the assurance team should consider that related entity when evaluating independence and applying appropriate safeguards.

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* See Definitions.

290.35 The evaluation of threats to independence and subsequent action should be supported by evidence obtained before accepting the engagement and while it is being performed. The obligation to make such an evaluation and take action arises when a firm, a network firm or a member of the assurance team knows, or could reasonably be expected to know, of circumstances or relationships that might compromise independence. There may be occasions when the firm, a network firm or an individual inadvertently violates this section. If such an inadvertent violation occurs, it would generally not compromise independence with respect to an assurance client provided the firm has appropriate quality control policies and procedures in place to promote independence and, once discovered, the violation is corrected promptly and any necessary safeguards are applied.

290.36 Throughout this section, reference is made to significant and clearly insignificant threats in the evaluation of independence. In considering the significance of any particular matter, qualitative as well as quantitative factors should be taken into account. A matter should be considered clearly insignificant only if it is deemed to be both trivial and inconsequential.

Objective and Structure of this Section

290.37 The objective of this section is to assist firms and members of assurance teams in:

(a) Identifying threats to independence;

(b) Evaluating whether these threats are clearly insignificant; and

(c) In cases when the threats are not clearly insignificant, identifying and applying appropriate safeguards to eliminate or reduce the threats to an acceptable level.

Consideration should always be given to what a reasonable and informed third party having knowledge of all relevant information, including safeguards applied, would reasonably conclude to be unacceptable. In situations when no safeguards are available to reduce the threat to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement.

290.38 This section concludes with some examples of how this conceptual approach to independence is to be applied to specific circumstances and relationships. The examples discuss threats to independence that may be created by specific circumstances and relationships (paragraphs 290.100 onwards). Professional judgment is used to determine the appropriate safeguards to eliminate threats to independence or to reduce them to an

acceptable level. In certain examples, the threats to independence are so significant the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement. In other examples, the threat can be eliminated or reduced to an acceptable level by the application of safeguards. The examples are not intended to be all-inclusive.

290.39 Certain examples in this section indicate how the framework is to be applied to a financial statements audit engagement for a listed entity. When a member body chooses not to differentiate between listed entities and other entities, the examples that relate to financial statement audit engagements for listed entities should be considered to apply to all financial statement audit engagements.

290.40 When threats to independence that are not clearly insignificant are identified, and the firm decides to accept or continue the assurance engagement, the decision should be documented. The documentation should include a description of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level.

290.41 The evaluation of the significance of any threats to independence and the safeguards necessary to reduce any threats to an acceptable level, takes into account the public interest. Certain entities may be of significant public interest because, as a result of their business, their size or their corporate status they have a wide range of stakeholders. Examples of such entities may include listed companies, credit institutions, insurance companies, and pension funds. Because of the strong public interest in the financial statements of listed entities, certain paragraphs in this section deal with additional matters that are relevant to the financial statement audit of listed entities. Consideration should be given to the application of the framework in relation to the financial statement audit of listed entities to other financial statement audit clients that may be of significant public interest.

290.42 Audit committees can have an important corporate governance role when they are independent of client management and can assist the Board of Directors in satisfying themselves that a firm is independent in carrying out its audit role. There should be regular communications between the firm and the audit committee (or other governance body if there is no audit committee) of listed entities regarding relationships and other matters that might, in the firm's opinion, reasonably be thought to bear on independence.

290.43 Firms should establish policies and procedures relating to independence communications with audit committees, or others charged with governance of the client. In the case of the financial statement audit of listed entities, the firm should communicate orally and in writing at least

annually, all relationships and other matters between the firm, network firms and the financial statement audit client that in the firm's professional judgment may reasonably be thought to bear on independence. Matters to be communicated will vary in each circumstance and should be decided by the firm, but should generally address the relevant matters set out in this section.

Engagement Period

290.44 The members of the assurance team and the firm should be independent of the assurance client during the period of the assurance engagement. The period of the engagement starts when the assurance team begins to perform assurance services and ends when the assurance report is issued, except when the assurance engagement is of a recurring nature. If the assurance engagement is expected to recur, the period of the assurance engagement ends with the notification by either party that the professional relationship has terminated or the issuance of the final assurance report, whichever is later.

290.45 In the case of a financial statement audit engagement, the engagement period includes the period covered by the financial statements reported on by the firm. When an entity becomes a financial statement audit client during or after the period covered by the financial statements that the firm will report on, the firm should consider whether any threats to independence may be created by:

- Financial or business relationships with the audit client during or after the period covered by the financial statements, but prior to the acceptance of the financial statement audit engagement; or
- Previous services provided to the audit client.

Similarly, in the case of an assurance engagement that is not a financial statement audit engagement, the firm should consider whether any financial or business relationships or previous services may create threats to independence.

290.46 If a non-assurance service was provided to the financial statement audit client during or after the period covered by the financial statements but before the commencement of professional services in connection with the financial statement audit and the service would be prohibited during the period of the audit engagement, consideration should be given to the threats to independence, if any, arising from the service. If the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards may include:

- Discussing independence issues related to the provision of the non-assurance service with those charged with governance of the client, such as the audit committee;
- Obtaining the client's acknowledgement of responsibility for the results of the non-assurance service;
- Precluding personnel who provided the non-assurance service from participating in the financial statement audit engagement; and
- Engaging another firm to review the results of the non-assurance service or having another firm re-perform the non-assurance service to the extent necessary to enable it to take responsibility for the service.

290.47 A non-assurance service provided to a non-listed financial statement audit client will not impair the firm's independence when the client becomes a listed entity provided:

(a) The previous non-assurance service was permissible under this section for non-listed financial statement audit clients;

(b) The service will be terminated within a reasonable period of time of the client becoming a listed entity, if they are impermissible under this section for financial statement audit clients that are listed entities; and

(c) The firm has implemented appropriate safeguards to eliminate any threats to independence arising from the previous service or reduce them to an acceptable level.

Application of Framework to Specific Situations

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Introduction

290.100 The following examples describe specific circumstances and relationships that may create threats to independence. The examples describe the potential threats created and the safeguards that may be appropriate to eliminate the threats or reduce them to an acceptable level in each circumstance. The examples are not all inclusive. In practice, the firm, network firms and the members of the assurance team will be required to assess the implications of similar, but different, circumstances and relationships and to determine whether safeguards, including the safeguards in paragraphs 200.12-200.15 can be applied to satisfactorily address the threats to independence.

290.101 Some of the examples deal with financial statement audit clients while others deal with assurance engagements for clients that are not financial statement audit clients. The examples illustrate how safeguards should be applied to fulfill the requirement for the members of the assurance team, the firm and network firms to be independent of a financial statement audit client, and for the members of the assurance team and the firm to be independent of an assurance client that is not a financial statement audit client. The examples do not include assurance reports to a non-financial statement audit client expressly restricted for use by identified users. As stated in paragraph 290.32 for such engagements, members of the assurance team and their immediate and close family are required to be independent of the assurance client. Further, the firm should not have a material financial interest, direct or indirect, in the assurance client.

290.102 The examples illustrate how the framework applies to financial statement audit clients and other assurance clients. The examples should be read in conjunction with paragraph 290.33 which explain that, in the majority of assurance engagements, there is one responsible party and that responsible party comprises the assurance client. However, in some assurance engagements there are two responsible parties. In such circumstances, consideration should be given to any threats the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter.

290.103 Interpretation 2005-01 to this section provides further guidance on the application of the independence requirements contained in this section to assurance engagements that are not financial statement audit engagements.

Financial Interests

290.104 A financial interest in an assurance client may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards

to be applied to eliminate the threat or reduce it to an acceptable level, it is necessary to examine the nature of the financial interest. This includes an evaluation of the role of the person holding the financial interest, the materiality of the financial interest and the type of financial interest (direct or indirect).

290.105 When evaluating the type of financial interest, consideration should be given to the fact that financial interests range from those where the individual has no control over the investment vehicle or the financial interest held (e.g., a mutual fund, unit trust or similar intermediary vehicle) to those where the individual has control over the financial interest (e.g., as a trustee) or is able to influence investment decisions. In evaluating the significance of any threat to independence, it is important to consider the degree of control or influence that can be exercised over the intermediary, the financial interest held, or its investment strategy. When control exists, the financial interest should be considered direct. Conversely, when the holder of the financial interest has no ability to exercise such control the financial interest should be considered indirect.

Provisions Applicable to all Assurance Clients

290.106 If a member of the assurance team, or their immediate family member, has a **direct financial interest**,* or a material **indirect financial interest**,* in the assurance client, the self-interest threat created would be so significant the only safeguards available to eliminate the threat or reduce it to an acceptable level would be to:

(a) Dispose of the direct financial interest prior to the individual becoming a member of the assurance team;

(b) Dispose of the indirect financial interest in total or dispose of a sufficient amount of it so that the remaining interest is no longer material prior to the individual becoming a member of the assurance team; or

(c) Remove the member of the assurance team from the assurance engagement.

290.107 If a member of the assurance team, or their immediate family member receives, by way of, for example, an inheritance, gift or, as a result of a merger, a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat would be created. The following safeguards should be applied to eliminate the threat or reduce it to an acceptable level:

(a) Disposing of the financial interest at the earliest practical date; or

* See Definitions.

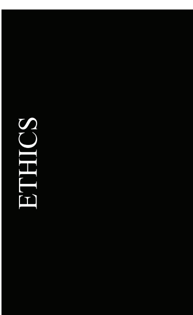
(b) Removing the member of the assurance team from the assurance engagement.

During the period prior to disposal of the financial interest or the removal of the individual from the assurance team, consideration should be given to whether additional safeguards are necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing the matter with those charged with governance, such as the audit committee; or
- Involving an additional professional accountant to review the work done, or otherwise advise as necessary.

290.108 When a member of the assurance team knows that his or her close family member has a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat may be created. In evaluating the significance of any threat, consideration should be given to the nature of the relationship between the member of the assurance team and the close family member and the materiality of the financial interest. Once the significance of the threat has been evaluated, safeguards should be considered and applied as necessary. Such safeguards might include:

- The close family member disposing of all or a sufficient portion of the financial interest at the earliest practical date;
- Discussing the matter with those charged with governance, such as the audit committee;
- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team with the close family relationship or otherwise advise as necessary; or
- Removing the individual from the assurance engagement.



290.109 When a firm or a member of the assurance team holds a direct financial interest or a material indirect financial interest in the assurance client as a trustee, a self-interest threat may be created by the possible influence of the trust over the assurance client. Accordingly, such an interest should only be held when:

(a) The member of the assurance team, an immediate family member of the member of the assurance team, and the firm are not beneficiaries of the trust;

(b) The interest held by the trust in the assurance client is not material to the trust;

(c) The trust is not able to exercise significant influence over the assurance client; and

(d) The member of the assurance team or the firm does not have significant influence over any investment decision involving a financial interest in the assurance client.

290.110 Consideration should be given to whether a self-interest threat may be created by the financial interests of individuals outside of the assurance team and their immediate and close family members. Such individuals would include:

- Partners, and their immediate family members, who are not members of the assurance team;
- Partners and managerial employees who provide non-assurance services to the assurance client; and
- Individuals who have a close personal relationship with a member of the assurance team.

Whether the interests held by such individuals may create a self-interest threat will depend upon factors such as:

- The firm's organizational, operating and reporting structure; and
- The nature of the relationship between the individual and the member of the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Where appropriate, policies to restrict people from holding such interests;
- Discussing the matter with those charged with governance, such as the audit committee; or
- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done or otherwise advise as necessary.

290.111 An inadvertent violation of this section as it relates to a financial interest in an assurance client would not impair the independence of the firm, the network firm or a member of the assurance team when:

(a) The firm, and the network firm, have established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the assurance client;

(b) The firm, and the network firm, promptly notify the professional that the financial interest should be disposed of; and

(c) The disposal occurs at the earliest practical date after identification of the issue, or the professional is removed from the assurance team.

290.112 When an inadvertent violation of this section relating to a financial interest in an assurance client has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- Excluding the individual from any substantive decision-making concerning the assurance engagement.

Provisions Applicable to Financial Statement Audit Clients

290.113 If a firm, or a network firm, has a direct financial interest in a financial statement audit client of the firm the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.

290.114 If a firm, or a network firm, has a material indirect financial interest in a financial statement audit client of the firm a self-interest threat is also created. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.115 If a firm, or a network firm, has a material financial interest in an entity that has a controlling interest in a financial statement audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.116 If the retirement benefit plan of a firm, or network firm, has a financial interest in a financial statement audit client a self-interest threat may be created. Accordingly, the significance of any such threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

290.117 If other partners, including partners who do not perform assurance engagements, or their immediate family, in the **office*** in which the

engagement partner* practices in connection with the financial statement audit hold a direct financial interest or a material indirect financial interest in that audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such partners or their immediate family should not hold any such financial interests in such an audit client.

290.118 The office in which the engagement partner practices in connection with the financial statement audit is not necessarily the office to which that partner is assigned. Accordingly, when the engagement partner is located in a different office from that of the other members of the assurance team, judgment should be used to determine in which office the partner practices in connection with that audit.

290.119 If other partners and managerial employees who provide non-assurance services to the financial statement audit client, except those whose involvement is clearly insignificant, or their immediate family, hold a direct financial interest or a material indirect financial interest in the audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such personnel or their immediate family should not hold any such financial interests in such an audit client.

290.120 A financial interest in a financial statement audit client that is held by an immediate family member of (a) a partner located in the office in which the engagement partner practices in connection with the audit, or (b) a partner or managerial employee who provides non-assurance services to the audit client is not considered to create an unacceptable threat provided it is received as a result of their employment rights (e.g., pension rights or share options) and, where necessary, appropriate safeguards are applied to reduce any threat to independence to an acceptable level.

290.121 A self-interest threat may be created if the firm, or the network firm, or a member of the assurance team has an interest in an entity and a financial statement audit client, or a director, officer or controlling owner thereof also has an investment in that entity. Independence is not compromised with respect to the audit client if the respective interests of the firm, the network firm, or member of the assurance team, and the audit client, or director, officer or controlling owner thereof are both immaterial and the audit client cannot exercise significant influence over the entity. If an interest is material, to either the firm, the network firm or the audit client, and the audit client can exercise significant influence over the entity, no safeguards are available to reduce the threat to an acceptable level and the firm, or the network firm, should either dispose of the interest or decline

* See Definitions.

the audit engagement. Any member of the assurance team with such a material interest should either:

(a) Dispose of the interest;

(b) Dispose of a sufficient amount of the interest so that the remaining interest is no longer material; or

(c) Withdraw from the audit.

Provisions Applicable to Non-Financial Statement Audit Assurance Clients

290.122 If a firm has a direct financial interest in an assurance client that is not a financial statement audit client the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.

290.123 If a firm has a material indirect financial interest in an assurance client that is not a financial statement audit client a self-interest threat is also created. The only action appropriate to permit the firm to perform the engagement would be for the firm to either dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.124 If a firm has a material financial interest in an entity that has a controlling interest in an assurance client that is not a financial statement audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only action appropriate to permit the firm to perform the engagement would be for the firm either to dispose of the financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.125 When a restricted use report for an assurance engagement that is not a financial statement audit engagement is issued, exceptions to the provisions in paragraphs 290.106-290.110 and 290.122-290.124 are set out in 290.32.

Loans and Guarantees

290.126 A loan, or a guarantee of a loan, to the firm from an assurance client that is a bank or a similar institution, would not create a threat to independence provided the loan, or guarantee, is made under normal lending procedures, terms and requirements and the loan is immaterial to both the firm and the assurance client. If the loan is material to the assurance client or the firm it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable level. Such safeguards might include involving an additional professional

accountant from outside the firm, or network firm, to review the work performed.

290.127 A loan, or a guarantee of a loan, from an assurance client that is a bank or a similar institution, to a member of the assurance team or their immediate family would not create a threat to independence provided the loan, or guarantee, is made under normal lending procedures, terms and requirements. Examples of such loans include home mortgages, bank overdrafts, car loans and credit card balances.

290.128 Similarly, deposits made by, or brokerage accounts of, a firm or a member of the assurance team with an assurance client that is a bank, broker or similar institution would not create a threat to independence provided the deposit or account is held under normal commercial terms.

290.129 If the firm, or a member of the assurance team, makes a loan to an assurance client, that is not a bank or similar institution, or guarantees such an assurance client's borrowing, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

290.130 Similarly, if the firm or a member of the assurance team accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

290.131 The examples in paragraphs 290.126–290.130 relate to loans and guarantees between the firm and an assurance client. In the case of a financial statement audit engagement, the provisions should be applied to the firm, all network firms and the audit client.

Close Business Relationships with Assurance Clients

290.132 A close business relationship between a firm or a member of the assurance team and the assurance client or its management, or between the firm, a network firm and a financial statement audit client, will involve a commercial or common financial interest and may create self-interest and intimidation threats. The following are examples of such relationships:

- Having a material financial interest in a joint venture with the assurance client or a controlling owner, director, officer or other individual who performs senior managerial functions for that client.

- Arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties.
- Distribution or marketing arrangements under which the firm acts as a distributor or marketer of the assurance client's products or services, or the assurance client acts as the distributor or marketer of the products or services of the firm.

In the case of a financial statement audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm, the network firm and the audit client, no safeguards could reduce the threat to an acceptable level. In the case of an assurance client that is not a financial statement audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm and the assurance client, no safeguards could reduce the threat to an acceptable level. Consequently, in both these circumstances the only possible courses of action are to:

(a) Terminate the business relationship;

(b) Reduce the magnitude of the relationship so that the financial interest is immaterial and the relationship is clearly insignificant; or

(c) Refuse to perform the assurance engagement.

Unless any such financial interest is immaterial and the relationship is clearly insignificant to the member of the assurance team, the only appropriate safeguard would be to remove the individual from the assurance team.

290.133 In the case of a financial statement audit client, business relationships involving an interest held by the firm, a network firm or a member of the assurance team or their immediate family in a closely held entity when the audit client or a director or officer of the audit client, or any group thereof, also has an interest in that entity, do not create threats to independence provided:

(a) The relationship is clearly insignificant to the firm, the network firm and the audit client;

(b) The interest held is immaterial to the investor, or group of investors; and

(c) The interest does not give the investor, or group of investors, the ability to control the closely held entity.

290.134 The purchase of goods and services from an assurance client by the firm (or from a financial statement audit client by a network firm) or a

member of the assurance team would not generally create a threat to independence providing the transaction is in the normal course of business and on an arm's length basis. However, such transactions may be of a nature or magnitude so as to create a self-interest threat. If the threat created is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Eliminating or reducing the magnitude of the transaction;
- Removing the individual from the assurance team; or
- Discussing the issue with those charged with governance, such as the audit committee.

Family and Personal Relationships

290.135 Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, may create self-interest, familiarity or intimidation threats. It is impracticable to attempt to describe in detail the significance of the threats that such relationships may create. The significance will depend upon a number of factors including the individual's responsibilities on the assurance engagement, the closeness of the relationship and the role of the family member or other individual within the assurance client. Consequently, there is a wide spectrum of circumstances that will need to be evaluated and safeguards to be applied to reduce the threat to an acceptable level.

290.136 When an immediate family member of a member of the assurance team is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement, or was in such a position during any period covered by the engagement, the threats to independence can only be reduced to an acceptable level by removing the individual from the assurance team. The closeness of the relationship is such that no other safeguard could reduce the threat to independence to an acceptable level. If application of this safeguard is not used, the only course of action is to withdraw from the assurance engagement. For example, in the case of an audit of financial statements, if the spouse of a member of the assurance team is an employee in a position to exert direct and significant influence over the preparation of the audit client's accounting records or financial statements, the threat to independence could only be reduced to an acceptable level by removing the individual from the assurance team.

290.137 When an immediate family member of a member the assurance team is an employee in a position to exert direct and significant influence over the

subject matter of the engagement, threats to independence may be created. The significance of the threats will depend on factors such as:

- The position the immediate family member holds with the client; and
- The role of the professional on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Removing the individual from the assurance team;
- Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the immediate family member; or
- Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

290.138 When a close family member of a member of the assurance team is a director, an officer, or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement, threats to independence may be created. The significance of the threats will depend on factors such as:

- The position the close family member holds with the client; and
- The role of the professional on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Removing the individual from the assurance team;
- Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the close family member; or
- Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

290.139 In addition, self-interest, familiarity or intimidation threats may be created when a person who is other than an immediate or close family member of a member of the assurance team has a close relationship with the member of the assurance team and is a director, an officer or an

employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement. Therefore, members of the assurance team are responsible for identifying any such persons and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship and the role of the individual within the assurance client.

290.140 Consideration should be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between a partner or employee of the firm who is not a member of the assurance team and a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement. Therefore partners and employees of the firm are responsible for identifying any such relationships and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship, the interaction of the firm professional with the assurance team, the position held within the firm, and the role of the individual within the assurance client.

290.141 An inadvertent violation of this section as it relates to family and personal relationships would not impair the independence of a firm or a member of the assurance team when:

(a) The firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence;

(b) Either the responsibilities of the assurance team are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom he or she is related or has a personal relationship, or, if this is not possible, the firm promptly removes the professional from the assurance engagement; and

(c) Additional care is given to reviewing the work of the professional.

290.142 When an inadvertent violation of this section relating to family and personal relationships has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- Excluding the individual from any substantive decision-making concerning the assurance engagement.

Employment with Assurance Clients

290.143 A firm or a member of the assurance team's independence may be threatened if a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former firm. Similarly, a member of the assurance team's independence may be threatened when an individual participates in the assurance engagement knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future.

290.144 If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:

(a) The position the individual has taken at the assurance client.

(b) The amount of any involvement the individual will have with the assurance team.

(c) The length of time that has passed since the individual was a member of the assurance team or firm.

(d) The former position of the individual within the assurance team or firm.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Considering the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
- Assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client;

- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary; or
- Quality control review of the assurance engagement.

In all cases, all of the following safeguards are necessary to reduce the threat to an acceptable level:

(a) The individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be of such significance to threaten the firm's independence.

(b) The individual does not continue to participate or appear to participate in the firm's business or professional activities.

290.145 A self-interest threat is created when a member of the assurance team participates in the assurance engagement while knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future. This threat can be reduced to an acceptable level by the application of all of the following safeguards:

(a) Policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client.

(b) Removal of the individual from the assurance engagement.

In addition, consideration should be given to performing an independent review of any significant judgments made by that individual while on the engagement.

Recent Service with Assurance Clients

290.146 To have a former officer, director or employee of the assurance client serve as a member of the assurance team may create self-interest, self-review and familiarity threats. This would be particularly true when a member of the assurance team has to report on, for example, subject matter information he or she had prepared or elements of the financial statements he or she had valued while with the assurance client.

290.147 If, during the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter information of the assurance engagement, the threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, such individuals should not be assigned to the assurance team.

290.148 If, prior to the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter information of the assurance engagement, this may create self-interest, self-review and familiarity threats. For example, such threats would be created if a decision made or work performed by the individual in the prior period, while employed by the assurance client, is to be evaluated in the current period as part of the current assurance engagement. The significance of the threats will depend upon factors such as:

- The position the individual held with the assurance client;
- The length of time that has passed since the individual left the assurance client; and
- The role the individual plays on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Involving an additional professional accountant to review the work done by the individual as part of the assurance team or otherwise advise as necessary; or
- Discussing the issue with those charged with governance, such as the audit committee.

Serving as an Officer or Director on the Board of Assurance Clients

290.149 If a partner or employee of the firm serves as an officer or as a director on the board of an assurance client the self-review and self-interest threats created would be so significant no safeguard could reduce the threats to an acceptable level. In the case of a financial statement audit engagement, if a partner or employee of a network firm were to serve as an officer or as a director on the board of the audit client the threats created would be so significant no safeguard could reduce the threats to an acceptable level. Consequently, if such an individual were to accept such a position the only course of action is to refuse to perform, or to withdraw from the assurance engagement.

290.150 The position of Company Secretary has different implications in different jurisdictions. The duties may range from administrative duties such as personnel management and the maintenance of company records and registers, to duties as diverse as ensuring that the company complies with regulations or providing advice on corporate governance matters.

Generally this position is seen to imply a close degree of association with the entity and may create self-review and advocacy threats.

290.151 If a partner or employee of the firm or a network firm serves as Company Secretary for a financial statement audit client the self-review and advocacy threats created would generally be so significant, no safeguard could reduce the threat to an acceptable level. When the practice is specifically permitted under local law, professional rules or practice, the duties and functions undertaken should be limited to those of a routine and formal administrative nature such as the preparation of minutes and maintenance of statutory returns.

290.152 Routine administrative services to support a company secretarial function or advisory work in relation to company secretarial administration matters is generally not perceived to impair independence, provided client management makes all relevant decisions.

Long Association of Senior Personnel with Assurance Clients

General Provisions

290.153 Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will depend upon factors such as:

- The length of time that the individual has been a member of the assurance team;
- The role of the individual on the assurance team;
- The structure of the firm; and
- The nature of the assurance engagement.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- Rotating the senior personnel off the assurance team;
- Involving an additional professional accountant who was not a member of the assurance team to review the work done by the senior personnel or otherwise advise as necessary; or
- Independent internal quality reviews.

Financial Statement Audit Clients that are Listed Entities[3]

290.154 Using the same engagement partner or the same individual responsible for the **engagement quality control review*** on a financial statement audit over a prolonged period may create a familiarity threat. This threat is particularly relevant in the context of the financial statement audit of a listed entity and safeguards should be applied in such situations to reduce such threat to an acceptable level. Accordingly in respect of the financial statement audit of listed entities:

(a) The engagement partner and the individual responsible for the engagement quality control review should be rotated after serving in either capacity, or a combination thereof, for a pre-defined period, normally no more than seven years; and

(b) Such an individual rotating after a pre-defined period should not participate in the audit engagement until a further period of time, normally two years, has elapsed.

290.155 When a financial statement audit client becomes a listed entity the length of time the engagement partner or the individual responsible for the engagement quality control review has served the audit client in that capacity should be considered in determining when the individual should be rotated. However, the person may continue to serve as the engagement partner or as the individual responsible for the engagement quality control review for two additional years before rotating off the engagement.

290.156 While the engagement partner and the individual responsible for the engagement quality control review should be rotated after such a pre-defined period, some degree of flexibility over timing of rotation may be necessary in certain circumstances. Examples of such circumstances include:

- Situations when the person's continuity is especially important to the financial statement audit client, for example, when there will be major changes to the audit client's structure that would otherwise coincide with the rotation of the person's; and
- Situations when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard.

In all such circumstances when the person is not rotated after such a pre-defined period equivalent safeguards should be applied to reduce any threats to an acceptable level.

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3 See also Interpretation 2003-01 on page 98.

* See Definitions.

290.157 When a firm has only a few people with the necessary knowledge and experience to serve as engagement partner or individual responsible for the engagement quality control review on a financial statement audit client that is a listed entity, rotation may not be an appropriate safeguard. In these circumstances the firm should apply other safeguards to reduce the threat to an acceptable level. Such safeguards would include involving an additional professional accountant who was not otherwise associated with the assurance team to review the work done or otherwise advise as necessary. This individual could be someone from outside the firm or someone within the firm who was not otherwise associated with the assurance team.

Provision of Non-Assurance Services to Assurance Clients[4]

290.158 Firms have traditionally provided to their assurance clients a range of non-assurance services that are consistent with their skills and expertise. Assurance clients value the benefits that derive from having these firms, which have a good understanding of the business, bring their knowledge and skill to bear in other areas. Furthermore, the provision of such non-assurance services will often result in the assurance team obtaining information regarding the assurance client's business and operations that is helpful in relation to the assurance engagement. The greater the knowledge of the assurance client's business, the better the assurance team will understand the assurance client's procedures and controls, and the business and financial risks that it faces. The provision of non-assurance services may, however, create threats to the independence of the firm, a network firm or the members of the assurance team, particularly with respect to perceived threats to independence. Consequently, it is necessary to evaluate the significance of any threat created by the provision of such services. In some cases it may be possible to eliminate or reduce the threat created by application of safeguards. In other cases no safeguards are available to reduce the threat to an acceptable level.

290.159 The following activities would generally create self-interest or self-review threats that are so significant that only avoidance of the activity or refusal to perform the assurance engagement would reduce the threats to an acceptable level:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so.

4 See also Interpretation 2003-02 on page 98.

- Determining which recommendation of the firm should be implemented.
- Reporting, in a management role, to those charged with governance.

290.160 The examples set out in paragraphs 290.166–290.205 are addressed in the context of the provision of non-assurance services to an assurance client. The potential threats to independence will most frequently arise when a non-assurance service is provided to a financial statement audit client. The financial statements of an entity provide financial information about a broad range of transactions and events that have affected the entity. The subject matter information of other assurance services, however, may be limited in nature. Threats to independence, however, may also arise when a firm provides a non-assurance service related to the subject matter information, of a non-financial statement audit assurance engagement. In such cases, consideration should be given to the significance of the firm's involvement with the subject matter information, of the engagement, whether any self-review threats are created and whether any threats to independence could be reduced to an acceptable level by application of safeguards, or whether the engagement should be declined. When the non-assurance service is not related to the subject matter information, of the non-financial statement audit assurance engagement, the threats to independence will generally be clearly insignificant.

290.161 The following activities may also create self-review or self-interest threats:

- Having custody of an assurance client's assets.
- Supervising assurance client employees in the performance of their normal recurring activities.
- Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Making arrangements so that personnel providing such services do not participate in the assurance engagement;
- Involving an additional professional accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team; or

- Other relevant safeguards set out in national regulations.

290.162 New developments in business, the evolution of financial markets, rapid changes in information technology, and the consequences for management and control, make it impossible to draw up an all-inclusive list of all situations when providing non-assurance services to an assurance client might create threats to independence and of the different safeguards that might eliminate these threats or reduce them to an acceptable level. In general, however, a firm may provide services beyond the assurance engagement provided any threats to independence have been reduced to an acceptable level.

290.163 The following safeguards may be particularly relevant in reducing to an acceptable level threats created by the provision of non-assurance services to assurance clients:

- Policies and procedures to prohibit professional staff from making management decisions for the assurance client, or assuming responsibility for such decisions.
- Discussing independence issues related to the provision of non-assurance services with those charged with governance, such as the audit committee.
- Policies within the assurance client regarding the oversight responsibility for provision of non-assurance services by the firm.
- Involving an additional professional accountant to advise on the potential impact of the non-assurance engagement on the independence of the member of the assurance team and the firm.
- Involving an additional professional accountant outside of the firm to provide assurance on a discrete aspect of the assurance engagement.
- Obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm.
- Disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged.
- Making arrangements so that personnel providing non-assurance services do not participate in the assurance engagement.

290.164 Before the firm accepts an engagement to provide a non-assurance service to an assurance client, consideration should be given to whether the provision of such a service would create a threat to independence. In situations when a threat created is other than clearly insignificant, the non-assurance engagement should be declined unless appropriate

safeguards can be applied to eliminate the threat or reduce it to an acceptable level.

290.165 The provision of certain non-assurance services to financial statement audit clients may create threats to independence so significant that no safeguard could eliminate the threat or reduce it to an acceptable level. However, the provision of such services to a related entity, division or discrete financial statement item of such clients may be permissible when any threats to the firm's independence have been reduced to an acceptable level by arrangements for that related entity, division or discrete financial statement item to be audited by another firm or when another firm re-performs the non-assurance service to the extent necessary to enable it to take responsibility for that service.

Preparing Accounting Records and Financial Statements

290.166 Assisting a financial statement audit client in matters such as preparing accounting records or financial statements may create a self-review threat when the financial statements are subsequently audited by the firm.

290.167 It is the responsibility of financial statement audit client management to ensure that accounting records are kept and financial statements are prepared, although they may request the firm to provide assistance. If firm, or network firm, personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptable level by any safeguards. Consequently, personnel should not make such decisions. Examples of such managerial decisions include:

- Determining or changing journal entries, or the classifications for accounts or transaction or other accounting records without obtaining the approval of the financial statement audit client;
- Authorizing or approving transactions; and
- Preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.

290.168 The audit process involves extensive dialogue between the firm and management of the financial statement audit client. During this process, management requests and receives significant input regarding such matters as accounting principles and financial statement disclosure, the appropriateness of controls and the methods used in determining the stated amounts of assets and liabilities. Technical assistance of this nature and advice on accounting principles for financial statement audit clients are an appropriate means to promote the fair presentation of the financial statements. The provision of such advice does not generally threaten the

firm's independence. Similarly, the financial statement audit process may involve assisting an audit client in resolving account reconciliation problems, analyzing and accumulating information for regulatory reporting, assisting in the preparation of consolidated financial statements (including the translation of local statutory accounts to comply with group accounting policies and the transition to a different reporting framework such as International Financial Reporting Standards), drafting disclosure items, proposing adjusting journal entries and providing assistance and advice in the preparation of local statutory accounts of subsidiary entities. These services are considered to be a normal part of the audit process and do not, under normal circumstances, threaten independence.

General Provisions

290.169 The examples in paragraphs 290.170–290.173 indicate that self-review threats may be created if the firm is involved in the preparation of accounting records or financial statements and those financial statements are subsequently the subject matter information of an audit engagement of the firm. This notion may be equally applicable in situations when the subject matter information of the assurance engagement is not financial statements. For example, a self-review threat would be created if the firm developed and prepared prospective financial information and subsequently provided assurance on this prospective financial information. Consequently, the firm should evaluate the significance of any self-review threat created by the provision of such services. If the self-review threat is other than clearly insignificant safeguards should be considered and applied as necessary to reduce the threat to an acceptable level.

Financial Statements Audit Clients that are Not Listed Entities

290.170 The firm, or a network firm, may provide a financial statement audit client that is not a listed entity with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services include:

- Recording transactions for which the audit client has determined or approved the appropriate account classification;
- Posting coded transactions to the audit client's general ledger;
- Preparing financial statements based on information in the trial balance; and
- Posting the audit client approved entries to the trial balance.

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Making arrangements so such services are not performed by a member of the assurance team;
- Implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the audit client;
- Requiring the source data for the accounting entries to be originated by the audit client;
- Requiring the underlying assumptions to be originated and approved by the audit client; or
- Obtaining audit client approval for any proposed journal entries or other changes affecting the financial statements.

Financial Statement Audit Clients that are Listed Entities

290.171 The provision of accounting and bookkeeping services, including payroll services and the preparation of financial statements or financial information which forms the basis of the financial statements on which the audit report is provided, on behalf of a financial statement audit client that is a listed entity, may impair the independence of the firm or network firm, or at least give the appearance of impairing independence. Accordingly, no safeguard other than the prohibition of such services, except in emergency situations and when the services fall within the statutory audit mandate, could reduce the threat created to an acceptable level. Therefore, a firm or a network firm should not, with the limited exceptions below, provide such services to a listed entity that is a financial statement audit client.

290.172 The provision of accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of a financial statement audit client that is a listed entity would not be seen as impairing independence with respect to the audit client provided that the following conditions are met:

(a) The services do not involve the exercise of judgment.

(b) The divisions or subsidiaries for which the service is provided are collectively immaterial to the audit client, or the services provided are collectively immaterial to the division or subsidiary.

(c) The fees to the firm, or network firm, from such services are collectively clearly insignificant.

If such services are provided, all of the following safeguards should be applied:

(a) The firm, or network firm, should not assume any managerial role nor make any managerial decisions.

(b) The audit client should accept responsibility for the results of the work.

(c) Personnel providing the services should not participate in the audit.

Emergency Situations

290.173 The provision of accounting and bookkeeping services to financial statement audit clients in emergency or other unusual situations, when it is impractical for the audit client to make other arrangements, would not be considered to pose an unacceptable threat to independence provided:

(a) The firm, or network firm, does not assume any managerial role or make any managerial decisions;

(b) The audit client accepts responsibility for the results of the work; and

(c) Personnel providing the services are not members of the assurance team.

Valuation Services

290.174 A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.

290.175 A self-review threat may be created when a firm or network firm performs a valuation for a financial statement audit client that is to be incorporated into the client's financial statements.

290.176 If the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the financial statement audit engagement.

290.177 Performing valuation services for a financial statement audit client that are neither separately, nor in the aggregate, material to the financial statements, or that do not involve a significant degree of subjectivity, may create a self-review threat that could be reduced to an acceptable level by the application of safeguards. Such safeguards might include:

- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary;
- Confirming with the audit client their understanding of the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
- Obtaining the audit client's acknowledgement of responsibility for the results of the work performed by the firm; and
- Making arrangements so that personnel providing such services do not participate in the audit engagement.

In determining whether the above safeguards would be effective, consideration should be given to the following matters:

(a) The extent of the audit client's knowledge, experience and ability to evaluate the issues concerned, and the extent of their involvement in determining and approving significant matters of judgment.

(b) The degree to which established methodologies and professional guidelines are applied when performing a particular valuation service.

(c) For valuations involving standard or established methodologies, the degree of subjectivity inherent in the item concerned.

(d) The reliability and extent of the underlying data.

(e) The degree of dependence on future events of a nature which could create significant volatility inherent in the amounts involved.

(f) The extent and clarity of the disclosures in the financial statements.

290.178 When a firm, or a network firm, performs a valuation service for a financial statement audit client for the purposes of making a filing or return to a tax authority, computing an amount of tax due by the client, or for the purpose of tax planning, this would not create a significant threat to independence because such valuations are generally subject to external review, for example by a tax authority.

290.179 When the firm performs a valuation that forms part of the subject matter information of an assurance engagement that is not a financial statement audit engagement, the firm should consider any self-review threats. If the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

Provision of Taxation Services to Financial Statement Audit Clients

290.180 In many jurisdictions, the firm may be asked to provide taxation services to a financial statement audit client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence.

Provision of Internal Audit Services to Financial Statement Audit Clients

290.181 A self-review threat may be created when a firm, or network firm, provides internal audit services to a financial statement audit client. Internal audit services may comprise an extension of the firm's audit service beyond requirements of generally accepted auditing standards, assistance in the performance of a client's internal audit activities or outsourcing of the activities. In evaluating any threats to independence, the nature of the service will need to be considered. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements.

290.182 Services involving an extension of the procedures required to conduct a financial statement audit in accordance with International Standards on Auditing would not be considered to impair independence with respect to the audit client provided that the firm's or network firm's personnel do not act or appear to act in a capacity equivalent to a member of audit client management.

290.183 When the firm, or a network firm, provides assistance in the performance of a financial statement audit client's internal audit activities or undertakes the outsourcing of some of the activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by client management and the internal audit activities themselves.

290.184 Performing a significant portion of the financial statement audit client's internal audit activities may create a self-review threat and a firm, or network firm, should consider the threats and proceed with caution before taking on such activities. Appropriate safeguards should be put in place and the firm, or network firm, should, in particular, ensure that the audit client acknowledges its responsibilities for establishing, maintaining and monitoring the system of internal controls.

290.185 Safeguards that should be applied in all circumstances to reduce any threats created to an acceptable level include ensuring that:

(a) The audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;

(b) The audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;

(c) The audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;

(d) The audit client is responsible for evaluating and determining which recommendations of the firm should be implemented;

(e) The audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm; and

(f) The findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.

290.186 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

Provision of IT Systems Services to Financial Statement Audit Clients

290.187 The provision of services by a firm or network firm to a financial statement audit client that involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may create a self-review threat.

290.188 The self-review threat is likely to be too significant to allow the provision of such services to a financial statement audit client unless appropriate safeguards are put in place ensuring that:

(a) The audit client acknowledges its responsibility for establishing and monitoring a system of internal controls;

(b) The audit client designates a competent employee, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;

(c) The audit client makes all management decisions with respect to the design and implementation process;

(d) The audit client evaluates the adequacy and results of the design and implementation of the system; and

(e) The audit client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.

290.189 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

290.190 The provision of services by a firm, or network firm, to a financial statement audit client which involve either the design or the implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may also create a self-review threat. The significance of the threat, if any, should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

290.191 The provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls are not considered to create a threat to independence provided that firm or network firm personnel do not perform management functions.

Temporary Staff Assignments to Financial Statement Audit Clients

290.192 The lending of staff by a firm, or network firm, to a financial statement audit client may create a self-review threat when the individual is in a position to influence the preparation of a client's accounts or financial statements. In practice, such assistance may be given (particularly in emergency situations) but only on the understanding that the firm's or network firm's personnel will not be involved in:

(a) Making management decisions;

(b) Approving or signing agreements or other similar documents; or

(c) Exercising discretionary authority to commit the client.

Each situation should be carefully analyzed to identify whether any threats are created and whether appropriate safeguards should be implemented. Safeguards that should be applied in all circumstances to reduce any threats to an acceptable level include:

- The staff providing the assistance should not be given audit responsibility for any function or activity that they performed or supervised during their temporary staff assignment; and

- The audit client should acknowledge its responsibility for directing and supervising the activities of firm, or network firm, personnel.

Provision of Litigation Support Services to Financial Statement Audit Clients

290.193 Litigation support services may include activities such as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval in relation to a dispute or litigation.

290.194 A self-review threat may be created when the litigation support services provided to a financial statement audit client include the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements. The significance of any threat created will depend upon factors such as:

- The materiality of the amounts involved;
- The degree of subjectivity inherent in the matter concerned; and
- The nature of the engagement.

The firm, or network firm, should evaluate the significance of any threat created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to perform the service; or
- The involvement of others, such as independent experts.

290.195 If the role undertaken by the firm or network firm involved making managerial decisions on behalf of the financial statement audit client, the threats created could not be reduced to an acceptable level by the application of any safeguard. Therefore, the firm or network firm should not perform this type of service for an audit client.

Provision of Legal Services to Financial Statement Audit Clients

290.196 Legal services are defined as any services for which the person providing the services must either be admitted to practice before the Courts of the jurisdiction in which such services are to be provided, or have the required legal training to practice law. Legal services encompass a wide and diversified range of areas including both corporate and commercial services to clients, such as contract support, litigation, mergers and acquisition advice and support and the provision of assistance to clients'

internal legal departments. The provision of legal services by a firm, or network firm, to an entity that is a financial statement audit client may create both self-review and advocacy threats.

290.197 Threats to independence need to be considered depending on the nature of the service to be provided, whether the service provider is separate from the assurance team and the materiality of any matter in relation to the entities' financial statements. The safeguards set out in paragraph 290.162 may be appropriate in reducing any threats to independence to an acceptable level. In circumstances when the threat to independence cannot be reduced to an acceptable level the only available action is to decline to provide such services or withdraw from the financial statement audit engagement.

290.198 The provision of legal services to a financial statement audit client which involve matters that would not be expected to have a material effect on the financial statements are not considered to create an unacceptable threat to independence.

290.199 There is a distinction between advocacy and advice. Legal services to support a financial statement audit client in the execution of a transaction (e.g., contract support, legal advice, legal due diligence and restructuring) may create self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Such a service would not generally impair independence, provided that:

(a) Members of the assurance team are not involved in providing the service; and

(b) In relation to the advice provided, the audit client makes the ultimate decision or, in relation to the transactions, the service involves the execution of what has been decided by the audit client.

290.200 Acting for a financial statement audit client in the resolution of a dispute or litigation in such circumstances when the amounts involved are material in relation to the financial statements of the audit client would create advocacy and self-review threats so significant no safeguard could reduce the threat to an acceptable level. Therefore, the firm should not perform this type of service for a financial statement audit client.

290.201 When a firm is asked to act in an advocacy role for a financial statement audit client in the resolution of a dispute or litigation in circumstances when the amounts involved are not material to the financial statements of the audit client, the firm should evaluate the significance of any advocacy and self-review threats created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to

eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client; or
- Using professionals who are not members of the assurance team to perform the service.

290.202 The appointment of a partner or an employee of the firm or network firm as General Counsel for legal affairs to a financial statement audit client would create self-review and advocacy threats that are so significant no safeguards could reduce the threats to an acceptable level. The position of General Counsel is generally a senior management position with broad responsibility for the legal affairs of a company and consequently, no member of the firm or network firm should accept such an appointment for a financial statement audit client.

Recruiting Senior Management

290.203 The recruitment of senior management for an assurance client, such as those in a position to affect the subject matter information of the assurance engagement, may create current or future self-interest, familiarity and intimidation threats. The significance of the threat will depend upon factors such as:

- The role of the person to be recruited; and
- The nature of the assistance sought.

The firm could generally provide such services as reviewing the professional qualifications of a number of applicants and provide advice on their suitability for the post. In addition, the firm could generally produce a short-list of candidates for interview, provided it has been drawn up using criteria specified by the assurance client.

The significance of the threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. In all cases, the firm should not make management decisions and the decision as to whom to hire should be left to the client.

Corporate Finance and Similar Activities

290.204 The provision of corporate finance services, advice or assistance to an assurance client may create advocacy and self-review threats. In the case of certain corporate finance services, the independence threats created would be so significant no safeguards could be applied to reduce the threats to an acceptable level. For example, promoting, dealing in, or underwriting of an assurance client's shares is not compatible with

providing assurance services. Moreover, committing the assurance client to the terms of a transaction or consummating a transaction on behalf of the client would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level. In the case of a financial statement audit client the provision of those corporate finance services referred to above by a firm or a network firm would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level.

290.205 Other corporate finance services may create advocacy or self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Examples of such services include assisting a client in developing corporate strategies, assisting in identifying or introducing a client to possible sources of capital that meet the client specifications or criteria, and providing structuring advice and assisting a client in analyzing the accounting effects of proposed transactions. Safeguards that should be considered include:

- Policies and procedures to prohibit individuals assisting the assurance client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to provide the services; and
- Ensuring the firm does not commit the assurance client to the terms of any transaction or consummate a transaction on behalf of the client.

Fees and Pricing

Fees—Relative Size

290.206 When the total fees generated by an assurance client represent a large proportion of a firm's total fees, the dependence on that client or client group and concern about the possibility of losing the client may create a self-interest threat. The significance of the threat will depend upon factors such as:

- The structure of the firm; and
- Whether the firm is well established or newly created.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing the extent and nature of fees charged with the audit committee, or others charged with governance;

- Taking steps to reduce dependency on the client;
- External quality control reviews; and
- Consulting a third party, such as a professional regulatory body or another professional accountant.

290.207 A self-interest threat may also be created when the fees generated by the assurance client represent a large proportion of the revenue of an individual partner. The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Policies and procedures to monitor and implement quality control of assurance engagements; and
- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary.

Fees—Overdue

290.208 A self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. Generally the payment of such fees should be required before the report is issued. The following safeguards may be applicable:

- Discussing the level of outstanding fees with the audit committee, or others charged with governance.
- Involving an additional professional accountant who did not take part in the assurance engagement to provide advice or review the work performed.

The firm should also consider whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be re-appointed.

Pricing

290.209 When a firm obtains an assurance engagement at a significantly lower fee level than that charged by the predecessor firm, or quoted by other firms, the self-interest threat created will not be reduced to an acceptable level unless:

(a) The firm is able to demonstrate that appropriate time and qualified staff are assigned to the task; and

(b) All applicable assurance standards, guidelines and quality control procedures are being complied with.

Contingent Fees

290.210 Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. For the purposes of this section, fees are not regarded as being contingent if a court or other public authority has established them.

290.211 A contingent fee charged by a firm in respect of an assurance engagement creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, a firm should not enter into any fee arrangement for an assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter information of the assurance engagement.

290.212 A contingent fee charged by a firm in respect of a non-assurance service provided to an assurance client may also create self-interest and advocacy threats. If the amount of the fee for a non-assurance engagement was agreed to, or contemplated, during an assurance engagement and was contingent on the result of that assurance engagement, the threats could not be reduced to an acceptable level by the application of any safeguard. Accordingly, the only acceptable action is not to accept such arrangements. For other types of contingent fee arrangements, the significance of the threats created will depend on factors such as:

- The range of possible fee amounts;
- The degree of variability;
- The basis on which the fee is to be determined;
- Whether the outcome or result of the transaction is to be reviewed by an independent third party; and
- The effect of the event or transaction on the assurance engagement.

The significance of the threats should be evaluated and, if the threats are other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threats to an acceptable level. Such safeguards might include:

- Disclosing to the audit committee, or others charged with governance, the extent and nature of fees charged;
- Review or determination of the final fee by an unrelated third party; or
- Quality and control policies and procedures.

Gifts and Hospitality

290.213 Accepting gifts or hospitality from an assurance client may create self-interest and familiarity threats. When a firm or a member of the assurance team accepts gifts or hospitality, unless the value is clearly insignificant, the threats to independence cannot be reduced to an acceptable level by the application of any safeguard. Consequently, a firm or a member of the assurance team should not accept such gifts or hospitality.

Actual or Threatened Litigation

290.214 When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest or intimidation threat may be created. The relationship between client management and the members of the assurance team must be characterized by complete candor and full disclosure regarding all aspects of a client's business operations. The firm and the client's management may be placed in adversarial positions by litigation, affecting management's willingness to make complete disclosures and the firm may face a self-interest threat. The significance of the threat created will depend upon such factors as:

- The materiality of the litigation;
- The nature of the assurance engagement; and
- Whether the litigation relates to a prior assurance engagement.

Once the significance of the threat has been evaluated the following safeguards should be applied, if necessary, to reduce the threats to an acceptable level:

(a) Disclosing to the audit committee, or others charged with governance, the extent and nature of the litigation;

(b) If the litigation involves a member of the assurance team, removing that individual from the assurance team; or

(c) Involving an additional professional accountant in the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary.

If such safeguards do not reduce the threat to an appropriate level, the only appropriate action is to withdraw from, or refuse to accept, the assurance engagement.

Section 290 Interpretations

These interpretations are directed towards the application of the IFAC *Code of Ethics for Professional Accountants* to the topics of the specific queries received. Those subject to the regulations of other authoritative bodies, such as the US Securities and Exchange Commission, may wish to consult with them for their positions on these matters.

Interpretation 2003-01

The Provision of Non-Assurance Services to Assurance Clients

The *Code of Ethics for Professional Accountants* addresses the issue of the provision of non assurance services to assurance clients in paragraphs 290.158–290.205 inclusive. The Code does not currently include any transitional provisions relating to the requirements set out in these paragraphs however the Ethics Committee[5] has concluded that it is appropriate to allow a transitional period of one year, during which existing contracts to provide non assurance services for assurance clients may be completed if additional safeguards are put in place to reduce any threat to independence to an insignificant level. This transitional period commences on December 31, 2004 (or from the date of implementation of the Code for members of those IFAC member bodies which have adopted an earlier implementation date).

Interpretation 2003-02

Lead Engagement Partner Rotation for Audit Clients that are Listed Entities

The *Code of Ethics for Professional Accountants* addresses the issue of engagement partner rotation for financial statement audit clients that are listed entities in paragraphs 290.154–290.157.

The paragraphs state that in the financial statement audit of a listed entity the engagement partner should be rotated after serving in that capacity for a pre-defined period, normally no more than seven years. They also state that some degree of flexibility in timing of rotation may be necessary in certain circumstances. The Ethics Committee[6] believes that the implementation (or early adoption) of the Code constitutes an example of a circumstance in which some degree of flexibility over timing of rotation may be necessary.

The Code does not currently include any transitional provisions relating to these requirements. However, the Ethics Committee[7] has concluded that it is appropriate to allow a transitional period of two years. Consequently, on implementation or early adoption of the Code, while the length of time the engagement partner has served the financial statement audit client in that capacity should be considered in determining

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5 Now referred to as the International Ethics Standards Board for Accountants.

6 See footnote 5.

7 See footnote 5.

when rotation should occur, the partner may continue to serve as the engagement partner for two additional years from the date of implementation (or early adoption) before rotating off the engagement. In such circumstances, the additional requirements of paragraph 290.157 to apply equivalent safeguards in order to reduce any threats to an acceptable level should be followed.

Interpretation 2005-01

Application of Section 290 to Assurance Engagements that are Not Financial Statement Audit Engagements

This interpretation provides guidance on the application of the independence requirements contained in Section 290 to assurance engagements that are not financial statement audit engagements.

This interpretation focuses on the application issues that are particular to assurance engagements that are not financial statement audit engagements. There are other matters noted in Section 290 that are relevant in the consideration of independence requirements for all assurance engagements. For example, paragraph 290.28 states that consideration should be given to any threats the firm has reason to believe may be created by network firms' interests and relationships. Similarly, paragraph 290.34 states that for assurance clients, that are other than listed entity financial statement audit clients, when the assurance team has reason to believe that a related entity of such an assurance client is relevant to the evaluation of the firm's independence of the client, the assurance team should consider that related entity when evaluating independence and applying appropriate safeguards. These matters are not specifically addressed in this interpretation.

As explained in the International Framework for Assurance Engagements issued by the International Auditing and Assurance Standards Board, in an assurance engagement, the professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

Assertion-Based Assurance Engagements

In an assertion-based assurance engagement, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.

In an assertion-based assurance engagement independence is required from the responsible party, which is responsible for the subject matter information and may be responsible for the subject matter.

In those assertion-based assurance engagements where the responsible party is responsible for the subject matter information but not the subject matter, independence is required from the responsible party. In addition, consideration

should be given to any threats the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter.

Direct Reporting Assurance Engagements

In a direct reporting assurance engagement, the professional accountant in public practice either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report.

In a direct reporting assurance engagement independence is required from the responsible party, which is responsible for the subject matter.

Multiple Responsible Parties

In both assertion-based assurance engagements and direct reporting assurance engagements there may be several responsible parties. For example, a public accountant in public practice may be asked to provide assurance on the monthly circulation statistics of a number of independently owned newspapers. The assignment could be an assertion based assurance engagement where each newspaper measures its circulation and the statistics are presented in an assertion that is available to the intended users. Alternatively, the assignment could be a direct reporting assurance engagement, where there is no assertion and there may or may not be a written representation from the newspapers.

In such engagements, when determining whether it is necessary to apply the provisions in Section 290 to each responsible party, the firm may take into account whether an interest or relationship between the firm, or a member of the assurance team, and a particular responsible party would create a threat to independence that is other than clearly insignificant in the context of the subject matter information. This will take into account:

- The materiality of the subject matter information (or the subject matter) for which the particular responsible party is responsible; and
- The degree of public interest that is associated with the engagement.

If the firm determines that the threat to independence created by any such relationships with a particular responsible party would be clearly insignificant it may not be necessary to apply all of the provisions of this section to that responsible party.

Example

The following example has been developed to demonstrate the application of Section 290. It is assumed that the client is not also a financial statement audit client of the firm, or a network firm.

A firm is engaged to provide assurance on the total proven oil reserves of 10 independent companies. Each company has conducted geographical and engineering surveys to determine their reserves (subject matter). There are established criteria to determine when a reserve may be considered to be proven which the professional accountant in public practice determines to be suitable criteria for the engagement.

The proven reserves for each company as at December 31, 20X0 were as follows:

	Proven oil reserves thousands barrels
Company 1	5,200
Company 2	725
Company 3	3,260
Company 4	15,000
Company 5	6,700
Company 6	39,126
Company 7	345
Company 8	175
Company 9	24,135
Company 10	9,635
Total	**104,301**

The engagement could be structured in differing ways:

Assertion-Based Engagements

A1 Each company measures its reserves and provides an assertion to the firm and to intended users.

A2 An entity other than the companies measures the reserves and provides an assertion to the firm and to intended users.

Direct Reporting Engagements

D1 Each company measures the reserves and provides the firm with a written representation that measures its reserves against the established criteria for measuring proven reserves. The representation is not available to the intended users.

D2 The firm directly measures the reserves of some of the companies.

Application of Approach

A1 Each company measures its reserves and provides an assertion to the firm and to intended users.

There are several responsible parties in this engagement (companies 1-10). When determining whether it is necessary to apply the independence provisions to all of the companies, the firm may take into account whether an interest or relationship with a particular company would create a threat to independence that is other than clearly insignificant. This will take into account factors such as:

- The materiality of the company's proven reserves in relation to the total reserves to be reported on; and
- The degree of public interest associated with the engagement. (Paragraph 290.33.)

For example, Company 8 accounts for 0.16% of the total reserves, therefore a business relationship or interest with Company 8 would create less of a threat than a similar relationship with Company 6, which accounts for approximately 37.5% of the reserves.

Having determined those companies to which the independence requirements apply, the assurance team and the firm are required to be independent of those responsible parties which would be considered to be the assurance client (paragraph 290.33).

A2 An entity other than the companies measures the reserves and provides an assertion to the firm and to intended users.

The firm would be required to be independent of the entity that measures the reserves and provides an assertion to the firm and to intended users (paragraph 290.30). That entity is not responsible for the subject matter and so consideration should be given to any threats the firm has reason to believe may be created by interests/relationships with the party responsible for the subject matter (paragraph 290.30). There are several parties responsible for subject matter in this engagement (Companies 1-10) As discussed in example A1 above, the firm may take into account whether an interest or relationship with a particular company would create a threat to independence that is other than clearly insignificant.

D1 Each company provides the firm with a representation that measures its reserves against the established criteria for measuring proven reserves. The representation is not available to the intended users.

There are several responsible parties in this engagement (Companies 1-10). When determining whether it is necessary to apply the independence provisions to all of the companies, the firm may take into account whether an interest or relationship with a particular company would create a threat to independence that is other than clearly insignificant. This will take into account factors such as:

- The materiality of the company's proven reserves in relation to the total reserves to be reported on; and
- The degree of public interest associated with the engagement. (paragraph 290.33).

For example Company 8 accounts for 0.16% of the reserves, therefore a business relationship or interest with Company 8 would create less of a threat than a similar relationship with Company 6 that accounts for approximately 37.5% of the reserves.

Having determined those companies to which the independence requirements apply, the assurance team and the firm are required to be independent of those responsible parties which would be considered to be the assurance client (paragraph 290.33).

D2 The firm directly measures the reserves of some of the companies.

The application is the same as in example D1.

PART C—PROFESSIONAL ACCOUNTANTS IN BUSINESS

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SECTION 300

Introduction

300.1 This Part of the Code illustrates how the conceptual framework contained in Part A is to be applied by professional accountants in business.

300.2 Investors, creditors, employers and other sectors of the business community, as well as governments and the public at large, all may rely on the work of professional accountants in business. Professional accountants in business may be solely or jointly responsible for the preparation and reporting of financial and other information, which both their employing organizations and third parties may rely on. They may also be responsible for providing effective financial management and competent advice on a variety of business-related matters.

300.3 A professional accountant in business may be a salaried employee, a partner, director (whether executive or non-executive), an owner manager, a volunteer or another working for one or more employing organization. The legal form of the relationship with the employing organization, if any, has no bearing on the ethical responsibilities incumbent on the professional accountant in business.

300.4 A professional accountant in business has a responsibility to further the legitimate aims of their employing organization. This Code does not seek to hinder a professional accountant in business from properly fulfilling that responsibility, but considers circumstances in which conflicts may be created with the absolute duty to comply with the fundamental principles.

300.5 A professional accountant in business often holds a senior position within an organization. The more senior the position, the greater will be the ability and opportunity to influence events, practices and attitudes. A professional accountant in business is expected, therefore, to encourage an ethics-based culture in an employing organization that emphasizes the importance that senior management places on ethical behavior.

300.6 The examples presented in the following sections are intended to illustrate how the conceptual framework is to be applied and are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances experienced by a professional accountant in business that may create threats to compliance with the principles. Consequently, it is not sufficient for a professional accountant in business merely to comply with the examples; rather, the framework should be applied to the particular circumstances faced.

Threats and Safeguards

300.7 Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

(a) Self-interest;

(b) Self-review;

(c) Advocacy;

(d) Familiarity; and

(e) Intimidation.

These threats are discussed further in Part A of this Code.

300.8 Examples of circumstances that may create self-interest threats for a professional accountant in business include, but are not limited to:

- Financial interests, loans or guarantees.
- Incentive compensation arrangements.
- Inappropriate personal use of corporate assets.
- Concern over employment security.
- Commercial pressure from outside the employing organization.

300.9 Circumstances that may create self-review threats include, but are not limited to, business decisions or data being subject to review and justification by the same professional accountant in business responsible for making those decisions or preparing that data.

300.10 When furthering the legitimate goals and objectives of their employing organizations professional accountants in business may promote the organization's position, provided any statements made are neither false nor misleading. Such actions generally would not create an advocacy threat.

300.11 Examples of circumstances that may create familiarity threats include, but are not limited to:

- A professional accountant in business in a position to influence financial or non-financial reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence.
- Long association with business contacts influencing business decisions.

- Acceptance of a gift or preferential treatment, unless the value is clearly insignificant.

300.12 Examples of circumstances that may create intimidation threats include, but are not limited to:

- Threat of dismissal or replacement of the professional accountant in business or a close or immediate family member over a disagreement about the application of an accounting principle or the way in which financial information is to be reported.
- A dominant personality attempting to influence the decision making process, for example with regard to the awarding of contracts or the application of an accounting principle.

300.13 Professional accountants in business may also find that specific circumstances give rise to unique threats to compliance with one or more of the fundamental principles. Such unique threats obviously cannot be categorized. In all professional and business relationships, professional accountants in business should always be on the alert for such circumstances and threats.

300.14 Safeguards that may eliminate or reduce to an acceptable level the threats faced by professional accountants in business fall into two broad categories:

(a) Safeguards created by the profession, legislation or regulation; and

(b) Safeguards in the work environment.

300.15 Examples of safeguards created by the profession, legislation or regulation are detailed in paragraph 100.12 of Part A of this Code.

300.16 Safeguards in the work environment include, but are not restricted to:

- The employing organization's systems of corporate oversight or other oversight structures.
- The employing organization's ethics and conduct programs.
- Recruitment procedures in the employing organization emphasizing the importance of employing high caliber competent staff.
- Strong internal controls.
- Appropriate disciplinary processes.
- Leadership that stresses the importance of ethical behavior and the expectation that employees will act in an ethical manner.
- Policies and procedures to implement and monitor the quality of employee performance.

- Timely communication of the employing organization's policies and procedures, including any changes to them, to all employees and appropriate training and education on such policies and procedures.
- Policies and procedures to empower and encourage employees to communicate to senior levels within the employing organization any ethical issues that concern them without fear of retribution.
- Consultation with another appropriate professional accountant.

300.17 In circumstances where a professional accountant in business believes that unethical behavior or actions by others will continue to occur within the employing organization, the professional accountant in business should consider seeking legal advice. In those extreme situations where all available safeguards have been exhausted and it is not possible to reduce the threat to an acceptable level, a professional accountant in business may conclude that it is appropriate to resign from the employing organization.

SECTION 310

Potential Conflicts

310.1 A professional accountant in business has a professional obligation to comply with the fundamental principles. There may be times, however, when their responsibilities to an employing organization and the professional obligations to comply with the fundamental principles are in conflict. Ordinarily, a professional accountant in business should support the legitimate and ethical objectives established by the employer and the rules and procedures drawn up in support of those objectives. Nevertheless, where compliance with the fundamental principles is threatened, a professional accountant in business must consider a response to the circumstances.

310.2 As a consequence of responsibilities to an employing organization, a professional accountant in business may be under pressure to act or behave in ways that could directly or indirectly threaten compliance with the fundamental principles. Such pressure may be explicit or implicit; it may come from a supervisor, manager, director or another individual within the employing organization. A professional accountant in business may face pressure to:

- Act contrary to law or regulation.
- Act contrary to technical or professional standards.
- Facilitate unethical or illegal earnings management strategies.
- Lie to, or otherwise intentionally mislead (including misleading by remaining silent) others, in particular:
  - The auditors of the employing organization; or
  - Regulators.
- Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts, including statements in connection with, for example:
  - The financial statements;
  - Tax compliance;
  - Legal compliance; or
  - Reports required by securities regulators.

310.3 The significance of threats arising from such pressures, such as intimidation threats, should be evaluated and, if they are other than clearly insignificant, safeguards should be considered and applied as

necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include:

- Obtaining advice where appropriate from within the employing organization, an independent professional advisor or a relevant professional body.
- The existence of a formal dispute resolution process within the employing organization.
- Seeking legal advice.

SECTION 320

Preparation and Reporting of Information

320.1 Professional accountants in business are often involved in the preparation and reporting of information that may either be made public or used by others inside or outside the employing organization. Such information may include financial or management information, for example, forecasts and budgets, financial statements, management discussion and analysis, and the management letter of representation provided to the auditors as part of an audit of financial statements. A professional accountant in business should prepare or present such information fairly, honestly and in accordance with relevant professional standards so that the information will be understood in its context.

320.2 A professional accountant in business who has responsibility for the preparation or approval of the general purpose financial statements of an employing organization should ensure that those financial statements are presented in accordance with the applicable financial reporting standards.

320.3 A professional accountant in business should maintain information for which the professional accountant in business is responsible in a manner that:

(a) Describes clearly the true nature of business transactions, assets or liabilities;

(b) Classifies and records information in a timely and proper manner; and

(c) Represents the facts accurately and completely in all material respects.

320.4 Threats to compliance with the fundamental principles, for example self-interest or intimidation threats to objectivity or professional competence and due care, may be created where a professional accountant in business may be pressured (either externally or by the possibility of personal gain) to become associated with misleading information or to become associated with misleading information through the actions of others.

320.5 The significance of such threats will depend on factors such as the source of the pressure and the degree to which the information is, or may be, misleading. The significance of the threats should be evaluated and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include consultation with superiors within the employing organization, for example, the audit committee or other body responsible for governance, or with a relevant professional body.

320.6 Where it is not possible to reduce the threat to an acceptable level, a professional accountant in business should refuse to remain associated with information they consider is or may be misleading. Should the professional accountant in business be aware that the issuance of misleading information is either significant or persistent, the professional accountant in business should consider informing appropriate authorities in line with the guidance in Section 140. The professional accountant in business may also wish to seek legal advice or resign.

SECTION 330

Acting with Sufficient Expertise

330.1 The fundamental principle of professional competence and due care requires that a professional accountant in business should only undertake significant tasks for which the professional accountant in business has, or can obtain, sufficient specific training or experience. A professional accountant in business should not intentionally mislead an employer as to the level of expertise or experience possessed, nor should a professional accountant in business fail to seek appropriate expert advice and assistance when required.

330.2 Circumstances that threaten the ability of a professional accountant in business to perform duties with the appropriate degree of professional competence and due care include:

- Insufficient time for properly performing or completing the relevant duties.
- Incomplete, restricted or otherwise inadequate information for performing the duties properly.
- Insufficient experience, training and/or education.
- Inadequate resources for the proper performance of the duties.

330.3 The significance of such threats will depend on factors such as the extent to which the professional accountant in business is working with others, relative seniority in the business and the level of supervision and review applied to the work. The significance of the threats should be evaluated and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Safeguards that may be considered include:

- Obtaining additional advice or training.
- Ensuring that there is adequate time available for performing the relevant duties.
- Obtaining assistance from someone with the necessary expertise.
- Consulting, where appropriate, with:
  - ° Superiors within the employing organization;
  - ° Independent experts; or
  - ° A relevant professional body.

330.4 Where threats cannot be eliminated or reduced to an acceptable level, professional accountants in business should consider whether to refuse to

perform the duties in question. If the professional accountant in business determines that refusal is appropriate the reasons for doing so should be clearly communicated.

SECTION 340

Financial Interests

340.1 Professional accountants in business may have financial interests, or may know of financial interests of immediate or close family members, that could, in certain circumstances, give rise to threats to compliance with the fundamental principles. For example, self-interest threats to objectivity or confidentiality may be created through the existence of the motive and opportunity to manipulate price sensitive information in order to gain financially. Examples of circumstances that may create self-interest threats include, but are not limited to situations where the professional accountant in business or an immediate or close family member:

- Holds a direct or indirect financial interest in the employing organization and the value of that financial interest could be directly affected by decisions made by the professional accountant in business;
- Is eligible for a profit related bonus and the value of that bonus could be directly affected by decisions made by the professional accountant in business;
- Holds, directly or indirectly, share options in the employing organization, the value of which could be directly affected by decisions made by the professional accountant in business;
- Holds, directly or indirectly, share options in the employing organization which are, or will soon be, eligible for conversion; or
- May qualify for share options in the employing organization or performance related bonuses if certain targets are achieved.

340.2 In evaluating the significance of such a threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, professional accountants in business must examine the nature of the financial interest. This includes an evaluation of the significance of the financial interest and whether it is direct or indirect. Clearly, what constitutes a significant or valuable stake in an organization will vary from individual to individual, depending on personal circumstances.

340.3 If threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate or reduce them to an acceptable level. Such safeguards may include:

- Policies and procedures for a committee independent of management to determine the level of form of remuneration of senior management.

- Disclosure of all relevant interests, and of any plans to trade in relevant shares to those charged with the governance of the employing organization, in accordance with any internal policies.
- Consultation, where appropriate, with superiors within the employing organization.
- Consultation, where appropriate, with those charged with the governance of the employing organization or relevant professional bodies.
- Internal and external audit procedures.
- Up-to-date education on ethical issues and the legal restrictions and other regulations around potential insider trading.

340.4 A professional accountant in business should neither manipulate information nor use confidential information for personal gain.

SECTION 350

Inducements

Receiving Offers

350.1 A professional accountant in business or an immediate or close family member may be offered an inducement. Inducements may take various forms, including gifts, hospitality, preferential treatment and inappropriate appeals to friendship or loyalty.

350.2 Offers of inducements may create threats to compliance with the fundamental principles. When a professional accountant in business or an immediate or close family member is offered an inducement, the situation should be carefully considered. Self-interest threats to objectivity or confidentiality are created where an inducement is made in an attempt to unduly influence actions or decisions, encourage illegal or dishonest behavior or obtain confidential information. Intimidation threats to objectivity or confidentiality are created if such an inducement is accepted and it is followed by threats to make that offer public and damage the reputation of either the professional accountant in business or an immediate or close family member.

350.3 The significance of such threats will depend on the nature, value and intent behind the offer. If a reasonable and informed third party, having knowledge of all relevant information, would consider the inducement insignificant and not intended to encourage unethical behavior, then a professional accountant in business may conclude that the offer is made in the normal course of business and may generally conclude that there is no significant threat to compliance with the fundamental principles.

350.4 If evaluated threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. When the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in business should not accept the inducement. As the real or apparent threats to compliance with the fundamental principles do not merely arise from acceptance of an inducement but, sometimes, merely from the fact of the offer having been made, additional safeguards should be adopted. A professional accountant in business should assess the risk associated with all such offers and consider whether the following actions should be taken:

(a) Where such offers have been made, immediately inform higher levels of management or those charged with governance of the employing organization;

(b) Inform third parties of the offer – for example, a professional body or the employer of the individual who made the offer; a professional accountant in business should, however, consider seeking legal advice before taking such a step;

(c) Advise immediate or close family members of relevant threats and safeguards where they are potentially in positions that might result in offers of inducements, for example as a result of their employment situation; and

(d) Inform higher levels of management or those charged with governance of the employing organization where immediate or close family members are employed by competitors or potential suppliers of that organization.

Making Offers

350.5 A professional accountant in business may be in a situation where the professional accountant in business is expected to, or is under other pressure to, offer inducements to subordinate the judgment of another individual or organization, influence a decision-making process or obtain confidential information.

350.6 Such pressure may come from within the employing organization, for example, from a colleague or superior. It may also come from an external individual or organization suggesting actions or business decisions that would be advantageous to the employing organization possibly influencing the professional accountant in business improperly.

350.7 A professional accountant in business should not offer an inducement to improperly influence professional judgment of a third party.

350.8 Where the pressure to offer an unethical inducement comes from within the employing organization, the professional accountant should follow the principles and guidance regarding ethical conflict resolution set out in Part A of this Code.

DEFINITIONS

In this *Code of Ethics for Professional Accountants* the following expressions have the following meanings assigned to them:

Advertising	The communication to the public of information as to the services or skills provided by professional accountants in public practice with a view to procuring professional business.
Assurance client	The responsible party that is the person (or persons) who: (a) In a direct reporting engagement, is responsible for the subject matter; or (b) In an assertion-based engagement, is responsible for the subject matter information and may be responsible for the subject matter. (For an assurance client that is a financial statement audit client see the definition of financial statement audit client.)
Assurance engagement	An engagement in which a professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. (For guidance on assurance engagements see the International Framework for Assurance Engagements issued by the International Auditing and Assurance Standards Board which describes the elements and objectives of an assurance engagement and identifies engagements to which International Standards on Auditing (ISAs), International Standards on Review Engagements (ISREs) and International Standards on Assurance Engagements (ISAEs) apply.)
Assurance team	(a) All members of the engagement team for the assurance engagement; (b) All others within a firm who can directly influence the outcome of the assurance engagement, including:

(i) Those who recommend the compensation of, or who provide direct supervisory, management or other oversight of the assurance engagement partner in connection with the performance of the assurance engagement. For the purposes of a financial statement audit engagement this includes those at all successively senior levels above the engagement partner through the firm's chief executive;

(ii) Those who provide consultation regarding technical or industry specific issues, transactions or events for the assurance engagement; and

(iii) Those who provide quality control for the assurance engagement, including those who perform the engagement quality control review for the assurance engagement; and

(c) For the purposes of a financial statement audit client, all those within a network firm who can directly influence the outcome of the financial statement audit engagement.

Clearly insignificant — A matter that is deemed to be both trivial and inconsequential.

Close family — A parent, child or sibling, who is not an immediate family member.

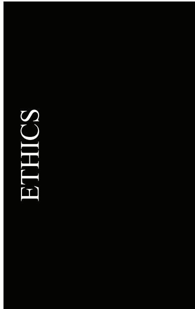
Contingent fee — A fee calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. A fee that is established by a court or other public authority is not a contingent fee.

Direct financial interest — A financial interest:

- Owned directly by and under the control of an individual or entity (including those managed on a discretionary basis by others); or
- Beneficially owned through a collective investment vehicle, estate, trust or other

intermediary over which the individual or entity has control.

Director or officer	Those charged with the governance of an entity, regardless of their title, which may vary from country to country.
Engagement partner	The partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
Engagement quality control review	A process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.
Engagement team	All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.
Existing accountant	A professional accountant in public practice currently holding an audit appointment or carrying out accounting, taxation, consulting or similar professional services for a client.
Financial interest	An interest in an equity or other security, debenture, loan or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.
Financial statements	The balance sheets, income statements or profit and loss accounts, statements of changes in financial position (which may be presented in a variety of ways, for example, as a statement of cash flows or a statement of fund flows), notes and other statements and explanatory material which are identified as being part of the financial statements.
Financial statement audit client	An entity in respect of which a firm conducts a financial statement audit engagement. When the client is a listed entity, financial statement audit client will always include its related entities.



Financial statement audit engagement	A reasonable assurance engagement in which a professional accountant in public practice expresses an opinion whether financial statements are prepared in all material respects in accordance with an identified financial reporting framework, such as an engagement conducted in accordance with International Standards on Auditing. This includes a Statutory Audit, which is a financial statement audit required by legislation or other regulation.
Firm	(a) A sole practitioner, partnership or corporation of professional accountants; (b) An entity that controls such parties through ownership, management or other means; and (c) An entity controlled by such parties through ownership, management or other means.
Immediate family	A spouse (or equivalent) or dependant.
Independence	Independence is: (a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism. (b) Independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.
Indirect financial interest	A financial interest beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual or entity has no control.
Listed entity	An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are

marketed under the regulations of a recognized stock exchange or other equivalent body.

Network

A larger structure:

(a) That is aimed at co-operation; and

(b) That is clearly aimed at profit or cost sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand-name, or a significant part of professional resources.

Network firm

A firm or entity that belongs to a network.

Office

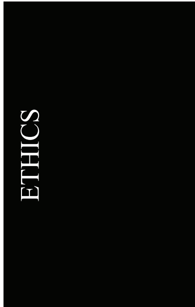
A distinct sub-group, whether organized on geographical or practice lines.

Professional accountant

An individual who is a member of an IFAC member body.

Professional accountant in business

A professional accountant employed or engaged in an executive or non-executive capacity in such areas as commerce, industry, service, the public sector, education, the not for profit sector, regulatory bodies or professional bodies, or a professional accountant contracted by such entities.



Professional accountant in public practice

A professional accountant, irrespective of functional classification (e.g., audit, tax or consulting) in a firm that provides professional services. This term is also used to refer to a firm of professional accountants in public practice.

Professional services

Services requiring accountancy or related skills performed by a professional accountant including accounting, auditing, taxation, management consulting and financial management services.

Related entity

An entity that has any of the following relationships with the client:

(a) An entity that has direct or indirect control over the client provided the client is material to such entity;

(b) An entity with a direct financial interest in the client provided that such entity has significant influence over the client and the

interest in the client is material to such entity;

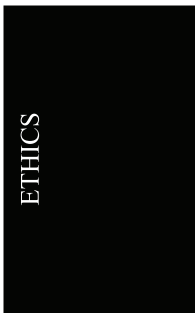
(c) An entity over which the client has direct or indirect control;

(d) An entity in which the client, or an entity related to the client under (c) above, has a direct financial interest that gives it significant influence over such entity and the interest is material to the client and its related entity in (c); and

(e) An entity which is under common control with the client (hereinafter a "sister entity") provided the sister entity and the client are both material to the entity that controls both the client and sister entity.

EFFECTIVE DATE

The Code is effective on June 30, 2006. Paragraphs 290.1-290.13 and 290.27-290.47 are applicable to assurance engagements when the assurance report is dated on or after June 30, 2006. Paragraphs 290.14-290.26 are applicable to assurance engagements when the assurance report is dated on or after December 31, 2008.



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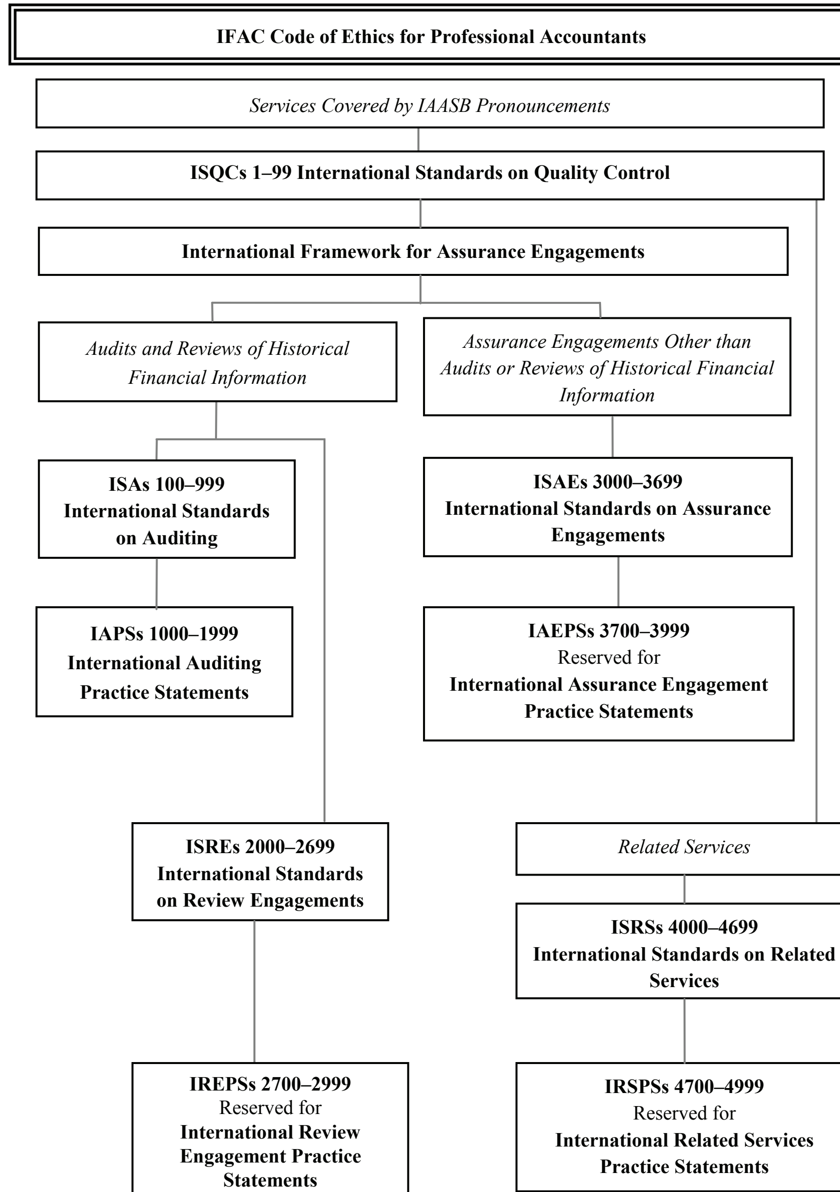
For additional information on the IAASB, recent developments, and to obtain outstanding exposure drafts, visit the IAASB's website at http://www.iaasb.org.

STRUCTURE OF PRONOUNCEMENTS ISSUED BY THE INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD



PREFACE TO THE INTERNATIONAL STANDARDS ON QUALITY CONTROL, AUDITING, REVIEW, OTHER ASSURANCE AND RELATED SERVICES

(Approved December 2005)*

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* An amended Preface was approved in December 2006. The amended Preface establishes the conventions to be used by the IAASB in drafting future International Standards on Auditing and the obligations of auditors who follow those Standards. See Part II of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements*.

Introduction

1. This preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (International Standards or IAASB's Standards) is issued to facilitate understanding of the scope and authority of the pronouncements the International Auditing and Assurance Standards Board (IAASB) issues, as set forth in the IAASB's Terms of Reference.

2. The IAASB is committed to the goal of developing a set of International Standards generally accepted worldwide. IAASB members act in the common interest of the public at large and the worldwide accountancy profession. This could result in their taking a position on a matter that is not in accordance with current practice in their country or firm or not in accordance with the position taken by those who put them forward for membership of the IAASB.

The IAASB's Pronouncements

3. The IAASB's pronouncements govern audit, review, other assurance and related services engagements that are conducted in accordance with International Standards. They do not override the local laws or regulations that govern the audit of historical financial statements or assurance engagements on other information in a particular country required to be followed in accordance with that country's national standards. In the event that local laws or regulations differ from, or conflict with, the IAASB's Standards on a particular subject, an engagement conducted in accordance with local laws or regulations will not automatically comply with the IAASB's Standards. A professional accountant should not represent compliance with the IAASB's Standards unless the professional accountant has complied fully with all of those relevant to the engagement.

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

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

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

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

7. 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.

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

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

10. The IAASB's Standards contain basic principles and essential procedures (identified in bold type lettering) 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 provide guidance for their application. It is therefore necessary to consider the whole text of a Standard to understand and apply the basic principles and essential procedures.

11. The nature of the IAASB's Standards requires professional accountants to exercise professional judgment in applying them. In exceptional circumstances, a professional accountant may judge it necessary to depart from a basic principle or essential procedure of an Engagement Standard to achieve the objective of the engagement. When such a situation arises, the professional accountant should be prepared to justify the departure.

12. Any limitation of the applicability of a specific International Standard is made clear in the standard.

13. International Standards are applicable to engagements in the public sector. When additional guidance is appropriate for the public sector, 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 Public Sector Perspective (PSP), where considered necessary, appearing at the end of the International Standard.

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

14. 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.

15. 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) addressed by the Practice Statement have been complied with.

Other Papers Published by the International Auditing and Assurance Standards Board

16. Other papers, for example Discussion Papers, are published[1] to promote discussion or debate on auditing, review, other assurance and related services and quality control issues affecting the accounting profession, present findings, or describe matters of interest relating to auditing, review, other assurance, related services and quality control issues affecting the accounting profession. They do not establish any basic principles or essential procedures to be followed in audit, review, other assurance or related services engagements.

Language

17. The sole authoritative text of an exposure draft, International Standard, Practice Statement or other paper is that published by the IAASB in the English language.

[1] The IAASB Chair will appoint a review group of four IAASB members to consider whether a draft paper has sufficient merit to be added to the IAASB's literature. The draft paper may come from any source and the IAASB need not have specifically commissioned it. If the review group believes that the paper has sufficient merit, it recommends to the IAASB that the paper be published and added to its literature.

GLOSSARY OF TERMS[1]

(December 2007)

Access controls—Procedures designed to restrict access to on-line terminal devices, programs and data. Access controls consist of "user authentication" and "user authorization." "User authentication" typically attempts to identify a user through unique logon identifications, passwords, access cards or biometric data. "User authorization" consists of access rules to determine the computer resources each user may access. Specifically, such procedures are designed to prevent or detect:

(a) Unauthorized access to on-line terminal devices, programs and data;

(b) Entry of unauthorized transactions;

(c) Unauthorized changes to data files;

(d) The use of computer programs by unauthorized personnel; and

(e) The use of computer programs that have not been authorized.

Accounting estimate—An approximation of the amount of an item in the absence of a precise means of measurement.

Accounting records—Generally include the records of initial entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers; journal entries and other adjustments to the financial statements that are not reflected in formal journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

Adverse opinion—(see Modified auditor's report)

Agreed-upon procedures engagement—An engagement in which an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures may misinterpret the results.

Analytical procedures—Evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships

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[1] In the case of public sector engagements, the terms in this glossary should be read as referring to their public sector equivalents.

Where accounting terms have not been defined in the pronouncements of the International Auditing and Assurance Standards Board, reference should be made to the Glossary of Terms published by the International Accounting Standards Board.

that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Annual report—A document issued by an entity, ordinarily on an annual basis, which includes its financial statements together with the auditor's report thereon.

Anomalous error—(see Audit sampling)

Applicable financial reporting framework—The financial reporting framework adopted by management in preparing the financial statements that the auditor has determined is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulations.

Application controls in information technology— Manual or automated procedures that typically operate at a business process level. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.

Appropriateness—The measure of the quality of evidence, that is, its relevance and reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions.

Assertions—Representations by management, explicit or otherwise, that are embodied in the financial statements.

Assess—Analyze identified risks of to conclude on their significance. "Assess," by convention, is used only in relation to risk. (also see Evaluate)

Assistants—Personnel involved in an individual audit other than the auditor.

Association—(see Auditor association with financial information)

Assurance—(see Reasonable assurance)

Assurance engagement—An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria (also see Subject matter information). Under the "International Framework for Assurance Engagements" there are two types of assurance engagement a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.

Reasonable assurance engagement—The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level

in the circumstances of the engagement[2] as the basis for a positive form of expression of the practitioner's conclusion.

Limited assurance engagement—The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Assurance engagement risk—The risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.

Attendance—Being present during all or part of a process being performed by others; for example, attending physical inventory taking will enable the auditor to inspect inventory, to observe compliance of management's procedures to count quantities and record such counts and to test-count quantities.

Audit documentation—The record of audit procedures performed,[3] relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used).

Audit evidence—All of the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence includes the information contained in the accounting records underlying the financial statements and other information.

Audit firm—(see *Firm*)

Audit matters of governance interest—Those matters that arise from the audit of financial statements and, in the opinion of the auditor, are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. Audit matters of governance interest include only those matters that have come to the attention of the auditor as a result of the performance of the audit.

Audit of financial statements—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. An audit of financial statements is an assurance engagement (see *Assurance engagement*).

Audit opinion—(see *Opinion*)

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2 Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

3 Audit procedures performed include audit planning, as addressed in ISA 300 (Redrafted), "Planning an Audit of Financial Statements."

Audit risk—Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement (or simply, the "risk of material misstatement") (i.e., the risk that the financial statements are materially misstated prior to audit) and the risk that the auditor will not detect such misstatement ("detection risk"). The risk of material misstatement has two components: inherent risk and control risk (as described at the assertion level below). Detection risk is the risk that the auditor's procedures will not detect a misstatement that exists in an assertion that could be material, individually or when aggregated with other misstatements.

> *Inherent risk*—Inherent risk is the susceptibility of an assertion to a misstatement, that could be material, individually or when aggregated with other misstatements assuming that there were no related internal controls.
>
> *Control risk*—Control risk is the risk that a misstatement that could occur in an assertion and that could be material, individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal control.

Audit sampling—The application of audit procedures to less than 100% of items within an account balance or class of transactions such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can use either a statistical or a non-statistical approach.

> *Anomalous error*—An error that arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of errors in the population.
>
> *Confidence levels*—The mathematical complements of sampling risk.
>
> *Expected error*—The error that the auditor expects to be present in the population.
>
> *Non-sampling risk*—Arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, most audit evidence is persuasive rather than conclusive, the auditor might use inappropriate procedures, or the auditor might misinterpret evidence and fail to recognize an error.
>
> *Non-statistical sampling*—Any sampling approach that does not have the characteristics of statistical sampling.
>
> *Population*—The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. A population may be divided into strata, or sub-populations, with each stratum being examined separately. The term population is used to include the term stratum.

Sampling risk—Arises from the possibility that the auditor's conclusion, based on a sample may be different from the conclusion reached if the entire population were subjected to the same audit procedure.

Sampling unit—The individual items constituting a population, for example checks listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances, or a monetary unit.

Statistical sampling—Any approach to sampling that has the following characteristics:

(a) Random selection of a sample; and

(b) Use of probability theory to evaluate sample results, including measurement of sampling risk.

Stratification—The process of dividing a population into subpopulations, each of which is a group of sampling units which have similar characteristics (often monetary value).

Tolerable error—The maximum error in a population that the auditor is willing to accept.

Total error—Either the rate of deviation or total misstatement.

Auditor—The engagement partner. The term "auditor" is used to describe either the engagement partner or the audit firm. Where it applies to the engagement partner, it describes the obligations or responsibilities of the engagement partner. Such obligations or responsibilities may be fulfilled by either the engagement partner or a member of the audit team. Where it is expressly intended that the obligation or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used. (The term "auditor" may be used when describing related services and assurance engagements other than audits. Such reference is not intended to imply that a person performing a related service or assurance engagement other than an audit need necessarily be the auditor of the entity's financial statements.)

Existing auditor—The auditor of the financial statements of the current period.

External auditor—Where appropriate the term "external auditor" is used to distinguish the external auditor from an internal auditor.

Incoming auditor—The auditor of the financial statements of the current period, where either the financial statements of the prior period have been audited by another auditor (in this case the incoming auditor also known as a successor auditor), or the audit is an initial audit engagement.

Internal auditor—A person performing an internal audit.

Other auditor—An auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component, which is included in the financial statements audited by the principal auditor. Other auditors include affiliated firms, whether using the same name or not, and correspondents, as well as unrelated auditors.

Predecessor auditor—The auditor who was previously the auditor of an entity and who has been replaced by an incoming auditor.

Principal auditor—The auditor with responsibility for reporting on the financial statements of an entity when those financial statements include financial information of one or more components audited by another auditor.

Proposed auditor—An auditor who is asked to replace an existing auditor.

Successor auditor—An auditor replacing an existing auditor (also known as an incoming auditor).

Auditor association with financial information—An auditor is associated with financial information when the auditor attaches a report to that information or consents to the use of the auditor's name in a professional connection.

Comparatives—Comparatives in financial statements, may present amounts (such as financial position, results of operations, cash flows) and appropriate disclosures of an entity for more than one period, depending on the framework. The frameworks and methods of presentation are as follows:

(a) Corresponding figures where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures"). These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures.

(b) Comparative financial statements where amounts and other disclosures for the preceding period are included for comparison with the financial statements of the current period, but do not form part of the current period financial statements.

Comparative financial statements—(see Comparatives)

Compilation engagement—An engagement in which accounting expertise, as opposed to auditing expertise, is used to collect, classify and summarize financial information.

Component—A division, branch, subsidiary, joint venture, associated company or other entity whose financial information is included in financial statements audited by the principal auditor.

Component of a complete set of financial statements—The applicable financial reporting framework adopted in preparing the financial statements determines what constitutes a complete set of financial statements. Components of a complete set of financial statements include: a single financial statement, specified accounts, elements of accounts or items in a financial statement.

Comprehensive basis of accounting—A comprehensive basis of accounting comprises a set of criteria used in preparing financial statements which applies to all material items and which has substantial support.

Computer-assisted audit techniques—Applications of auditing procedures using the computer as an audit tool (also known as CAATs).

Computer information systems (CIS) environment—Exists when a computer of any type or size is involved in the processing by the entity of financial information of significance to the audit, whether that computer is operated by the entity or by a third party.

Confidence levels—(see Audit sampling)

Confirmation—A specific type of inquiry that is the process of obtaining a representation of information or of an existing condition directly from a third party.

Control activities—Those policies and procedures that help ensure that management directives are carried out. Control activities are a component of internal control.

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 is a component of internal control.

Control risk—(see Audit risk)

Corporate governance—(see Governance)

Corresponding figures—(see Comparatives)

Criteria—The benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria can be formal or less formal. There can be different criteria for the same subject matter. Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment.

Suitable criteria—Exhibit the following characteristics:

(a) Relevance: relevant criteria contribute to conclusions that assist decision-making by the intended users.

(b) Completeness: criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure.

(c) Reliability: reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners.

(d) Neutrality: neutral criteria contribute to conclusions that are free from bias.

(e) Understandability: understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

Current period figures—Amounts and other disclosures relating to the current period.

Database—A collection of data that is shared and used by a number of different users for different purposes.

Date of the financial statements—The date of the end of the latest period covered by the financial statements, which is normally the date of the most recent balance sheet in the financial statements subject to audit.

Date of approval of the financial statements—The date on which those with the recognized authority assert that they have prepared the entity's complete set of financial statements, including the related notes, and that they have taken responsibility for them. In some jurisdictions, the law or regulation identifies the individuals or bodies (for example, the directors) that are responsible for concluding that a complete set of financial statements has been prepared, and specifies the necessary approval process. In other jurisdictions, the approval process is not prescribed in law or regulation and the entity follows its own procedures in preparing and finalizing its financial statements in view of its management and governance structures. In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of the ISAs is the earlier date on which those with the recognized authority determine that a complete set of financial statements has been prepared.

Date of the auditor's report—The date selected by the auditor to date the report on the financial statements. The auditor's report is not dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements.[4] Sufficient appropriate audit evidence includes evidence that the entity's complete set of financial statements has been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

4 In rare circumstances, law or regulation also identifies the point in the financial statement reporting process at which the audit is expected to be complete.

Date the financial statements are issued—The date that the auditor's report and audited financial statements are made available to third parties, which may be, in many circumstances, the date that they are filed with a regulatory authority.

Detection risk—(see Audit risk)

Disclaimer of opinion—(see Modified auditor's report)

Electronic Data Interchange (EDI)—The electronic transmission of documents between organizations in a machine-readable form.

Emphasis of matter paragraph(s)—(see Modified auditor's report)

Employee fraud—Fraud involving only employees of the entity subject to the audit.

Encryption (cryptography)—The process of transforming programs and information into a form that cannot be understood without access to specific decoding algorithms (cryptographic keys). For example, the confidential personal data in a payroll system may be encrypted against unauthorized disclosure or modification. Encryption can provide an effective control for protecting confidential or sensitive programs and information from unauthorized access or modification. However, effective security depends upon proper controls over access to the cryptographic keys.

Engagement documentation—The record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are sometimes used). The documentation for a specific engagement is assembled in an engagement file.

Engagement partner—The partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Engagement letter—An engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports.

Engagement quality control review—A process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

Engagement quality control reviewer—A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report.

Engagement team—All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

Entity's risk assessment process—A component of internal control that is the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.

Environmental matters—

(a) Initiatives to prevent, abate, or remedy damage to the environment, or to deal with conservation of renewable and non-renewable resources (such initiatives may be required by environmental laws and regulations or by contract, or they may be undertaken voluntarily);

(b) Consequences of violating environmental laws and regulations;

(c) Consequences of environmental damage done to others or to natural resources; and

(d) Consequences of vicarious liability imposed by law (for example, liability for damages caused by previous owners).

Environmental performance report—A report, separate from the financial statements, in which an entity provides third parties with qualitative information on the entity's commitments towards the environmental aspects of the business, its policies and targets in that field, its achievement in managing the relationship between its business processes and environmental risk, and quantitative information on its environmental performance.

Environmental risk—In certain circumstances, factors relevant to the assessment of inherent risk for the development of the overall audit plan may include the risk of material misstatement of the financial statements due to environmental matters.

Error—An unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

Evaluate—Identify and analyze the relevant issues, including performing further procedures as necessary, to come to a specific conclusion on a matter. "Evaluation," by convention, is used only in relation to a range of matters, including evidence, the results of procedures and the effectiveness of management's response to a risk. (also see Assess)

Existing auditor—(see Auditor)

Expected error—(see Audit sampling)

Experienced auditor—An individual (whether internal or external to the firm) who has a reasonable understanding of (a) audit processes, (b) ISAs and applicable legal and regulatory requirements, (c) the business environment in which the entity operates, and (d) auditing and financial reporting issues relevant to the entity's industry.

Expert—A person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

External audit—An audit performed by an external auditor.

External auditor—(see Auditor)

External confirmation—The process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements.

Fair value—The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial statements—A structured representation of the financial information, which ordinarily includes accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The term can refer to a complete set of financial statements, but it can also refer to a single financial statement, for example, a balance sheet, or a statement of revenues and expenses, and related explanatory notes.

Firewall—A combination of hardware and software that protects a WAN, LAN or PC from unauthorized access through the Internet and from the introduction of unauthorized or harmful software, data or other material in electronic form.

Firm[5]— A sole practitioner, partnership or corporation or other entity of professional accountants.

Forecast—Prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).

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. Two types of intentional misstatement are relevant to the auditor: misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets (also see Fraudulent financial reporting and Misappropriation of assets).

Fraudulent financial reporting—Involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users.

General IT-controls— 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. General IT-controls commonly include controls over data center and network operations; system software acquisition, change and maintenance; access security; and application system acquisition, development, and maintenance.

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5 As defined in the IFAC *Code of Ethics for Professional Accountants* (the Code) issued in June 2005. The definition of the term "firm" in the Code was revised in June 2006 and that definition is effective for assurance reports dated on or after December 31, 2008.

Going concern assumption—Under this assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

General purpose financial statements—Financial statements prepared in accordance with a financial reporting framework that is designed to meet the common information needs of a wide range of users.

Governance—Describes the role of persons entrusted with the supervision, control and direction of an entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions.

Government business enterprises—Businesses that operate within the public sector ordinarily to meet a political or social interest objective. They are ordinarily required to operate commercially, that is, to make profits or to recoup, through user charges a substantial proportion of their operating costs.

Incoming auditor—(see Auditor)

Independence[6]—Comprises:

(a) Independence of mind—the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

(b) Independence in appearance—the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

Information system relevant to financial reporting—A component of internal control that includes the financial reporting system, and consists of the procedures and records established to initiate, record, process and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity.

Inherent risk—(see Audit risk)

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6 As defined in the IFAC *Code of Ethics for Professional Accountants*.

Initial audit engagement—An audit engagement in which either the financial statements are audited for the first time; or the financial statements for the prior period were audited by another auditor.

Inquiry—Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, throughout the entity or outside the entity.

Inspection (as an audit procedure)—Examining records or documents, whether internal or external, or tangible assets.

Inspection (in relation to completed engagements)—Procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures;

Intended users—The person, persons or class of persons for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.

Interim financial information or statements—Financial information (which may be less than a complete set of financial statements as defined above) issued at interim dates (usually half-yearly or quarterly) in respect of a financial period.

Internal auditing—An appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control.

Internal auditor—(see Auditor)

Internal control—The process designed and effected by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Internal control consists of the following components:

(a) The control environment;

(b) The entity's risk assessment process;

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

(d) Control activities; and

(e) Monitoring of controls.

Investigate—Inquire into matters arising from other procedures to resolve them.

IT environment—The policies and procedures that the entity implements and the IT infrastructure (hardware, operating systems, etc.) and application software that it uses to support business operations and achieve business strategies.

Limited assurance engagement—(see Assurance engagement)

Limitation on scope—A limitation on the scope of the auditor's work may sometimes be imposed by the entity (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary). A scope limitation may be imposed by circumstances (for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories). It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed desirable.

Listed entity[7]—An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.

Local Area Network (LAN)—A communications network that serves users within a confined geographical area. LANs were developed to facilitate the exchange and sharing of resources within an organization, including data, software, storage, printers and telecommunications equipment. They allow for decentralized computing. The basic components of a LAN are transmission media and software, user terminals and shared peripherals.

Management—Comprises officers and others who also perform senior managerial functions. Management includes those charged with governance only in those instances when they perform such functions.

Management fraud—Fraud involving one or more members of management or those charged with governance.

Management representations—Representations made by management to the auditor during the course of an audit, either unsolicited or in response to specific inquiries.

Material inconsistency—Exists when other information contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.

Material misstatement of fact—Exists in other information when such information, not related to matters appearing in the audited financial statements, is incorrectly stated or presented.

Material weakness—A weakness in internal control that could have a material effect on the financial statements.

Materiality—Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cutoff point rather

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[7] As defined in the IFAC *Code of Ethics for Professional Accountants*.

than being a primary qualitative characteristic which information must have if it is to be useful.

Misappropriation of assets—Involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more capable of disguising or concealing misappropriations in ways that are difficult to detect.

Misstatement—A misstatement of the financial statements that can arise from fraud or error (also see Fraud and Error).

Modified auditor's report—An auditor's report is considered to be modified if either an emphasis of matter paragraph(s) is added to the report or if the opinion is other than unqualified:

Matters that Do Not Affect the Auditor's Opinion

Emphasis of matter paragraph(s)—An auditor's report may be modified by adding an emphasis of matter paragraph(s) to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph(s) does not affect the auditor's opinion. The auditor may also modify the auditor's report by using an emphasis of matter paragraph(s) to report matters other than those affecting the financial statements.

Matters that Do Affect the Auditor's Opinion

Qualified opinion—A qualified opinion is expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion.

Disclaimer of opinion—A disclaimer of opinion is expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

Adverse opinion—An adverse opinion is expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Monitoring (in relation to quality control)—A process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.

Monitoring of controls—A process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a

timely basis and taking necessary corrective actions modified for changes in conditions. Monitoring of controls is a component of internal control.

National practices (auditing)—A set of guidelines not having the authority of standards defined by an authoritative body at a national level and commonly applied by auditors in the conduct of an audit, review, other assurance or related services.

National standards (auditing)—A set of standards defined by law or regulations or an authoritative body at a national level, the application of which is mandatory in conducting an audit, review, other assurance or related services.

Network firm[9]— An entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.

Noncompliance—Refers to acts of omission or commission by the entity being audited, either intentional or unintentional, that are contrary to the prevailing laws or regulations.

Non-sampling risk—(see Audit sampling)

Non-statistical sampling—(see Audit sampling)

Observation—Consists of looking at a process or procedure being performed by others, for example, the observation by the auditor of the counting of inventories by the entity's personnel or the performance of control activities.

Opening balances—Those account balances which exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions of prior periods and accounting policies applied in the prior period.

Opinion—The auditor's report contains a clear written expression of opinion on the financial statements. An unqualified opinion is expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. (also see Modified auditor's report)

Other auditor—(see Auditor)

Other information—Financial or non-financial information (other than the financial statements or the auditor's report thereon) included – either by law or custom – in the annual report.

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9 As defined in the IFAC *Code of Ethics for Professional Accountants* (the Code) issued in June 2005. The definition of the term "network firm" in the Code was revised in June 2006. At the same time a definition of the term "network" was added to the Code. These definitions are effective for assurance reports dated on or after December 31, 2008.

Overall audit strategy—Sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

Partner—Any individual with authority to bind the firm with respect to the performance of a professional services engagement.

PCs or personal computers (also referred to as microcomputers)—Economical yet powerful self-contained general purpose computers consisting typically of a monitor (visual display unit), a case containing the computer electronics and a keyboard (and mouse). These features may be combined in portable computers (laptops). Programs and data may be stored internally on a hard disk or on removable storage media such as CDs or floppy disks. PCs may be connected to on-line networks, printers and other devices such as scanners and modems.

Personnel—Partners and staff.

Planning—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.

Population—(see Audit sampling)

Post balance sheet events—(see Subsequent events)

Practitioner—A professional accountant in public practice.

Predecessor auditor—(see Auditor)

Principal auditor—(see Auditor)

Professional accountant[10]—An individual who is a member of an IFAC member body.

Professional accountant in public practice[11]—A professional accountant, irrespective of functional classification (e.g., audit, tax or consulting) in a firm that provides professional services. This term is also used to refer to a firm of professional accountants in public practice.

Professional skepticism—An attitude that includes a questioning mind and a critical assessment of evidence.

Professional standards—IAASB engagement standards, as defined in the IAASB's "Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services," and relevant ethical requirements, which ordinarily comprise Parts A and B of the IFAC *Code of Ethics for Professional Accountants* and relevant national ethical requirements.

Programming controls—Procedures designed to prevent or detect improper changes to computer programs that are accessed through on-line terminal devices. Access may be restricted by controls such as the use of separate operational and program development

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10 As defined in the IFAC *Code of Ethics for Professional Accountants*.

11 As defined in the IFAC *Code of Ethics for Professional Accountants*.

libraries and the use of specialized program library software. It is important for on-line changes to programs to be adequately documented, controlled and monitored.

Projection—Prospective financial information prepared on the basis of:

(a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or

(b) A mixture of best-estimate and hypothetical assumptions.

Proposed auditor—(see Auditor)

Prospective financial information—Financial information based on assumptions about events that may occur in the future and possible actions by an entity. Prospective financial information can be in the form of a forecast, a projection or a combination of both. (see Forecast and Projection)

Public sector—National governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises).

Qualified opinion—(see Modified auditor's report)

Quality controls—The policies and procedures adopted by a firm designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances.

Reasonable assurance (in the context of quality control)—A high, but not absolute, level of assurance.

Reasonable assurance (in the context of an audit engagement)—A high, but not absolute, level of assurance, expressed positively in the auditor's report as reasonable assurance, that the information subject to audit is free of material misstatement.

Reasonable assurance engagement—(see Assurance engagement)

Recalculation—Consists of checking the mathematical accuracy of documents or records.

Related party— A party is related to an entity if:

(a) Directly, or indirectly through one or more intermediaries, the party:

- (i) Controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);

- (ii) Has an interest in the entity that gives it significant influence over the entity; or

- (iii) Has joint control over the entity;

(b) The party is an associate (as defined in IAS 28, "Investments in Associates") of the entity;

(c) The party is a joint venture in which the entity is a venturer (see IAS 31, "Interest in Joint Ventures");

(d) The party is a member of the key management personnel of the entity or its parent;

(e) The party is a close member of the family of any individual referred to in (a) or (d);

(f) The party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

(g) The party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

Related party transaction—A transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

Related services—Comprise agreed-upon procedures and compilations.

Reperformance—The auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal controls, either manually or through the use of CAATs.

Responsible party—The person (or persons) who:

(a) In a direct reporting engagement, is responsible for the subject matter; or

(b) In an assertion-based engagement, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter.

The responsible party may or may not be the party who engages the practitioner (the engaging party).

Review (in relation to quality control)—Appraising the quality of the work performed and conclusions reached by others.

Review engagement—The objective of a review engagement is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

Review procedures—The procedures deemed necessary to meet the objective of a review engagement, primarily inquiries of entity personnel and analytical procedures applied to financial data.

Risk assessment procedures—The audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and assertion levels.

Risk of material misstatement—(see Audit Risk)

Sampling risk—(see Audit sampling)

Sampling unit—(see Audit sampling)

Scope of an audit—The audit procedures that, in the auditor's judgment and based on the ISAs, are deemed appropriate in the circumstances to achieve the objective of the audit.

Scope of a review—The review procedures deemed necessary in the circumstances to achieve the objective of the review.

Scope limitation—(see Limitation on scope)

Segment information—Information in the financial statements regarding distinguishable components or industry and geographical aspects of an entity.

Significance—The relative importance of a matter, taken in context. The significance of a matter is judged by the practitioner in the context in which it is being considered. This might include, for example, the reasonable prospect of its changing or influencing the decisions of intended users of the practitioner's report; or, as another example, where the context is a judgment about whether to report a matter to those charged with governance, whether the matter would be regarded as important by them in relation to their duties. Significance can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and effect on the subject matter and the expressed interests of intended users or recipients.

Significant risk—A risk that requires special audit consideration.

Small entity—Any entity in which:

(a) There is concentration of ownership and management in a small number of individuals (often a single individual); and

(b) One or more of the following are also found:

    (i) Few sources of income;

    (ii) Unsophisticated record-keeping; and

    (iii) Limited internal controls together with the potential for management override of controls.

Small entities will ordinarily display characteristic (a), and one or more of the characteristics included under (b).

Special purpose auditor's report—A report issued in connection with the independent audit of financial information other than an auditor's report on financial statements, including:

(a) A complete set of financial statements prepared in accordance with ~~a~~ an other comprehensive basis of accounting;

(b) A component of a complete set of general purpose or special purpose financial statements, such as a single financial statement, specified accounts, elements of accounts, or items in a financial statement;

(c) Compliance with contractual agreements; and

(d) Summarized financial statements.

Staff—Professionals, other than partners, including any experts the firm employs.

Statistical sampling—(see Audit sampling)

Stratification—(see Audit sampling)

Subject matter information—The outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report.

Subsequent events—International Accounting Standard (IAS) 10, "Events After the Balance Sheet Date," deals with the treatment in financial statements of events, both favorable and unfavorable, that occur between the date of the financial statements (referred to as the "balance sheet date" in the IAS) and the date when the financial statements are authorized for issue and identifies two types of events:

(a) Those that provide evidence of conditions that existed at the date of the financial statements; and

(b) Those that are indicative of conditions that arose after the date of the financial statements.

Substantive procedures—Audit procedures performed to detect material misstatements at the assertion level; they include:

(a) Tests of details of classes of transactions, account balances; and disclosures and

(b) Substantive analytical procedures.

Successor auditor—(see Auditor)

Sufficiency—Sufficiency is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the risk of misstatement and also by the quality of such audit evidence.

Suitable criteria—(see Criteria)

Suitably qualified external person (for the purpose of ISQC 1)—An individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, other assurance or related services engagements, or of an organization that provides relevant quality control services.

Summarized financial statements—Financial statements summarizing an entity's annual audited financial statements for the purpose of informing user groups interested in the highlights only of the entity's financial performance and position.

Supplementary information—Information that is presented together with the financial statements that is not required by the applicable financial reporting framework used to prepare the financial statements, normally presented in either supplementary schedules or as additional notes.

Supreme Audit Institution—The public body of a State which, however designated, constituted or organized, exercises by virtue of law, the highest public auditing function of that State.

Test—The application of procedures to some or all items in a population.

Tests of control—Tests performed to obtain audit evidence about the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Those charged with governance—(see Governance)

Tolerable error—(see Audit sampling)

Total error—(see Audit sampling)

Transaction logs—Reports that are designed to create an audit trail for each on-line transaction. Such reports often document the source of a transaction (terminal, time and user) as well as the transaction's details.

Uncertainty—A matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

Understanding of the entity and its environment—The auditor's understanding of the entity and its environment consists of the following aspects:

(a) Industry, regulatory, and other external factors, including the applicable financial reporting framework.

(b) Nature of the entity, including the entity's selection and application of accounting policies.

(c) Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.

(d) Measurement and review of the entity's financial performance.

(e) Internal control.

Unqualified opinion—(see Opinion)

Walk-through test—Involves tracing a few transactions through the financial reporting system.

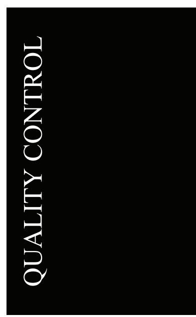
Wide Area Network (WAN)—A communications network that transmits information across an expanded area such as between plant sites, cities and nations. WANs allow for on-line access to applications from remote terminals. Several LANs can be interconnected in a WAN.

Working papers—The material prepared by and for, or obtained and retained by, the auditor in connection with the performance of the audit. Working papers may be in the form of data stored on paper, film, electronic media or other media.

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

(Effective as of June 15, 2006)♦



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International Standard on Quality Control (ISQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISQCs.

♦ ISA 230, "Audit Documentation" gave rise to conforming amendments to ISQC 1. Systems of quality control in compliance with the amended ISQC 1 were required to be established by June 15, 2006. The conforming amendments have been incorporated in the text of ISQC 1..

Introduction

1. The purpose of this International Standard on Quality Control (ISQC) is to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements. This ISQC is to be read in conjunction with Parts A and B of the IFAC *Code of Ethics for Professional Accountants* (the Code).

2. Additional standards and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements are set out in other pronouncements of the International Auditing and Assurance Standards Board (IAASB). International Standards on Auditing (ISA) 220, "Quality Control for Audits of Historical Financial Information," for example, establishes standards and provides guidance on quality control procedures for audits of historical financial information.

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

4. A system of quality control consists of policies designed to achieve the objectives set out in paragraph 3 and the procedures necessary to implement and monitor compliance with those policies.

5. This ISQC applies to all firms. The nature of the policies and procedures developed by individual firms to comply with this ISQC will depend on various factors such as the size and operating characteristics of the firm, and whether it is part of a network.

Definitions

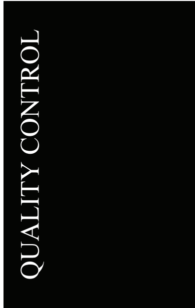
6. In this ISQC, the following terms have the meanings attributed below:

   (a) "Engagement documentation" – the record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are sometimes used). The documentation for a specific engagement is assembled in an engagement file.

   (b) "Engagement partner" – the partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

(c) "Engagement quality control review" – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

(d) "Engagement quality control reviewer" – a partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report.



(e) "Engagement team" – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

(f) "Firm"* – a sole practitioner, partnership or corporation or other entity of professional accountants.

(g) "Inspection" – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.

(h) "Listed entity"* – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.

(i) "Monitoring" – a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.

(j) "Network firm"* – an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.

(k) "Partner" – any individual with authority to bind the firm with respect to the performance of a professional services engagement.

(l) "Personnel" – partners and staff.

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* As defined in the IFAC *Code of Ethics for Professional Accountants* (the Code) issued in June 2005. The definitions of the terms "firm" and "network firm" in the Code were revised in June 2006. At the same time a definition of the term "network" was added to the Code. These definitions are effective for assurance reports dated on or after December 31, 2008.

(m) "Professional standards" – IAASB Engagement Standards, as defined in the IAASB's "Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services," and relevant ethical requirements, which ordinarily comprise Parts A and B of the IFAC Code and relevant national ethical requirements.

(n) "Reasonable assurance" – in the context of this ISQC, a high, but not absolute, level of assurance.

(o) "Staff" – professionals, other than partners, including any experts the firm employs.

(p) "Suitably qualified external person" – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organization that provides relevant quality control services.

Elements of a System of Quality Control

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

   (a) **Leadership responsibilities for quality within the firm.**

   (b) **Ethical requirements.**

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

   (d) **Human resources.**

   (e) **Engagement performance.**

   (f) **Monitoring.**

8. **The quality control policies and procedures should be documented and communicated to the firm's personnel.** Such communication describes the quality control policies and procedures and the objectives they are designed to achieve, and includes the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. In addition, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.

Leadership Responsibilities for Quality within the Firm

9. **The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent), to assume ultimate responsibility for the firm's system of quality control.**

10. The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management emphasizing the firm's quality control policies and procedures, and the requirement to:

    (a) Perform work that complies with professional standards and regulatory and legal requirements; and

    (b) Issue reports that are appropriate in the circumstances.

    Such actions and messages encourage a culture that recognizes and rewards high quality work. They may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They are incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

11. Of particular importance is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs. Accordingly:

    (a) The firm assigns its management responsibilities so that commercial considerations do not override the quality of work performed;

    (b) The firm's policies and procedures addressing performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel, are designed to demonstrate the firm's overriding commitment to quality; and

    (c) The firm devotes sufficient resources for the development, documentation and support of its quality control policies and procedures.

12. **Any person or persons assigned operational responsibility for the firm's quality control system by the firm's chief executive officer or managing board of partners should have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.**

13. Sufficient and appropriate experience and ability enables the responsible person or persons to identify and understand quality control issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

Ethical Requirements

14. **The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.**

15. Ethical requirements relating to audits and reviews of historical financial information, and other assurance and related services engagements ordinarily comprise Parts A and B of the Code together with national requirements that are more restrictive. The Code establishes the fundamental principles of professional ethics, which include:

    (a) Integrity;

    (b) Objectivity;

    (c) Professional competence and due care;

    (d) Confidentiality; and

    (e) Professional behavior.

16. Part B of the Code includes a conceptual approach to independence for assurance engagements that takes into account threats to independence, accepted safeguards and the public interest.

17. The firm's policies and procedures emphasize the fundamental principles, which are reinforced in particular by (a) the leadership of the firm, (b) education and training, (c) monitoring, and (d) a process for dealing with non-compliance. Independence for assurance engagements is so significant that it is addressed separately in paragraphs 18-27 below. These paragraphs need to be read in conjunction with the Code.

Independence

18. **The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the Code and national ethical requirements. Such policies and procedures should enable the firm to:**

    (a) **Communicate its independence requirements to its personnel and, where applicable, others subject to them; and**

(b) **Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.**

19. **Such policies and procedures should require:**

(a) **Engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements;**

(b) **Personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken; and**

(c) **The accumulation and communication of relevant information to appropriate personnel so that:**

(i) **The firm and its personnel can readily determine whether they satisfy independence requirements;**

(ii) **The firm can maintain and update its records relating to independence; and**

(iii) **The firm can take appropriate action regarding identified threats to independence.**

20. **The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:**

(a) **All who are subject to independence requirements to promptly notify the firm of independence breaches of which they become aware;**

(b) **The firm to promptly communicate identified breaches of these policies and procedures to:**

(i) **The engagement partner who, with the firm, needs to address the breach; and**

(ii) **Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action; and**

(c) **Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in**

subparagraph (b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.

21. Comprehensive guidance on threats to independence and safeguards, including application to specific situations, is set out in Section 290 of the Code.

22. A firm receiving notice of a breach of independence policies and procedures promptly communicates relevant information to engagement partners, others in the firm as appropriate and, where applicable, experts contracted by the firm and network firm personnel, for appropriate action. Appropriate action by the firm and the relevant engagement partner includes applying appropriate safeguards to eliminate the threats to independence or to reduce them to an acceptable level, or withdrawing from the engagement. In addition, the firm provides independence education to personnel who are required to be independent.

23. **At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the Code and national ethical requirements.**

24. Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating non-compliance, the firm demonstrates the importance that it attaches to independence and makes the issue current for, and visible to, its personnel.

25. The Code discusses the familiarity threat that may be created by using the same senior personnel on an assurance engagement over a long period of time and the safeguards that might be appropriate to address such a threat. **Accordingly, the firm should establish policies and procedures:**

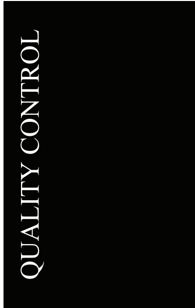
    (a) **Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and**

    (b) **For all audits of financial statements of listed entities, requiring the rotation of the engagement partner after a specified period in compliance with the Code and national ethical requirements that are more restrictive.**

26. Using the same senior personnel on assurance engagements over a prolonged period may create a familiarity threat or otherwise impair the quality of performance of the engagement. Therefore, the firm establishes criteria for determining the need for safeguards to address this threat. In determining appropriate criteria, the firm considers such matters as (a) the nature of the engagement, including the extent to which it involves a matter

of public interest, and (b) the length of service of the senior personnel on the engagement. Examples of safeguards include rotating the senior personnel or requiring an engagement quality control review.

27. The Code recognizes that the familiarity threat is particularly relevant in the context of financial statement audits of listed entities. For these audits, the Code requires the rotation of the engagement partner after a pre-defined period, normally no more than seven years, and provides related standards and guidance. National requirements may establish shorter rotation periods.



Acceptance and Continuance of Client Relationships and Specific Engagements

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

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

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

    (c) **Can comply with ethical requirements.**

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

29. With regard to the integrity of a client, matters that the firm considers include, for example:

    - The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
    - The nature of the client's operations, including its business practices.
    - Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
    - Whether the client is aggressively concerned with maintaining the

firm's fees as low as possible.

- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

30. Information on such matters that the firm obtains may come from, for example:

- Communications with existing or previous providers of professional accountancy services to the client in accordance with the Code, and discussions with other third parties.
- Inquiry of other firm personnel or third parties such as bankers, legal counsel and industry peers.
- Background searches of relevant databases.

31. In considering whether the firm has the capabilities, competence, time and resources to undertake a new engagement from a new or an existing client, the firm reviews the specific requirements of the engagement and existing partner and staff profiles at all relevant levels. Matters the firm considers include whether:

- Firm personnel have knowledge of relevant industries or subject matters;
- Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
- The firm has sufficient personnel with the necessary capabilities and competence;
- Experts are available, if needed;
- Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; and
- The firm is able to complete the engagement within the reporting deadline.

32. The firm also considers whether accepting an engagement from a new or an existing client may give rise to an actual or perceived conflict of interest.

Where a potential conflict is identified, the firm considers whether it is appropriate to accept the engagement.

33. Deciding whether to continue a client relationship includes consideration of significant matters that have arisen during the current or previous engagements, and their implications for continuing the relationship. For example, a client may have started to expand its business operations into an area where the firm does not possess the necessary knowledge or expertise.

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

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

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

35. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

    - Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.
    - If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.
    - Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
    - Documenting significant issues, consultations, conclusions and the basis for the conclusions.

Human Resources

36. **The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the**

capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

37. Such policies and procedures address the following personnel issues:

(a) Recruitment;

(b) Performance evaluation;

(c) Capabilities;

(d) Competence;

(e) Career development;

(f) Promotion;

(g) Compensation; and

(h) The estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity with the capacity to develop the capabilities and competence necessary to perform the firm's work.

38. Capabilities and competence are developed through a variety of methods, including the following:

- Professional education.
- Continuing professional development, including training.
- Work experience.
- Coaching by more experienced staff, for example, other members of the engagement team.

39. The continuing competence of the firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain their knowledge and capabilities. The firm therefore emphasizes in its policies and procedures the need for continuing training for all levels of firm personnel, and provides the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence. Where internal technical and training resources are unavailable, or for any other reason, the firm may use a suitably qualified external person for that purpose.

40. The firm's performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. In particular, the firm:

    (a) Makes personnel aware of the firm's expectations regarding performance and ethical principles;

    (b) Provides personnel with evaluation of, and counseling on, performance, progress and career development; and

    (c) Helps personnel understand that advancement to positions of greater responsibility depends, among other things, upon performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

41. The size and circumstances of the firm will influence the structure of the firm's performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

Assignment of Engagement Teams

42. **The firm should assign responsibility for each engagement to an engagement partner. The firm should establish policies and procedures requiring that:**

    (a) **The identity and role of the engagement partner are communicated to key members of client management and those charged with governance;**

    (b) **The engagement partner has the appropriate capabilities, competence, authority and time to perform the role; and**

    (c) **The responsibilities of the engagement partner are clearly defined and communicated to that partner.**

43. Policies and procedures include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

44. **The firm should also assign appropriate staff with the necessary capabilities, competence and time to perform engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.**

45. The firm establishes procedures to assess its staff's capabilities and competence. The capabilities and competence considered when assigning

engagement teams, and in determining the level of supervision required, include the following:

- An understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation.
- An understanding of professional standards and regulatory and legal requirements.
- Appropriate technical knowledge, including knowledge of relevant information technology.
- Knowledge of relevant industries in which the clients operate.
- Ability to apply professional judgment.
- An understanding of the firm's quality control policies and procedures.

Engagement Performance

46. **The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances.**

47. Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:

    - How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
    - Processes for complying with applicable engagement standards.
    - Processes of engagement supervision, staff training and coaching.
    - Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
    - Appropriate documentation of the work performed and of the timing and extent of the review.
    - Processes to keep all policies and procedures current.

48. It is important that all members of the engagement team understand the objectives of the work they are to perform. Appropriate team-working and

training are necessary to assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

49. Supervision includes the following:

- Tracking the progress of the engagement.
- Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement.
- Addressing significant issues arising during the engagement, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the engagement.

50. Review responsibilities are determined on the basis that more experienced engagement team members, including the engagement partner, review work performed by less experienced team members. Reviewers consider whether:

(a) The work has been performed in accordance with professional standards and regulatory and legal requirements;

(b) Significant matters have been raised for further consideration;

(c) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

(d) There is a need to revise the nature, timing and extent of work performed;

(e) The work performed supports the conclusions reached and is appropriately documented;

(f) The evidence obtained is sufficient and appropriate to support the report; and

(g) The objectives of the engagement procedures have been achieved.

Consultation

51. **The firm should establish policies and procedures designed to provide it with reasonable assurance that:**

(a) **Appropriate consultation takes place on difficult or contentious matters;**

(b) **Sufficient resources are available to enable appropriate consultation to take place;**

(c) **The nature and scope of such consultations are documented; and**

(d) **Conclusions resulting from consultations are documented and implemented.**

52. Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter.

53. Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. The firm seeks to establish a culture in which consultation is recognized as a strength and encourages personnel to consult on difficult or contentious matters.

54. Effective consultation with other professionals requires that those consulted be given all the relevant facts that will enable them to provide informed advice on technical, ethical or other matters. Consultation procedures require consultation with those having appropriate knowledge, seniority and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical and other matters, and appropriate documentation and implementation of conclusions resulting from consultations.

55. A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by (a) other firms, (b) professional and regulatory bodies, or (c) commercial organizations that provide relevant quality control services. Before contracting for such services, the firm considers whether the external provider is suitably qualified for that purpose.

56. The documentation of consultations with other professionals that involve difficult or contentious matters is agreed by both the individual seeking consultation and the individual consulted. The documentation is sufficiently complete and detailed to enable an understanding of:

(a) The issue on which consultation was sought; and

(b) The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Differences of Opinion

57. **The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those**

consulted and, where applicable, between the engagement partner and the engagement quality control reviewer. Conclusions reached should be documented and implemented.

58. Such procedures encourage identification of differences of opinion at an early stage, provide clear guidelines as to the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached. **The report should not be issued until the matter is resolved**.

59. A firm using a suitably qualified external person to conduct an engagement quality control review recognizes that differences of opinion can occur and establishes procedures to resolve such differences, for example, by consulting with another practitioner or firm, or a professional or regulatory body.

Engagement Quality Control Review

60. **The firm should establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. Such policies and procedures should:**

    (a) **Require an engagement quality control review for all audits of financial statements of listed entities;**

    (b) **Set out criteria against which all other audits and reviews of historical financial information, and other assurance and related services engagements should be evaluated to determine whether an engagement quality control review should be performed; and**

    (c) **Require an engagement quality control review for all engagements meeting the criteria established in compliance with subparagraph (b).**

61. **The firm's policies and procedures should require the completion of the engagement quality control review before the report is issued.**

62. Criteria that a firm considers when determining which engagements other than audits of financial statements of listed entities are to be subject to an engagement quality control review include the following:

    - The nature of the engagement, including the extent to which it involves a matter of public interest.
    - The identification of unusual circumstances or risks in an engagement or class of engagements.
    - Whether laws or regulations require an engagement quality control review.

63. **The firm should establish policies and procedures setting out:**

    (a) **The nature, timing and extent of an engagement quality control review;**

    (b) **Criteria for the eligibility of engagement quality control reviewers; and**

    (c) **Documentation requirements for an engagement quality control review.**

Nature, Timing and Extent of the Engagement Quality Control Review

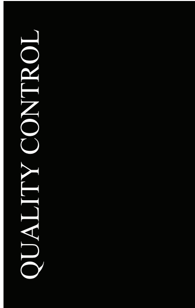
64. An engagement quality control review ordinarily involves discussion with the engagement partner, a review of the financial statements or other subject matter information and the report, and, in particular, consideration of whether the report is appropriate. It also involves a review of selected working papers relating to the significant judgments the engagement team made and the conclusions they reached. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

65. An engagement quality control review for audits of financial statements of listed entities includes considering the following:

    - The engagement team's evaluation of the firm's independence in relation to the specific engagement.
    - Significant risks identified during the engagement and the responses to those risks.
    - Judgments made, particularly with respect to materiality and significant risks.
    - Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
    - The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
    - The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
    - Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
    - The appropriateness of the report to be issued.

Engagement quality control reviews for engagements other than audits of financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

66. The engagement quality control reviewer conducts the review in a timely manner at appropriate stages during the engagement so that significant matters may be promptly resolved to the reviewer's satisfaction before the report is issued.



67. Where the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the firm's procedures for dealing with differences of opinion.

Criteria for the Eligibility of Engagement Quality Control Reviewers

68. **The firm's policies and procedures should address the appointment of engagement quality control reviewers and establish their eligibility through:**

    (a) **The technical qualifications required to perform the role, including the necessary experience and authority; and**

    (b) **The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity.**

69. The firm's policies and procedures on the technical qualifications of engagement quality control reviewers address the technical expertise, experience and authority necessary to perform the role. What constitutes sufficient and appropriate technical expertise, experience and authority depends on the circumstances of the engagement. In addition, the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities.

70. The firm's policies and procedures are designed to maintain the objectivity of the engagement quality control reviewer. For example, the engagement quality control reviewer:

    (a) Is not selected by the engagement partner;

    (b) Does not otherwise participate in the engagement during the period of review;

    (c) Does not make decisions for the engagement team; and

(d) Is not subject to other considerations that would threaten the reviewer's objectivity.

71. The engagement partner may consult the engagement quality control reviewer during the engagement. Such consultation need not compromise the engagement quality control reviewer's eligibility to perform the role. Where the nature and extent of the consultations become significant, however, care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person is appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement. The firm's policies provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.

72. Suitably qualified external persons may be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. Where the firm contracts suitably qualified external persons, the firm follows the requirements and guidance in paragraphs 68-71.

Documentation of the Engagement Quality Control Review

73. **Policies and procedures on documentation of the engagement quality control review should require documentation that:**

(a) **The procedures required by the firm's policies on engagement quality control review have been performed;**

(b) **The engagement quality control review has been completed before the report is issued; and**

(c) **The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.**

Engagement Documentation

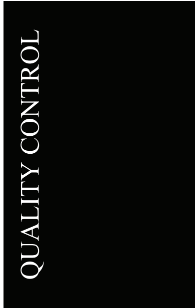
Completion of the Assembly of Final Engagement Files

73a. **The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized.**

73b. Law or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagement should be completed. Where no such time limits are prescribed in law or regulation,

the firm establishes time limits appropriate to the nature of the engagements that reflect the need to complete the assembly of final engagement files on a timely basis. In the case of an audit, for example, such a time limit is ordinarily not more than 60 days after the date of the auditor's report.

73c. Where two or more different reports are issued in respect of the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files address each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on a component's financial information for group consolidation purposes and, at a subsequent date, an auditor's report on the same financial information for statutory purposes.



Confidentiality, Safe Custody, Integrity, Accessibility and Retrievability of Engagement Documentation

73d. **The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.**

73e. Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information, or there is a legal or professional duty to do so. Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

73f. Whether engagement documentation is in paper, electronic or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. Accordingly, the firm designs and implements appropriate controls for engagement documentation to:

(a) Enable the determination of when and by whom engagement documentation was created, changed or reviewed;

(b) Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via the Internet;

(c) Prevent unauthorized changes to the engagement documentation; and

(d) Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

73g. Controls that the firm may design and implement to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation include, for example:

- The use of a password among engagement team members to restrict access to electronic engagement documentation to authorized users.
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Procedures for properly distributing engagement documentation to the team members at the start of engagement, processing it during engagement, and collating it at the end of engagement.
- Procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.

73h. For practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In that case, the firm implements appropriate procedures requiring engagement teams to:

(a) Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;

(b) Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and

(c) Enable the scanned copies to be retrieved and printed as necessary.

The firm considers whether to retain original paper documentation that has been scanned for legal, regulatory or other reasons.

Retention of Engagement Documentation

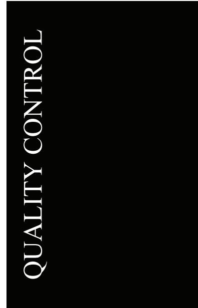
73i. **The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation.**

73j. The needs of the firm for retention of engagement documentation, and the period of such retention, will vary with the nature of the engagement and the firm's circumstances, for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether local law or regulation prescribes specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the jurisdiction in the absence of specific legal or regulatory requirements. In the specific case of audit engagements, the retention period ordinarily is no shorter than five years

from the date of the auditor's report, or, if later, the date of the group auditor's report.

73k. Procedures that the firm adopts for retention of engagement documentation include those that:

- Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time.
- Provide, where necessary, a record of changes made to engagement documentation after the engagement files have been completed.
- Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.



Ownership of Engagement Documentation

73l. Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

Monitoring

74. **The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.**

75. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

    (a) Adherence to professional standards and regulatory and legal requirements;

    (b) Whether the quality control system has been appropriately designed and effectively implemented; and

(c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

76. The firm entrusts responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility. Monitoring of the firm's system of quality control is performed by competent individuals and covers both the appropriateness of the design and the effectiveness of the operation of the system of quality control.

77. Ongoing consideration and evaluation of the system of quality control includes matters such as the following:

- Analysis of:
  - New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;
  - Written confirmation of compliance with policies and procedures on independence;
  - Continuing professional development, including training; and
  - Decisions related to acceptance and continuance of client relationships and specific engagements.
- Determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.
- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.
- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

78. The inspection of a selection of completed engagements is ordinarily performed on a cyclical basis. Engagements selected for inspection include at least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:

- The size of the firm.
- The number and geographical location of offices.

- The results of previous monitoring procedures.
- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
- The nature and complexity of the firm's practice and organization.
- The risks associated with the firm's clients and specific engagements.

79. The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. Those inspecting the engagements are not involved in performing the engagement or the engagement quality control review. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an independent external inspection program does not act as a substitute for the firm's own internal monitoring program.

80. Small firms and sole practitioners may wish to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, they may wish to establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

81. **The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and should determine whether they are either:**

    (a) **Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or**

    (b) **Systemic, repetitive or other significant deficiencies that require prompt corrective action.**

82. **The firm should communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.**

83. **The firm's evaluation of each type of deficiency should result in recommendations for one or more of the following:**

    (a) **Taking appropriate remedial action in relation to an individual engagement or member of personnel;**

    (b) **The communication of the findings to those responsible for**

training and professional development;

(c) **Changes to the quality control policies and procedures; and**

(d) **Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.**

84. **Where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement, the firm should determine what further action is appropriate to comply with relevant professional standards and regulatory and legal requirements. It should also consider obtaining legal advice.**

85. **At least annually, the firm should communicate the results of the monitoring of its quality control system to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing board of partners. Such communication should enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities. Information communicated should include the following:**

(a) **A description of the monitoring procedures performed.**

(b) **The conclusions drawn from the monitoring procedures.**

(c) **Where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.**

86. The reporting of identified deficiencies to individuals other than the relevant engagement partners ordinarily does not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

87. Some firms operate as part of a network and, for consistency, may implement some or all of their monitoring procedures on a network basis. Where firms within a network operate under common monitoring policies and procedures designed to comply with this ISQC, and these firms place reliance on such a monitoring system:

(a) At least annually, the network communicates the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms;

(b) The network communicates promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant

network firm or firms so that the necessary action can be taken; and

(c) Engagement partners in the network firms are entitled to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.

88. Appropriate documentation relating to monitoring:

(a) Sets out monitoring procedures, including the procedure for selecting completed engagements to be inspected;

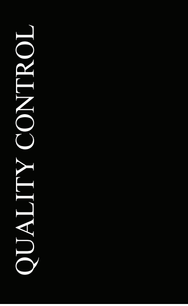
(b) Records the evaluation of:

(i) Adherence to professional standards and regulatory and legal requirements;

(ii) Whether the quality control system has been appropriately designed and effectively implemented; and

(iii) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances; and

(c) Identifies the deficiencies noted, evaluates their effect, and sets out the basis for determining whether and what further action is necessary.



Complaints and Allegations

89. **The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:**

(a) **Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and**

(b) **Allegations of non-compliance with the firm's system of quality control.**

90. Complaints and allegations (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients or other third parties. They may be received by engagement team members or other firm personnel.

91. As part of this process, the firm establishes clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

92. The firm investigates such complaints and allegations in accordance with established policies and procedures. The investigation is supervised by a

partner with sufficient and appropriate experience and authority within the firm but who is not otherwise involved in the engagement, and includes involving legal counsel as necessary. Small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation. Complaints, allegations and the responses to them are documented.

93. Where the results of the investigations indicate deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control by an individual or individuals, the firm takes appropriate action as discussed in paragraph 83.

Documentation

94. **The firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.**

95. How such matters are documented is the firm's decision. For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more informal methods such as manual notes, checklists and forms.

96. Factors to consider when determining the form and content of documentation evidencing the operation of each of the elements of the system of quality control include the following:

- The size of the firm and the number of offices.
- The degree of authority both personnel and offices have.
- The nature and complexity of the firm's practice and organization.

97. The firm retains this documentation for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

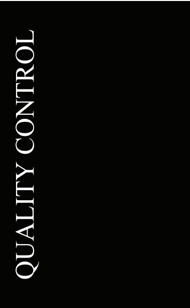
Effective Date

98. Systems of quality control in compliance with this ISQC are required to be established by June 15, 2006. Firms consider the appropriate transitional arrangements for engagements in process at this date.

Public Sector Perspective

1. Some of the terms in the ISQC, such as "engagement partner" and "firm," should be read as referring to their public sector equivalents. However,

with limited exceptions, there is no public sector equivalent of "listed entities," although there may be audits of particularly significant public sector entities which should be subject to the listed entity requirements of mandatory rotation of the engagement partner (or equivalent) and engagement quality control review. There are no fixed objective criteria on which this determination of significance should be based. However, such an assessment should encompass an evaluation of all factors relevant to the audited entity. Such factors include size, complexity, commercial risk, parliamentary or media interest and the number and range of stakeholders affected.



2. *ISQC 1, paragraph 70, states that "The firm's policies and procedures are designed to maintain the objectivity of the engagement quality control reviewer." Subparagraph (a) notes as an example that the engagement quality control reviewer is not selected by the engagement partner. However, in many jurisdictions, there is a single statutorily appointed auditor-general who acts in a role equivalent to that of "engagement partner" and who has overall responsibility for public sector audits. In such circumstances, where applicable, the engagement reviewer should be selected having regard to the need for independence and objectivity.*

3. *In the public sector, auditors may be appointed in accordance with statutory procedures. Accordingly, considerations regarding the acceptance and continuance of client relationships and specific engagements, as set out in paragraphs 28-35 of ISQC 1, may not apply.*

4. *Similarly, the independence of public sector auditors may be protected by statutory measures, with the consequence that certain of the threats to independence of the nature envisaged by paragraphs 18-27 of ISQC 1 are unlikely to occur.*

INTERNATIONAL FRAMEWORK FOR ASSURANCE ENGAGEMENTS

(Effective for assurance reports issued on or after January 1, 2005)

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Introduction

1. This Framework defines and describes the elements and objectives of an assurance engagement, and identifies engagements to which International Standards on Auditing (ISAs), International Standards on Review Engagements (ISREs) and International Standards on Assurance Engagements (ISAEs) apply. It provides a frame of reference for:

   (a) Professional accountants in public practice ("practitioners") when performing assurance engagements. Professional accountants in the public sector refer to the Public Sector Perspective at the end of the Framework. Professional accountants who are neither in public practice nor in the public sector are encouraged to consider the Framework when performing assurance engagements;[1]

   (b) Others involved with assurance engagements, including the intended users of an assurance report and the responsible party; and

   (c) The International Auditing and Assurance Standards Board (IAASB) in its development of ISAs, ISREs and ISAEs.

2. This Framework does not itself establish standards or provide procedural requirements for the performance of assurance engagements. ISAs, ISREs and ISAEs contain basic principles, essential procedures and related guidance, consistent with the concepts in this Framework, for the performance of assurance engagements. The relationship between the Framework and the ISAs, ISREs and ISAEs is illustrated in the "Structure of Pronouncements Issued by the IAASB" section of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements*.

3. The following is an overview of this Framework:

   - *Introduction*: This Framework deals with assurance engagements performed by practitioners. It provides a frame of reference for practitioners and others involved with assurance engagements, such as those engaging a practitioner (the "engaging party").

   - *Definition and objective of an assurance engagement*: This section defines assurance engagements and identifies the objectives of the two types of assurance engagement a practitioner is permitted to perform. This

[1] If a professional accountant not in public practice, for example an internal auditor, applies this Framework, and (a) this Framework, the ISAs, ISREs or the ISAEs are referred to in the professional accountant's report; and (b) the professional accountant or other members of the assurance team and, when applicable, the professional accountant's employer, are not independent of the entity in respect of which the assurance engagement is being performed, the lack of independence and the nature of the relationship(s) with the entity are prominently disclosed in the professional accountant's report. Also, that report does not include the word "independent" in its title, and the purpose and users of the report are restricted.

Framework calls these two types reasonable assurance engagements and limited assurance engagements.[2]

- *Scope of the Framework:* This section distinguishes assurance engagements from other engagements, such as consulting engagements.
- *Engagement acceptance:* This section sets out characteristics that must be exhibited before a practitioner can accept an assurance engagement.
- *Elements of an assurance engagement*: This section identifies and discusses five elements assurance engagements performed by practitioners exhibit: a three party relationship, a subject matter, criteria, evidence and an assurance report. It explains important distinctions between reasonable assurance engagements and limited assurance engagements (also outlined in the Appendix). This section also discusses, for example, the significant variation in the subject matters of assurance engagements, the required characteristics of suitable criteria, the role of risk and materiality in assurance engagements, and how conclusions are expressed in each of the two types of assurance engagement.
- *Inappropriate use of the practitioner's name*: This section discusses implications of a practitioner's association with a subject matter.

Ethical Principles and Quality Control Standards

4. In addition to this Framework and ISAs, ISREs and ISAEs, practitioners who perform assurance engagements are governed by:

    (a) The IFAC *Code of Ethics for Professional Accountants* (the Code), which establishes fundamental ethical principles for professional accountants; and

    (b) International Standards on Quality Control (ISQCs), which establish standards and provide guidance on a firm's system of quality control.[3]

5. Part A of the Code sets out the fundamental ethical principles that all professional accountants are required to observe, including:

    (a) Integrity;

    (b) Objectivity;

    (c) Professional competence and due care;

    (d) Confidentiality; and

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[2] For assurance engagements regarding historical financial information in particular, reasonable assurance engagements are called audits, and limited assurance engagements are called reviews.

[3] Additional standards and guidance on quality control procedures for specific types of assurance engagement are set out in ISAs, ISREs and ISAEs.

(e) Professional behavior.

6. Part B of the Code, which applies only to professional accountants in public practice ("practitioners"), includes a conceptual approach to independence that takes into account, for each assurance engagement, threats to independence, accepted safeguards and the public interest. It requires firms and members of assurance teams to identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate these threats or to reduce them to an acceptable level by the application of safeguards.

Definition and Objective of an Assurance Engagement

7. "Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

8. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. For example:

   - The recognition, measurement, presentation and disclosure represented in the financial statements (outcome) result from applying a financial reporting framework for recognition, measurement, presentation and disclosure, such as International Financial Reporting Standards, (criteria) to an entity's financial position, financial performance and cash flows (subject matter).
   - An assertion about the effectiveness of internal control (outcome) results from applying a framework for evaluating the effectiveness of internal control, such as COSO[4] or CoCo,[5] (criteria) to internal control, a process (subject matter).

   In the remainder of this Framework, the term "subject matter information" will be used to mean the outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report.

9. Subject matter information can fail to be properly expressed in the context of the subject matter and the criteria, and can therefore be misstated, potentially to a material extent. This occurs when the subject matter information does not

4 "Internal Control – Integrated Framework," The Committee of Sponsoring Organizations of the Treadway Commission.

5 "Guidance on Assessing Control – The CoCo Principles," Criteria of Control Board, The Canadian Institute of Chartered Accountants.

properly reflect the application of the criteria to the subject matter, for example, when an entity's financial statements do not give a true and fair view of (or present fairly, in all material respects) its financial position, financial performance and cash flows in accordance with International Financial Reporting Standards, or when an entity's assertion that its internal control is effective is not fairly stated, in all material respects, based on COSO or CoCo.

10. In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. These engagements are called "assertion-based engagements." In other assurance engagements, the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These engagements are called "direct reporting engagements."

11. Under this Framework, there are two types of assurance engagement a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement. The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement[6] as the basis for a positive form of expression of the practitioner's conclusion. The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Scope of the Framework

12. Not all engagements performed by practitioners are assurance engagements. Other frequently performed engagements that do not meet the above definition (and therefore are not covered by this Framework) include:

    - Engagements covered by International Standards for Related Services, such as agreed-upon procedures engagements and compilations of financial or other information.
    - The preparation of tax returns where no conclusion conveying assurance is expressed.

[6] Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

- Consulting (or advisory) engagements,[7] such as management and tax consulting.

13. An assurance engagement may be part of a larger engagement, for example, when a business acquisition consulting engagement includes a requirement to convey assurance regarding historical or prospective financial information. In such circumstances, this Framework is relevant only to the assurance portion of the engagement.

14. The following engagements, which may meet the definition in paragraph 7, need not be performed in accordance with this Framework:

    (a) Engagements to testify in legal proceedings regarding accounting, auditing, taxation or other matters; and

    (b) Engagements that include professional opinions, views or wording from which a user may derive some assurance, if all of the following apply:

        (i) Those opinions, views or wording are merely incidental to the overall engagement;

        (ii) Any written report issued is expressly restricted for use by only the intended users specified in the report;

        (iii) Under a written understanding with the specified intended users, the engagement is not intended to be an assurance engagement; and

        (iv) The engagement is not represented as an assurance engagement in the professional accountant's report.

Reports on Non-Assurance Engagements

15. A practitioner reporting on an engagement that is not an assurance engagement within the scope of this Framework, clearly distinguishes that report from an assurance report. So as not to confuse users, a report that is not an assurance report avoids, for example:

    - Implying compliance with this Framework, ISAs, ISREs or ISAEs.

[7] Consulting engagements employ a professional accountant's technical skills, education, observations, experiences, and knowledge of the consulting process. The consulting process is an analytical process that typically involves some combination of activities relating to: objective-setting, fact-finding, definition of problems or opportunities, evaluation of alternatives, development of recommendations including actions, communication of results, and sometimes implementation and follow-up. Reports (if issued) are generally written in a narrative (or "long form") style. Generally the work performed is only for the use and benefit of the client. The nature and scope of work is determined by agreement between the professional accountant and the client. Any service that meets the definition of an assurance engagement is not a consulting engagement but an assurance engagement.

- Inappropriately using the words "assurance," "audit" or "review."
- Including a statement that could reasonably be mistaken for a conclusion designed to enhance the degree of confidence of intended users about the outcome of the evaluation or measurement of a subject matter against criteria.

16. The practitioner and the responsible party may agree to apply the principles of this Framework to an engagement when there are no intended users other than the responsible party but where all other requirements of the ISAs, ISREs or ISAEs are met. In such cases, the practitioner's report includes a statement restricting the use of the report to the responsible party.

Engagement Acceptance

17. A practitioner accepts an assurance engagement only where the practitioner's preliminary knowledge of the engagement circumstances indicates that:

    (a) Relevant ethical requirements, such as independence and professional competence will be satisfied; and

    (b) The engagement exhibits all of the following characteristics:

        (i) The subject matter is appropriate;

        (ii) The criteria to be used are suitable and are available to the intended users;

        (iii) The practitioner has access to sufficient appropriate evidence to support the practitioner's conclusion;

        (iv) The practitioner's conclusion, in the form appropriate to either a reasonable assurance engagement or a limited assurance engagement, is to be contained in a written report; and

        (v) The practitioner is satisfied that there is a rational purpose for the engagement. If there is a significant limitation on the scope of the practitioner's work (see paragraph 55), it may be unlikely that the engagement has a rational purpose. Also, a practitioner may believe the engaging party intends to associate the practitioner's name with the subject matter in an inappropriate manner (see paragraph 61).

    Specific ISAs, ISREs or ISAEs may include additional requirements that need to be satisfied prior to accepting an engagement.

18. When a potential engagement cannot be accepted as an assurance engagement because it does not exhibit all the characteristics in the previous paragraph, the engaging party may be able to identify a different engagement that will meet the needs of intended users. For example:

(a) If the original criteria were not suitable, an assurance engagement may still be performed if:

(i) The engaging party can identify an aspect of the original subject matter for which those criteria are suitable, and the practitioner could perform an assurance engagement with respect to that aspect as a subject matter in its own right. In such cases, the assurance report makes it clear that it does not relate to the original subject matter in its entirety; or

(ii) Alternative criteria suitable for the original subject matter can be selected or developed.

(b) The engaging party may request an engagement that is not an assurance engagement, such as a consulting or an agreed-upon procedures engagement.

19. Having accepted an assurance engagement, a practitioner may not change that engagement to a non-assurance engagement, or from a reasonable assurance engagement to a limited assurance engagement without reasonable justification. A change in circumstances that affects the intended users' requirements, or a misunderstanding concerning the nature of the engagement, ordinarily will justify a request for a change in the engagement. If such a change is made, the practitioner does not disregard evidence that was obtained prior to the change.

Elements of an Assurance Engagement

20. The following elements of an assurance engagement are discussed in this section:

(a) A three party relationship involving a practitioner, a responsible party, and intended users;

(b) An appropriate subject matter;

(c) Suitable criteria;

(d) Sufficient appropriate evidence; and

(e) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.

Three Party Relationship

21. Assurance engagements involve three separate parties: a practitioner, a responsible party and intended users.

22. The responsible party and the intended users may be from different entities or the same entity. As an example of the latter case, in a two-tier board structure, the supervisory board may seek assurance about information provided by the

management board of that entity. The relationship between the responsible party and the intended users needs to be viewed within the context of a specific engagement and may differ from more traditionally defined lines of responsibility. For example, an entity's senior management (an intended user) may engage a practitioner to perform an assurance engagement on a particular aspect of the entity's activities that is the immediate responsibility of a lower level of management (the responsible party), but for which senior management is ultimately responsible.

Practitioner

23. The term "practitioner" as used in this Framework is broader than the term "auditor" as used in ISAs and ISREs, which relates only to practitioners performing audit or review engagements with respect to historical financial information.

24. A practitioner may be requested to perform assurance engagements on a wide range of subject matters. Some subject matters may require specialized skills and knowledge beyond those ordinarily possessed by an individual practitioner. As noted in paragraph 17 (a), a practitioner does not accept an engagement if preliminary knowledge of the engagement circumstances indicates that ethical requirements regarding professional competence will not be satisfied. In some cases this requirement can be satisfied by the practitioner using the work of persons from other professional disciplines, referred to as experts. In such cases, the practitioner is satisfied that those persons carrying out the engagement collectively possess the requisite skills and knowledge, and that the practitioner has an adequate level of involvement in the engagement and understanding of the work for which any expert is used.

Responsible Party

25. The responsible party is the person (or persons) who:

    (a) In a direct reporting engagement, is responsible for the subject matter; or

    (b) In an assertion-based engagement, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter. An example of when the responsible party is responsible for both the subject matter information and the subject matter, is when an entity engages a practitioner to perform an assurance engagement regarding a report it has prepared about its own sustainability practices. An example of when the responsible party is responsible for the subject matter information but not the subject matter, is when a government organization engages a practitioner to perform an assurance engagement regarding a report about a private company's sustainability practices that the organization has prepared and is to distribute to intended users.

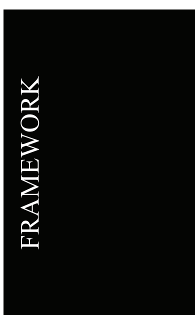
The responsible party may or may not be the party who engages the practitioner (the engaging party).

26. The responsible party ordinarily provides the practitioner with a written representation that evaluates or measures the subject matter against the identified criteria, whether or not it is to be made available as an assertion to the intended users. In a direct reporting engagement, the practitioner may not be able to obtain such a representation when the engaging party is different from the responsible party.

Intended Users

27. The intended users are the person, persons or class of persons for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.

28. Whenever practical, the assurance report is addressed to all the intended users, but in some cases there may be other intended users. The practitioner may not be able to identify all those who will read the assurance report, particularly where there is a large number of people who have access to it. In such cases, particularly where possible readers are likely to have a broad range of interests in the subject matter, intended users may be limited to major stakeholders with significant and common interests. Intended users may be identified in different ways, for example, by agreement between the practitioner and the responsible party or engaging party, or by law.



29. Whenever practical, intended users or their representatives are involved with the practitioner and the responsible party (and the engaging party if different) in determining the requirements of the engagement. Regardless of the involvement of others however, and unlike an agreed-upon procedures engagement (which involves reporting findings based upon the procedures, rather than a conclusion):

    (a) The practitioner is responsible for determining the nature, timing and extent of procedures; and

    (b) The practitioner is required to pursue any matter the practitioner becomes aware of that leads the practitioner to question whether a material modification should be made to the subject matter information.

30. In some cases, intended users (for example, bankers and regulators) impose a requirement on, or request the responsible party (or the engaging party if different) to arrange for, an assurance engagement to be performed for a specific purpose. When engagements are designed for specified intended users or a specific purpose, the practitioner considers including a restriction in the assurance report that limits its use to those users or that purpose.

Subject Matter

31. The subject matter, and subject matter information, of an assurance engagement can take many forms, such as:

    - Financial performance or conditions (for example, historical or prospective financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in financial statements.
    - Non-financial performance or conditions (for example, performance of an entity) for which the subject matter information may be key indicators of efficiency and effectiveness.
    - Physical characteristics (for example, capacity of a facility) for which the subject matter information may be a specifications document.
    - Systems and processes (for example, an entity's internal control or IT system) for which the subject matter information may be an assertion about effectiveness.
    - Behavior (for example, corporate governance, compliance with regulation, human resource practices) for which the subject matter information may be a statement of compliance or a statement of effectiveness.

32. Subject matters have different characteristics, including the degree to which information about them is qualitative versus quantitative, objective versus subjective, historical versus prospective, and relates to a point in time or covers a period. Such characteristics affect the:

    (a) Precision with which the subject matter can be evaluated or measured against criteria; and

    (b) The persuasiveness of available evidence.

    The assurance report notes characteristics of particular relevance to the intended users.

33. An appropriate subject matter is:

    (a) Identifiable, and capable of consistent evaluation or measurement against the identified criteria; and

    (b) Such that the information about it can be subjected to procedures for gathering sufficient appropriate evidence to support a reasonable assurance or limited assurance conclusion, as appropriate.

Criteria

34. Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria

can be formal, for example in the preparation of financial statements, the criteria may be International Financial Reporting Standards or International Public Sector Accounting Standards; when reporting on internal control, the criteria may be an established internal control framework or individual control objectives specifically designed for the engagement; and when reporting on compliance, the criteria may be the applicable law, regulation or contract. Examples of less formal criteria are an internally developed code of conduct or an agreed level of performance (such as the number of times a particular committee is expected to meet in a year).

35. Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding. Suitable criteria are context-sensitive, that is, relevant to the engagement circumstances. Even for the same subject matter there can be different criteria. For example, one responsible party might select the number of customer complaints resolved to the acknowledged satisfaction of the customer for the subject matter of customer satisfaction; another responsible party might select the number of repeat purchases in the three months following the initial purchase.

36. Suitable criteria exhibit the following characteristics:

    (a) Relevance: relevant criteria contribute to conclusions that assist decision-making by the intended users.

    (b) Completeness: criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure.

    (c) Reliability: reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners.

    (d) Neutrality: neutral criteria contribute to conclusions that are free from bias.

    (e) Understandability: understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

    The evaluation or measurement of a subject matter on the basis of the practitioner's own expectations, judgments and individual experience would not constitute suitable criteria.

37. The practitioner assesses the suitability of criteria for a particular engagement by considering whether they reflect the above characteristics. The relative

importance of each characteristic to a particular engagement is a matter of judgment. Criteria can either be established or specifically developed. Established criteria are those embodied in laws or regulations, or issued by authorized or recognized bodies of experts that follow a transparent due process. Specifically developed criteria are those designed for the purpose of the engagement. Whether criteria are established or specifically developed affects the work that the practitioner carries out to assess their suitability for a particular engagement.

38. Criteria need to be available to the intended users to allow them to understand how the subject matter has been evaluated or measured. Criteria are made available to the intended users in one or more of the following ways:

(a) Publicly.

(b) Through inclusion in a clear manner in the presentation of the subject matter information.

(c) Through inclusion in a clear manner in the assurance report.

(d) By general understanding, for example the criterion for measuring time in hours and minutes.

Criteria may also be available only to specific intended users, for example the terms of a contract, or criteria issued by an industry association that are available only to those in the industry. When identified criteria are available only to specific intended users, or are relevant only to a specific purpose, use of the assurance report is restricted to those users or for that purpose.[8]

Evidence

39. The practitioner plans and performs an assurance engagement with an attitude of professional skepticism to obtain sufficient appropriate evidence about whether the subject matter information is free of material misstatement. The practitioner considers materiality, assurance engagement risk, and the quantity and quality of available evidence when planning and performing the engagement, in particular when determining the nature, timing and extent of evidence-gathering procedures.

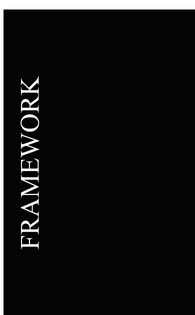
Professional Skepticism

40. The practitioner plans and performs an assurance engagement with an attitude of professional skepticism recognizing that circumstances may exist that cause

8 While an assurance report may be restricted whenever it is intended only for specified intended users or for a specific purpose, the absence of a restriction regarding a particular reader or purpose, does not itself indicate that a legal responsibility is owed by the practitioner in relation to that reader or for that purpose. Whether a legal responsibility is owed will depend on the circumstances of each case and the relevant jurisdiction.

the subject matter information to be materially misstated. An attitude of professional skepticism means the practitioner makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party. For example, an attitude of professional skepticism is necessary throughout the engagement process for the practitioner to reduce the risk of overlooking suspicious circumstances, of over generalizing when drawing conclusions from observations, and of using faulty assumptions in determining the nature, timing and extent of evidence gathering procedures and evaluating the results thereof.

41. An assurance engagement rarely involves the authentication of documentation, nor is the practitioner trained as or expected to be an expert in such authentication. However, the practitioner considers the reliability of the information to be used as evidence, for example photocopies, facsimiles, filmed, digitized or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.



Sufficiency and Appropriateness of Evidence

42. Sufficiency is the measure of the quantity of evidence. Appropriateness is the measure of the quality of evidence; that is, its relevance and its reliability. The quantity of evidence needed is affected by the risk of the subject matter information being materially misstated (the greater the risk, the more evidence is likely to be required) and also by the quality of such evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of evidence are interrelated. However, merely obtaining more evidence may not compensate for its poor quality.

43. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of evidence can be made; however, such generalizations are subject to important exceptions. Even when evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained. For example, evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of evidence may be useful:

- Evidence is more reliable when it is obtained from independent sources outside the entity.
- Evidence that is generated internally is more reliable when the related controls are effective.
- Evidence obtained directly by the practitioner (for example, observation of the application of a control) is more reliable than evidence obtained

indirectly or by inference (for example, inquiry about the application of a control).

- Evidence is more reliable when it exists in documentary form, whether paper, electronic, or other media (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of what was discussed).
- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles.

44. The practitioner ordinarily obtains more assurance from consistent evidence obtained from different sources or of a different nature than from items of evidence considered individually. In addition, obtaining evidence from different sources or of a different nature may indicate that an individual item of evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance the practitioner obtains from a representation from the responsible party. Conversely, when evidence obtained from one source is inconsistent with that obtained from another, the practitioner determines what additional evidence-gathering procedures are necessary to resolve the inconsistency.

45. In terms of obtaining sufficient appropriate evidence, it is generally more difficult to obtain assurance about subject matter information covering a period than about subject matter information at a point in time. In addition, conclusions provided on processes ordinarily are limited to the period covered by the engagement; the practitioner provides no conclusion about whether the process will continue to function in the specified manner in the future.

46. The practitioner considers the relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an evidence-gathering procedure for which there is no alternative. The practitioner uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of evidence, and thus its sufficiency and appropriateness, to support the assurance report.

Materiality

47. Materiality is relevant when the practitioner determines the nature, timing and extent of evidence-gathering procedures, and when assessing whether the subject matter information is free of misstatement. When considering materiality, the practitioner understands and assesses what factors might influence the decisions of the intended users. For example, when the identified criteria allow for variations in the presentation of the subject matter information, the practitioner considers how the adopted presentation might influence the decisions of the intended users. Materiality is considered in the context of quantitative and qualitative factors, such as relative magnitude, the

nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users. The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular engagement are matters for the practitioner's judgment.

Assurance Engagement Risk

48. Assurance engagement risk is the risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.[9] In a reasonable assurance engagement, the practitioner reduces assurance engagement risk to an acceptably low level in the circumstances of the engagement to obtain reasonable assurance as the basis for a positive form of expression of the practitioner's conclusion. The level of assurance engagement risk is higher in a limited assurance engagement than in a reasonable assurance engagement because of the different nature, timing or extent of evidence-gathering procedures. However in a limited assurance engagement, the combination of the nature, timing and extent of evidence-gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance as the basis for a negative form of expression. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

49. In general, assurance engagement risk can be represented by the following components, although not all of these components will necessarily be present or significant for all assurance engagements:

    (a) The risk that the subject matter information is materially misstated, which in turn consists of:

        (i) Inherent risk: the susceptibility of the subject matter information to a material misstatement, assuming that there are no related controls; and

        (ii) Control risk: the risk that a material misstatement that could occur will not be prevented, or detected and corrected, on a timely basis by related internal controls. When control risk is relevant to the subject matter, some control risk will always

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[9] (a) This includes the risk, in those direct reporting engagements where the subject matter information is presented only in the practitioner's conclusion, that the practitioner inappropriately concludes that the subject matter does, in all material respects, conform with the criteria, for example: "In our opinion, internal control is effective, in all material respects, based on *XYZ criteria.*"

(b) In addition to assurance engagement risk, the practitioner is exposed to the risk of expressing an inappropriate conclusion when the subject matter information is not materially misstated, and risks through loss from litigation, adverse publicity, or other events arising in connection with a subject matter reported on. These risks are not part of assurance engagement risk.

exist because of the inherent limitations of the design and operation of internal control; and

(b) Detection risk: the risk that the practitioner will not detect a material misstatement that exists.

The degree to which the practitioner considers each of these components is affected by the engagement circumstances, in particular by the nature of the subject matter and whether a reasonable assurance or a limited assurance engagement is being performed.

Nature, Timing and Extent of Evidence-gathering Procedures

50. The exact nature, timing and extent of evidence-gathering procedures will vary from one engagement to the next. In theory, infinite variations in evidence-gathering procedures are possible. In practice, however, these are difficult to communicate clearly and unambiguously. The practitioner attempts to communicate them clearly and unambiguously and uses the form appropriate to a reasonable assurance engagement or a limited assurance engagement.[10]

51. "Reasonable assurance" is a concept relating to accumulating evidence necessary for the practitioner to conclude in relation to the subject matter information taken as a whole. To be in a position to express a conclusion in the positive form required in a reasonable assurance engagement, it is necessary for the practitioner to obtain sufficient appropriate evidence as part of an iterative, systematic engagement process involving:

(a) Obtaining an understanding of the subject matter and other engagement circumstances which, depending on the subject matter, includes obtaining an understanding of internal control;

(b) Based on that understanding, assessing the risks that the subject matter information may be materially misstated;

(c) Responding to assessed risks, including developing overall responses, and determining the nature, timing and extent of further procedures;

(d) Performing further procedures clearly linked to the identified risks, using a combination of inspection, observation, confirmation, re-calculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures including, where applicable, obtaining corroborating information from sources independent of the responsible party, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and

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[10] Where the subject matter information is made up of a number of aspects, separate conclusions may be provided on each aspect. While not all such conclusions need to relate to the same level of evidence-gathering procedures, each conclusion is expressed in the form that is appropriate to either a reasonable assurance or a limited assurance engagement.

(e) Evaluating the sufficiency and appropriateness of evidence.

52. "Reasonable assurance" is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- The use of selective testing.
- The inherent limitations of internal control.
- The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
- The use of judgment in gathering and evaluating evidence and forming conclusions based on that evidence.
- In some cases, the characteristics of the subject matter when evaluated or measured against the identified criteria.

53. Both reasonable assurance and limited assurance engagements require the application of assurance skills and techniques and the gathering of sufficient appropriate evidence as part of an iterative, systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances. The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance engagement are, however, deliberately limited relative to a reasonable assurance engagement. For some subject matters, there may be specific pronouncements to provide guidance on procedures for gathering sufficient appropriate evidence for a limited assurance engagement. For example, ISRE 2400, "Engagements to Review Financial Statements" establishes that sufficient appropriate evidence for reviews of financial statements is obtained primarily through analytical procedures and inquiries. In the absence of a relevant pronouncement, the procedures for gathering sufficient appropriate evidence will vary with the circumstances of the engagement, in particular, the subject matter, and the needs of the intended users and the engaging party, including relevant time and cost constraints. For both reasonable assurance and limited assurance engagements, if the practitioner becomes aware of a matter that leads the practitioner to question whether a material modification should be made to the subject matter information, the practitioner pursues the matter by performing other procedures sufficient to enable the practitioner to report.

Quantity and Quality of Available Evidence

54. The quantity or quality of available evidence is affected by:

(a) The characteristics of the subject matter and subject matter information. For example, less objective evidence might be expected when information about the subject matter is future oriented rather than historical (see paragraph 32); and

(b) Circumstances of the engagement other than the characteristics of the subject matter, when evidence that could reasonably be expected to exist is not available because of, for example, the timing of the practitioner's appointment, an entity's document retention policy, or a restriction imposed by the responsible party.

Ordinarily, available evidence will be persuasive rather than conclusive.

55. An unqualified conclusion is not appropriate for either type of assurance engagement in the case of a material limitation on the scope of the practitioner's work, that is, when:

    (a) Circumstances prevent the practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level; or

    (b) The responsible party or the engaging party imposes a restriction that prevents the practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level.

Assurance Report

56. The practitioner provides a written report containing a conclusion that conveys the assurance obtained about the subject matter information. ISAs, ISREs and ISAEs establish basic elements for assurance reports. In addition, the practitioner considers other reporting responsibilities, including communicating with those charged with governance when it is appropriate to do so.

57. In an assertion-based engagement, the practitioner's conclusion can be worded either:

    (a) In terms of the responsible party's assertion (for example: "In our opinion *the responsible party's* assertion that internal control is effective, in all material respects, based on *XYZ criteria,* is fairly stated"); or

    (b) Directly in terms of the subject matter and the criteria (for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*").

    In a direct reporting engagement, the practitioner's conclusion is worded directly in terms of the subject matter and the criteria.

58. In a reasonable assurance engagement, the practitioner expresses the conclusion in the positive form, for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*." This form of expression conveys "reasonable assurance." Having performed evidence-gathering procedures of a nature, timing and extent that were reasonable given the characteristics of the subject matter and other relevant engagement circumstances described in the

assurance report, the practitioner has obtained sufficient appropriate evidence to reduce assurance engagement risk to an acceptably low level.

59. In a limited assurance engagement, the practitioner expresses the conclusion in the negative form, for example, "Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on *XYZ criteria*." This form of expression conveys a level of "limited assurance" that is proportional to the level of the practitioner's evidence-gathering procedures given the characteristics of the subject matter and other engagement circumstances described in the assurance report.

60. A practitioner does not express an unqualified conclusion for either type of assurance engagement when the following circumstances exist and, in the practitioner's judgment, the effect of the matter is or may be material:

(a) There is a limitation on the scope of the practitioner's work (see paragraph 55). The practitioner expresses a qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the limitation is. In some cases the practitioner considers withdrawing from the engagement.

(b) In those cases where:

(i) The practitioner's conclusion is worded in terms of the responsible party's assertion, and that assertion is not fairly stated, in all material respects; or

(ii) The practitioner's conclusion is worded directly in terms of the subject matter and the criteria, and the subject matter information is materially misstated,[11]

the practitioner expresses a qualified or adverse conclusion depending on how material or pervasive the matter is.

(c) When it is discovered after the engagement has been accepted, that the criteria are unsuitable or the subject matter is not appropriate for an assurance engagement. The practitioner expresses:

(i) A qualified conclusion or adverse conclusion depending on how material or pervasive the matter is, when the unsuitable criteria or inappropriate subject matter is likely to mislead the intended users; or

[11] In those direct reporting engagements where the subject matter information is presented only in the practitioner's conclusion, and the practitioner concludes that the subject matter does not, in all material respects, conform with the criteria, for example: "In our opinion, except for *[...]*, internal control is effective, in all material respects, based on *XYZ criteria,*" such a conclusion would also be considered to be qualified (or adverse as appropriate).

(ii) A qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the matter is, in other cases.

In some cases the practitioner considers withdrawing from the engagement.

Inappropriate Use of the Practitioner's Name

61. A practitioner is associated with a subject matter when the practitioner reports on information about that subject matter or consents to the use of the practitioner's name in a professional connection with that subject matter. If the practitioner is not associated in this manner, third parties can assume no responsibility of the practitioner. If the practitioner learns that a party is inappropriately using the practitioner's name in association with a subject matter, the practitioner requires the party to cease doing so. The practitioner also considers what other steps may be needed, such as informing any known third party users of the inappropriate use of the practitioner's name or seeking legal advice.

Public Sector Perspective

1. *This Framework is relevant to all professional accountants in the public sector who are independent of the entity for which they perform assurance engagements. Where professional accountants in the public sector are not independent of the entity for which they perform an assurance engagement, the guidance in footnote 1 should be adopted.*

Appendix

Differences Between Reasonable Assurance Engagements and Limited Assurance Engagements

This Appendix outlines the differences between a reasonable assurance engagement and a limited assurance engagement discussed in the Framework (see in particular the referenced paragraphs).

Type of engagement	Objective	Evidence-gathering procedures[12]	The assurance report
Reasonable assurance engagement	A reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement, as the basis for a positive form of expression of the practitioner's conclusion (Paragraph 11)	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: • Obtaining an understanding of the engagement circumstances; • Assessing risks; • Responding to assessed risks; • Performing further procedures using a combination of inspection, observation, confirmation, re-calculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive	Description of the engagement circumstances, and a positive form of expression of the conclusion (Paragraph 58)

12 A detailed discussion of evidence-gathering requirements is only possible within ISAEs for specific subject matters.

Type of engagement	Objective	Evidence-gathering procedures[12]	The assurance report
		procedures, including , where applicable, obtaining corroborating information, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and • Evaluating the evidence obtained (Paragraphs 51 and 52)	
Limited assurance engagement	A reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion (Paragraph 11)	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to a reasonable assurance engagement (Paragraph 53)	Description of the engagement circumstances, and a negative form of expression of the conclusion (Paragraph 59)

INTERNATIONAL STANDARD ON AUDITING 200

OBJECTIVE AND GENERAL PRINCIPLES GOVERNING AN AUDIT OF FINANCIAL STATEMENTS

(Effective for audits of financial statements for periods beginning on or after June 15, 2006)*

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* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks" and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 200. These amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 200.

ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" gave rise to conforming amendments to ISA 200. The amendments have been incorporated in the text of ISA 200. Implementation of the final sentence of paragraph 3 and paragraphs 37-48 of the amended ISA 200 has been deferred until such time as ISA 800 (Revised and Redrafted), "Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" becomes effective. The remainder of the amended ISA 200 is effective for audits of financial statements for periods beginning on or after December 15, 2005.

ISA 230, "Audit Documentation" gave rise to conforming amendments to ISA 200. These amendments are effective for audits of financial statements for periods beginning on or after June 15, 2006 and have been incorporated in the text of ISA 200.

International Standard on Auditing (ISA) 200, "Objective and General Principles Governing an Audit of Financial Statements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" which sets out the application and authority of ISAs.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements. It also describes management's responsibility for the preparation and presentation of the financial statements and for identifying the financial reporting framework to be used in preparing the financial statements, referred to in the ISAs as the "applicable financial reporting framework."

Objective of an Audit of Financial Statements

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

3. An audit of financial statements is an assurance engagement, as defined in the International Framework for Assurance Engagements. The Framework defines and describes the elements and objectives of an assurance engagement. The ISAs apply the Framework in the context of an audit of financial statements and contain the basic principles and essential procedures, together with related guidance, to be applied in such an audit. Paragraphs 34-35 in this ISA discuss the meaning of the term "financial statements" and management's responsibility for such statements. As discussed in the Framework, a condition for acceptance of an assurance engagement is that the criteria referred to in the definition are "suitable criteria" and available to intended users. Paragraphs 37-48 in this ISA discuss suitable criteria and their availability to intended users for an audit of financial statements through the auditor's consideration of the acceptability of the financial reporting framework.[1]

Ethical Requirements Relating to an Audit of Financial Statements

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

5. As discussed in ISA 220, "Quality Control for Audits of Historical Financial Information," ethical requirements relating to audits of financial statements ordinarily comprise Parts A and B of the International Federation of Accountants' *Code of Ethics for Professional Accountants* (the IFAC Code) together with national requirements that are more restrictive. ISA 220 identifies the fundamental principles of professional ethics established by Parts A and B of

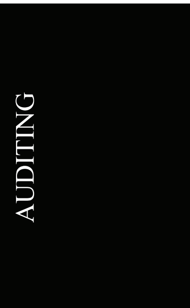
[1] Implementation of the final sentence of paragraph 3 has been deferred until such time as ISA 800 (Revised and Redrafted), "Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" becomes effective.

the IFAC Code and sets out the engagement partner's responsibilities with respect to ethical requirements. ISA 220 recognizes that the engagement team is entitled to rely on a firm's systems in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement (for example, in relation to capabilities and competence of personnel through their recruitment and formal training; independence through the accumulation and communication of relevant independence information; maintenance of client relationships through acceptance and continuance systems; and adherence to regulatory and legal requirements through the monitoring process), unless information provided by the firm or other parties suggests otherwise. Accordingly, International Standard on Quality Control (ISQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements," requires the firm to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

Conduct of an Audit of Financial Statements

6. **The auditor should conduct an audit in accordance with International Standards on Auditing.**

7. ISAs contain basic principles and essential procedures 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 explanatory and other material that provide guidance for their application. The text of a whole Standard is considered in order to understand and apply the basic principles and essential procedures.



8. In conducting an audit in accordance with ISAs, the auditor is also aware of and considers International Auditing Practice Statements (IAPSs) applicable to the audit engagement. IAPSs provide interpretive guidance and practical assistance to auditors in implementing ISAs. An auditor who does not apply the guidance included in a relevant IAPS needs to be prepared to explain how the basic principles and essential procedures in the Standard addressed by the IAPS have been complied with.

9. The auditor may also conduct the audit in accordance with both ISAs and auditing standards of a specific jurisdiction or country.

Scope of an Audit of Financial Statements

10. The term "scope of an audit" refers to the audit procedures that, in the auditor's judgment and based on the ISAs, are deemed appropriate in the circumstances to achieve the objective of the audit.

11. **In determining the audit procedures to be performed in conducting an audit in accordance with International Standards on Auditing, the auditor**

should comply with each of the International Standards on Auditing relevant to the audit.

12. In performing an audit, auditors may be required to comply with other professional, legal or regulatory requirements in addition to the ISAs. The ISAs do not override the local laws and regulations that govern an audit of financial statements. In the event that those laws and regulations differ from the ISAs, an audit conducted in accordance with the local laws and regulations will not automatically comply with ISAs.

13. When the auditor conducts the audit in accordance with ISAs and auditing standards of a specific jurisdiction or country, in addition to complying with each of the ISAs relevant to the audit, the auditor also performs any additional audit procedures necessary to comply with the relevant standards of that jurisdiction or country.

14. **The auditor should not represent compliance with International Standards on Auditing unless the auditor has complied fully with all of the International Standards on Auditing relevant to the audit.** The auditor may, in exceptional circumstances, judge it necessary to depart from a basic principle or an essential procedure that is relevant in the circumstances of the audit, in order to achieve the objective of the audit. In such a case, the auditor is not precluded from representing compliance with ISAs, provided the departure is appropriately documented as required by ISA 230, "Audit Documentation."

Professional Skepticism

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

16. An attitude of professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. For example, an attitude of professional skepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking unusual circumstances, of over generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof. When making inquiries and performing other audit procedures, the auditor is not satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Reasonable Assurance

17. An auditor conducting an audit in accordance with ISAs obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process.

18. An auditor cannot obtain absolute assurance because there are inherent limitations in an audit that affect the auditor's ability to detect material misstatements. These limitations result from factors such as the following:
    - The use of testing.
    - The inherent limitations of internal control (for example, the possibility of management override or collusion).
    - The fact that most audit evidence is persuasive rather than conclusive.

19. Also, the work undertaken by the auditor to form an audit opinion is permeated by judgment, in particular regarding:

    (a) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures; and

    (b) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

20. Further, other limitations may affect the persuasiveness of audit evidence available to draw conclusions on particular assertions[2] (for example, transactions between related parties). In these cases certain ISAs identify specified audit procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:

    (a) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or

    (b) Any indication that a material misstatement has occurred.

21. Accordingly, because of the factors described above, an audit is not a guarantee that the financial statements are free from material misstatement, because absolute assurance is not attainable. Further, an audit opinion does not assure the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

AUDITING

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[2] Paragraphs 15-18 of ISA 500, "Audit Evidence" discuss the use of assertions in obtaining audit evidence.

Audit Risk and Materiality

22. Entities pursue strategies to achieve their objectives, and depending on the nature of their operations and industry, the regulatory environment in which they operate, and their size and complexity, they face a variety of business risks.[3] Management is responsible for identifying such risks and responding to them. However, not all risks relate to the preparation of the financial statements. The auditor is ultimately concerned only with risks that may affect the financial statements.

23. The auditor obtains and evaluates audit evidence to obtain reasonable assurance about whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. The concept of reasonable assurance acknowledges that there is a risk the audit opinion is inappropriate. The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated is known as "audit risk."[4]

24. **The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.** The auditor reduces audit risk by designing and performing audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

25. Audit risk is a function of the risk of material misstatement of the financial statements (or simply, the "risk of material misstatement") (i.e., the risk that the financial statements are materially misstated prior to audit) and the risk that the auditor will not detect such misstatement ("detection risk"). The auditor performs audit procedures to assess the risk of material misstatement and seeks to limit detection risk by performing further audit procedures based on that assessment (see ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks"). The audit process involves the exercise of professional judgment in designing the audit approach, through focusing on what can go wrong (i.e., what are the potential misstatements that may arise) at the assertion level (see ISA 500, "Audit Evidence") and performing audit procedures in response to the assessed risks in order to obtain sufficient appropriate audit evidence.

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[3] Paragraphs 30-34 of ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" discuss the concept of business risks and how they relate to risks of material misstatement.

[4] This definition of audit risk does not include the risk that the auditor might erroneously express an opinion that the financial statements are materially misstated.

26. The auditor is concerned with material misstatements, and is not responsible for the detection of misstatements that are not material to the financial statements taken as a whole. The auditor considers whether the effect of identified uncorrected misstatements, both individually and in the aggregate, is material to the financial statements taken as a whole. Materiality and audit risk are related (see ISA 320, "Audit Materiality"). In order to design audit procedures to determine whether there are misstatements that are material to the financial statements taken as a whole, the auditor considers the risk of material misstatement at two levels: the overall financial statement level and in relation to classes of transactions, account balances, and disclosures and the related assertions.[5]

27. The auditor considers the risk of material misstatement at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature often relate to the entity's control environment (although these risks may also relate to other factors, such as declining economic conditions), and are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, this overall risk represents circumstances that increase the risk that there could be material misstatements in any number of different assertions, for example, through management override of internal control. Such risks may be especially relevant to the auditor's consideration of the risk of material misstatement arising from fraud. The auditor's response to the assessed risk of material misstatement at the overall financial statement level includes consideration of the knowledge, skill, and ability of personnel assigned significant engagement responsibilities, including whether to involve experts; the appropriate levels of supervision; and whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

28. The auditor also considers the risk of material misstatement at the class of transactions, account balance, and disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level.[6] The auditor seeks to obtain sufficient appropriate audit evidence at the class of transactions, account balance, and disclosure level in such a way that enables the auditor, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an

[5] ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" provides additional guidance on the auditor's requirement to assess risks of material misstatement at the financial statement level and at the assertion level.

[6] ISA 330, "The Auditor's Procedures in Response to Assessed Risks" provides additional guidance on the requirement for the auditor to design and perform further audit procedures in response to the assessed risks at the assertion level.

acceptably low level of audit risk. Auditors use various approaches to accomplish that objective.[7]

29. The discussion in the following paragraphs provides an explanation of the components of audit risk. The risk of material misstatement at the assertion level consists of two components as follows:

    - "Inherent risk" is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Accounts consisting of amounts derived from accounting estimates that are subject to significant measurement uncertainty pose greater risks than do accounts consisting of relatively routine, factual data. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. In addition to those circumstances that are peculiar to a specific assertion, factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may influence the inherent risk related to a specific assertion. These latter factors include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.
    - "Control risk" is the risk that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.

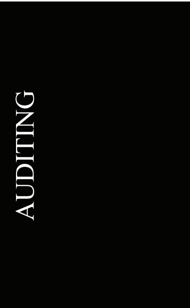
30. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements. The auditor is required to assess the risk of material misstatement at the assertion level as a basis for further audit procedures, though that assessment is a judgment, rather than a precise measurement of risk. When the auditor's assessment of the risk of material

[7] The auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an appropriate level of detection risk. Some auditors find such a model to be useful when planning audit procedures to achieve a desired audit risk though the use of such a model does not eliminate the judgment inherent in the audit process.

misstatement includes an expectation of the operating effectiveness of controls, the auditor performs tests of controls to support the risk assessment. The ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risk of material misstatement." Although the ISAs ordinarily describe a combined assessment of the risk of material misstatement, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risk of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

31. "Detection risk" is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor usually does not examine all of a class of transactions, account balance, or disclosure and because of other factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors ordinarily can be addressed through adequate planning, proper assignment of personnel to the engagement team, the application of professional skepticism, and supervision and review of the audit work performed.

32. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level. The greater the risk of material misstatement the auditor believes exists, the less the detection risk that can be accepted. Conversely, the less risk of material misstatement the auditor believes exist, the greater the detection risk that can be accepted.



Responsibility for the Financial Statements

33. While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework is that of the management[8] of the entity, with oversight from those

[8] The term "management" has been used in this ISA to describe those responsible for the preparation and presentation of the financial statements. Other terms may be appropriate depending on the legal framework in the particular jurisdiction.

charged with governance.[9] The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

34. The term "financial statements" refers to a structured representation of the financial information, which ordinarily includes accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The term can refer to a complete set of financial statements, but it can also refer to a single financial statement, for example, a balance sheet, or a statement of revenues and expenses, and related explanatory notes.

35. The requirements of the financial reporting framework determine the form and content of the financial statements and what constitutes a complete set of financial statements. For certain financial reporting frameworks, a single financial statement such as a cash flow statement and the related explanatory notes constitutes a complete set of financial statements. For example, the International Public Sector Accounting Standard (IPSAS), "Financial Reporting Under the Cash Basis of Accounting," states that the primary financial statement is a statement of cash receipts and payments when a public sector entity prepares and presents its financial statements in accordance with that IPSAS. Financial statements prepared by reference to International Financial Reporting Standards (IFRSs), on the other hand, are intended to provide information about the financial position, performance and cash flows of an entity. A complete set of financial statements under IFRSs includes a balance sheet; an income statement; a statement of changes in equity; a cash flow statement; and notes, comprising a summary of significant accounting policies and other explanatory notes.

36. Management is responsible for identifying the financial reporting framework to be used in the preparation and presentation of the financial statements. Management is also responsible for preparing and presenting the financial statements in accordance with that applicable financial reporting framework. This responsibility includes:

- Designing, implementing and maintaining internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error;
- Selecting and applying appropriate accounting policies; and
- Making accounting estimates that are reasonable in the circumstances.

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9 The structures of governance vary from country to country, reflecting cultural and legal backgrounds. Therefore, the respective responsibilities of management and those charged with governance vary depending on the legal responsibilities in the particular jurisdiction.

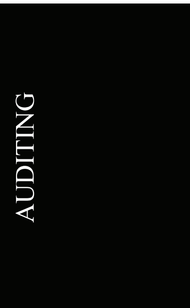
Determining the Acceptability of the Financial Reporting Framework[10]

37. **The auditor should determine whether the financial reporting framework adopted by management in preparing the financial statements is acceptable.** The auditor ordinarily makes this determination when considering whether to accept the audit engagement, as discussed in ISA 210, "Terms of Audit Engagements." An acceptable financial reporting framework is referred to in the ISAs as the "applicable financial reporting framework."

38. The auditor determines whether the financial reporting framework adopted by management is acceptable in view of the nature of the entity (for example, whether it is a business enterprise, a public sector entity or a not for profit organization) and the objective of the financial statements.

Financial Statements Designed to Meet the Financial Information Needs of Specific Users

39. In some cases, the objective of the financial statements will be to meet the financial information needs of specific users. The information needs of such users will determine the applicable financial reporting framework in these circumstances. Examples of financial reporting frameworks that address the needs of specific users are: a tax basis of accounting for a set of financial statements that accompany an entity's tax return; the financial reporting provisions of a government regulatory agency for a set of financial statements to meet the information needs of that agency; or a financial reporting framework established by the provisions of an agreement specifying the financial statements to be prepared. Financial statements prepared in accordance with such financial reporting frameworks may be the only financial statements prepared by an entity and, in such circumstances, are often used by users in addition to those for whom the financial reporting framework is designed. Despite the broad distribution of the financial statements in those circumstances, the financial statements are still considered to be designed to meet the financial information needs of specific users for purposes of the ISAs. ISA 800, "The Independent Auditor's Report on Special Purpose Audit Engagements" establishes standards and provides guidance on financial statements whose objective is to meet the financial information needs of specific users. Although specific users may not be identified, financial statements that are prepared in accordance with a framework that is not designed to achieve fair presentation are also addressed in ISA 800.



[10] Implementation of paragraphs 37-48 has been deferred until such time as ISA 800 (Revised and Redrafted), "Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" becomes effective.

Financial Statements Designed to Meet the Common Financial Information Needs of a Wide Range of Users

40. Many users of financial statements are not in a position to demand financial statements tailored to meet their specific information needs. While all the information needs of specific users cannot be met, there are financial information needs that are common to a wide range of users. Financial statements prepared in accordance with a financial reporting framework that is designed to meet the common information needs of a wide range of users are referred to as "general purpose financial statements."

Financial Reporting Frameworks Established by Authorized or Recognized Organizations

41. At present, there is no objective and authoritative basis that has been generally recognized globally for judging the acceptability of financial reporting frameworks that have been designed for general purpose financial statements. Until such a basis exists, financial reporting frameworks established by organizations that are authorized or recognized to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders Examples of such financial reporting frameworks include:

- IFRSs promulgated by the International Accounting Standards Board;
- IPSASs promulgated by the International Federation of Accountants – International Public Sector Accounting Standards Board; and
- Generally accepted accounting principles promulgated by a recognized standards setter in a particular jurisdiction.

These financial reporting frameworks are often identified as the applicable financial reporting framework in legislative and regulatory requirements governing the preparation of general purpose financial statements. Refer to ISA 800 for financial reporting frameworks designed to meet the particular needs of a government regulatory agency.

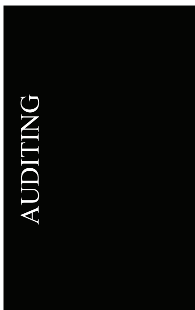
Financial Reporting Frameworks Supplemented with Legislative and Regulatory Requirements

42. In some jurisdictions, legislative and regulatory requirements may supplement a financial reporting framework adopted by management with additional requirements relating to the preparation and presentation of financial statements. In these jurisdictions, the applicable financial reporting framework, for the purposes of applying the ISAs, encompasses both the identified financial reporting framework and such additional requirements, provided they do not conflict with the applicable financial reporting framework. This may, for

example, be the case when additional requirements prescribe disclosures in addition to those required by the identified financial reporting framework or when they narrow the range of acceptable choices that can be made within the identified financial reporting framework. If the additional requirements conflict with the applicable financial reporting framework, the auditor discusses the nature of the requirements with management and whether the additional requirements can be met through additional disclosures. If this is not possible, the auditor considers whether it is necessary to modify the auditor's report, see ISA 701, "Modifications to the Independent Auditor's Report."

Jurisdictions that Do Not have an Authorized or Recognized Standards Setting Organization

43. When an entity is registered or operating in a jurisdiction that does not have an authorized or recognized standards setting organization, the entity identifies an applicable financial reporting framework. Practice in such jurisdictions is often to use a financial reporting framework established by one of the organizations described in paragraph 41. Alternatively, there may be established accounting conventions in a particular jurisdiction that are generally recognized as the applicable financial reporting framework for the general purpose financial statements prepared by certain specified entities operating in that jurisdiction. When such a financial reporting framework is adopted by the entity, the auditor determines whether the accounting conventions collectively can be considered to constitute an acceptable financial reporting framework for general purpose financial statements. When the accounting conventions are widely used in a particular jurisdiction, the accounting profession in that jurisdiction may have considered the acceptability of the financial reporting framework on behalf of the auditors. Alternatively, the auditor makes this determination by considering whether the accounting conventions exhibit attributes normally exhibited by acceptable financial reporting frameworks or by comparing the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable.



44. Acceptable financial reporting frameworks for general purpose financial statements normally exhibit the following attributes that result in information provided in financial statements that is useful to users:

    (a) Relevance, in that the information provided in the financial statements is relevant to the nature of the entity and the objective of the financial statements. (For example, in the case of a business enterprise that prepares general purpose financial statements, relevance is assessed in terms of the information necessary to meet the common information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting fairly the financial position, financial performance and cash flows of the business enterprise.)

(b) Completeness, in that transactions and events, account balances and disclosures that could affect the fair presentation of the financial statements are not omitted.

(c) Reliability, in that the information provided in the financial statements:

   (i) Reflects the economic substance of events and transactions and not merely their legal form; and

   (ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances;

(d) Neutrality, in that it contributes to information in the financial statements that is free from bias; and

(e) Understandability, in that the information in the financial statements is clear and comprehensive and not subject to significantly different interpretation.

45. A conglomeration of accounting conventions devised to suit individual preferences is not an acceptable financial reporting framework for financial statements intended to address the common information needs of a wide range of users.

46. The description of the financial reporting framework in the financial statements includes information about the basis of preparation of the financial statements and the accounting policies selected and applied for significant transactions and other significant events.

47. The auditor may decide to compare the accounting conventions to the requirements of an existing framework considered to be acceptable such as, for example, IFRSs promulgated by the International Accounting Standards Board. For an audit of a small entity, the auditor may decide to compare such accounting conventions to a financial reporting framework specifically developed for such entities by an authorized or recognized standards setting organization. When the auditor makes such a comparison and differences are identified, the decision as to whether the accounting conventions adopted by management constitute an acceptable financial reporting framework includes consideration of the reasons for the differences and whether application of the accounting conventions could result in financial statements that are misleading.

48. When the auditor concludes that the financial reporting framework adopted by management is not acceptable, the auditor considers the implications in relation to engagement acceptance (see ISA 210) and the auditor's report (see ISA 701).

Expressing an Opinion on the Financial Statements

49. When the auditor is expressing an opinion on a complete set of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation, the auditor refers to ISA

700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements," for standards and guidance on the matters the auditor considers in forming an opinion on such financial statements and on the form and content of the auditor's report. The auditor also refers to ISA 701 when expressing a modified audit opinion, including an emphasis of matter, a qualified opinion, a disclaimer of opinion or an adverse opinion.

50. The auditor refers to ISA 800 when expressing an opinion on:

    (a) A complete set of financial statements prepared in accordance with an other comprehensive basis of accounting;

    (b) A component of a complete set of general purpose or special purpose financial statements, such as a single financial statement, specified accounts, elements of accounts, or items in a financial statement;

    (c) Compliance with contractual agreements; and

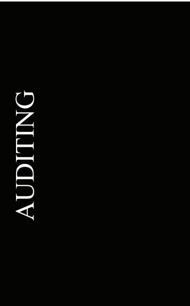
    (d) Summarized financial statements.

51. In addition to addressing reporting considerations, ISA 800 also addresses other matters the auditor considers in such engagements related to, for example, engagement acceptance and the conduct of the audit.

Effective Date

52. This ISA is effective for audits of financial statements for periods beginning on or after June 15, 2006.

Public Sector Perspective



1. *Irrespective of whether an audit is being conducted in the private or public sector, the basic principles of auditing remain the same. What may differ for audits carried out in the public sector is the audit objective and scope. These factors are often attributable to differences in the audit mandate and legal requirements or the form of reporting (for example, public sector entities may be required to prepared additional financial reports).*

2. *When carrying out audits of public sector entities, the auditor will need to take into account the specific requirements of any other relevant regulations, ordinances or ministerial directives which affect the audit mandate and any special auditing requirements, including the need to have regard to issues of national security. Audit mandates may be more specific than those in the private sector, and often encompass a wider ranged of objectives and a broader scope than is ordinarily applicable for the audit of private sector financial statements. The mandates and requirements may also effect, for example, the extent of the auditor's discretion in establishing materiality, in reporting fraud and error, and in the form of the auditor's report. Differences in audit approach and style*

may also exist. However, these differences would not constitute a difference in the basic principles and essential procedures.

INTERNATIONAL STANDARD ON AUDITING 210

TERMS OF AUDIT ENGAGEMENTS

(Effective for audits of financial statements for periods beginning on or after December 15, 2006. Appendix 2 contains conforming amendments to the Standard that become effective at a future date.)*

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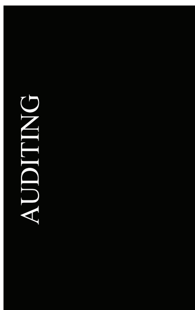
International Standard on Auditing (ISA) 210, "Terms of Audit Engagements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.



* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks" and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 210. These conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 210.

ISRE 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" gave rise to a conforming amendment to ISA 210. This amendment is effective for audits of financial statements for periods beginning on or after December 15, 2006 and has been incorporated in the text of ISA 210.

ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" gave rise to conforming amendments to ISA 210. Implementation of these amendments has been deferred until such time as proposed ISA 800 (Revised and Redrafted), "Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" becomes effective. The amended ISA 210 is set out in Appendix 2 to this ISA.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on:

   (a) Agreeing the terms of the engagement with the client; and

   (b) The auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

2. **The auditor and the client should agree on the terms of the engagement.** The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.

3. This ISA is intended to assist the auditor in the preparation of engagement letters relating to audits of financial statements. The guidance is also applicable to related services. When other services such as tax, accounting, or management advisory services are to be provided, separate letters may be appropriate.

4. In some countries, the objective and scope of an audit and the auditor's obligations are established by law. Even in those situations the auditor may still find audit engagement letters informative for their clients.

Audit Engagement Letters

5. It is in the interest of both client and auditor that the auditor sends an engagement letter, preferably before the commencement of the engagement, to help in avoiding misunderstandings with respect to the engagement. The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports.

Principal Contents

6. The form and content of audit engagement letters may vary for each client, but they would generally include reference to:

   - The objective of the audit of financial statements;
   - Management's responsibility for the financial statements;
   - The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres;
   - The form of any reports or other communication of results of the engagement;
   - The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of internal control, there is an

unavoidable risk that even some material misstatement may remain undiscovered;

- Unrestricted access to whatever records, documentation and other information requested in connection with the audit; and
- Management's responsibility for establishing and maintaining effective internal control.

7. The auditor may also wish to include the following in the letter:
   - Arrangements regarding the planning and performance of the audit.
   - Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
   - Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
   - Description of any other letters or reports the auditor expects to issue to the client.
   - Basis on which fees are computed and any billing arrangements.
8. When relevant, the following points could also be made:
   - Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
   - Arrangements concerning the involvement of internal auditors and other client staff.
   - Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
   - Any restriction of the auditor's liability when such possibility exists.
   - A reference to any further agreements between the auditor and the client.
   - An example of an audit engagement letter is set out in the Appendix.

Audits of Components

9. When the auditor of a parent entity is also the auditor of its subsidiary, branch or division (component), the factors that influence the decision whether to send a separate engagement letter to the component include the following:
   - Who appoints the auditor of the component.
   - Whether a separate auditor's report is to be issued on the component.
   - Legal requirements.
   - The extent of any work performed by other auditors.

- Degree of ownership by parent.
- Degree of independence of the component's management.

Recurring Audits

10. **On recurring audits, the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.**

11. The auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter:
    - Any indication that the client misunderstands the objective and scope of the audit.
    - Any revised or special terms of the engagement.
    - A recent change of senior management or those charged with governance.
    - A significant change in ownership.
    - A significant change in nature or size of the client's business.
    - Legal or regulatory requirements.

Acceptance of a Change in Engagement

12. **An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.**

13. A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement.

14. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of service originally requested would ordinarily be considered a reasonable basis for requesting a change in the engagement. In contrast a change would not be considered reasonable if it appeared that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.

15. Before agreeing to change an audit engagement to a related service, an auditor who was engaged to perform an audit in accordance with ISAs would consider, in addition to the above matters, any legal or contractual implications of the change.

16. If the auditor concludes, that there is reasonable justification to change the engagement and if the audit work performed complies with the ISAs applicable to the changed engagement, the report issued would be that appropriate for the revised terms of engagement. In order to avoid confusing the reader, the report would not include reference to:

    (a) The original engagement; or

    (b) Any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

17. **Where the terms of the engagement are changed, the auditor and the client should agree on the new terms.**

18. **The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.** An example might be an audit engagement where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the client asks for the engagement to be changed to a review engagement to avoid a qualified audit opinion or a disclaimer of opinion.

19. **If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report to other parties, such as those charged with governance or shareholders, the circumstances necessitating the withdrawal.**

Public Sector Perspective

1. *The purpose of the engagement letter is to inform the auditee of the nature of the engagement and to clarify the responsibilities of the parties involved. The legislation and regulations governing the operations of public sector audits generally mandate the appointment of a public sector auditor and the use of audit engagement letters may not be a widespread practice. Nevertheless, a letter setting out the nature of the engagement or recognizing an engagement not indicated in the legislative mandate may be useful to both parties. Public sector auditors have to give serious consideration to issuing audit engagements letters when undertaking an audit.*

2. *Paragraphs 12-19 of this ISA deal with the action a private sector auditor may take when there are attempts to change an audit engagement to one which provides a lower level of assurance. In the public sector specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a minister, the legislature or the*

public if management (including the department head) attempts to limit the scope of the audit.

Appendix 1

Example of an Audit Engagement Letter

The following letter is for use as a guide in conjunction with the considerations outlined in this ISA and will need to be varied according to individual requirements and circumstances.

To the Board of Directors or the appropriate representative of senior management:

You have requested that we audit the balance sheet of .... as of ...., and the related statements of income and cash flows for the year then ending. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be made with the objective of our expressing an opinion on the financial statements.

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

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

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

We remind you that the responsibility for the preparation of financial statements including adequate disclosure is that of the management of the company. This includes the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies, and the safeguarding of the assets of the company. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with our audit. Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

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

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

XYZ & Co.

Acknowledged on behalf of ABC Company by

(signed)
....
Name and Title
Date

Appendix 2

ISA 210 Amended as a Result of ISA 700—Effective Date to be Determined

ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" issued in December 2004 and effective for auditors' reports dated on or after December 31, 2006 gave rise to conforming amendments to ISA 210. Implementation of these amendments has been deferred until such time as ISA 800 (Revised and Redrafted), "Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" becomes effective.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on:

    (a) Agreeing the terms of the engagement with the client; and

    (b) The auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

2. **The auditor and the client should agree on the terms of the engagement.** The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.

3. This ISA is intended to assist the auditor in the preparation of engagement letters relating to audits of financial statements.

4. In some countries, the objective and scope of an audit and the auditor's obligations are established by law. Even in those situations the auditor may still find audit engagement letters informative for their clients.

Audit Engagement Letters

5. It is in the interest of both client and auditor that the auditor sends an engagement letter, preferably before the commencement of the engagement, to help in avoiding misunderstandings with respect to the engagement. The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports.

Principal Contents

6. The form and content of audit engagement letters may vary for each client, but they would generally include reference to:

    - The objective of the audit of financial statements.

- Management's responsibility for the financial statements as described in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements."
- The financial reporting framework adopted by management in preparing the financial statements, i.e., the applicable financial reporting framework.
- The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres.
- The form of any reports or other communication of results of the engagement.
- The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered.
- Unrestricted access to whatever records, documentation and other information requested in connection with the audit.
- Management's responsibility for establishing and maintaining effective internal control.

7. The auditor may also wish to include in the letter:

- Arrangements regarding the planning and performance of the audit.
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
- Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
- Description of any other letters or reports the auditor expects to issue to the client.
- Basis on which fees are computed and any billing arrangements.

8. When relevant, the following points could also be made:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other client staff.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the client.

An example of an audit engagement letter is set out in the Appendix.

Audits of Components

9. When the auditor of a parent entity is also the auditor of its subsidiary, branch or division (component), the factors that influence the decision whether to send a separate engagement letter to the component include the following:

   - Who appoints the auditor of the component.
   - Whether a separate auditor's report is to be issued on the component.
   - Legal requirements.
   - The extent of any work performed by other auditors.
   - Degree of ownership by parent.
   - Degree of independence of the component's management.

Agreement on the Applicable Financial Reporting Framework

10. **The terms of the engagement should identify the applicable financial reporting framework.**

11. As stated in ISA 200 the acceptability of the financial reporting framework adopted by management in preparing the financial statements will depend on the nature of the entity and on the objective of the financial statements. In some cases, the objective of the financial statements will be to meet the common information needs of a wide range of users; in others, to meet the needs of specific users.

12. ISA 200 describes the financial reporting frameworks that are presumed to be acceptable for general purpose financial statements. Legislative and regulatory requirements often identify the applicable financial reporting framework for general purpose financial statements. In most cases, the applicable financial reporting framework will be established by a standards setting organization that is authorized or recognized to promulgate standards in the jurisdiction in which the entity is registered or operates.

13. **The auditor should accept an engagement for an audit of financial statements only when the auditor concludes that the financial reporting framework adopted by management is acceptable or when it is required by law or regulation. When law or regulation requires use of a financial reporting framework for general purpose financial statements that the auditor considers to be unacceptable, the auditor should accept the engagement only if the deficiencies in the framework can be adequately explained to avoid misleading users.**

14. Without an acceptable financial reporting framework management does not have an appropriate basis for preparing the financial statements and the auditor does

not have suitable criteria for evaluating the entity's financial statements. In these circumstances, unless use of the financial reporting framework is required by law or regulation, the auditor encourages management to address the deficiencies in the financial reporting framework or to adopt another financial reporting framework that is acceptable. When the financial reporting framework is required by law or regulation and management has no choice but to adopt this framework, the auditor accepts the engagement only if the deficiencies can be adequately explained to avoid misleading users, see ISA 701, "Modifications to the Independent Auditor's Report," paragraph 5 and, unless required by law or regulation to do so, does not express the opinion on the financial statements using the terms "give a true and fair view" or "are presented fairly, in all material respects," in accordance with the applicable financial reporting framework.

15. When the auditor accepts an engagement involving an applicable financial reporting framework that is not established by an organization that is authorized or recognized to promulgate standards for general purpose financial statements of certain types of entities, the auditor may encounter deficiencies in that framework that were not anticipated when the engagement was initially accepted and that indicate that the framework is not acceptable for general purpose financial statements. In these circumstances, the auditor discusses the deficiencies with management and the ways in which such deficiencies may be addressed. If the deficiencies result in financial statements that are misleading and there is agreement that management will adopt another financial reporting framework that is acceptable, the auditor refers to the change in the financial reporting framework in a new engagement letter. If management refuses to adopt another financial reporting framework, the auditor considers the impact of the deficiencies on the auditor's report, see ISA 701.

Recurring Audits

16. **On recurring audits, the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.**

17. The auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter:

- Any indication that the client misunderstands the objective and scope of the audit.
- Any revised or special terms of the engagement.
- A recent change of senior management or those charged with governance.
- A significant change in ownership.
- A significant change in nature or size of the client's business.

- Legal or regulatory requirements.
- A change in the financial reporting framework adopted by management in preparing the financial statements (as discussed in paragraph 15).

Acceptance of a Change in Engagement

18. **An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.**

19. A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement.

20. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of service originally requested would ordinarily be considered a reasonable basis for requesting a change in the engagement. In contrast a change would not be considered reasonable if it appeared that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.

21. Before agreeing to change an audit engagement to a related service, an auditor who was engaged to perform an audit in accordance with the ISAs would consider, in addition to the above matters, any legal or contractual implications of the change.

22. If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complies with the ISAs applicable to the changed engagement, the report issued would be that appropriate for the revised terms of engagement. In order to avoid confusing the reader, the report would not include reference to:

    (a) The original engagement; or

    (b) Any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

23. **Where the terms of the engagement are changed, the auditor and the client should agree on the new terms.**

24. **The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.** An example might be an audit engagement where the auditor is unable to obtain sufficient appropriate audit

evidence regarding receivables and the client asks for the engagement to be changed to a review engagement to avoid a qualified audit opinion or a disclaimer of opinion.

25. **If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report to other parties, such as those charged with governance or shareholders, the circumstances necessitating the withdrawal.**

Effective Date

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

Public Sector Perspective

1. The purpose of the engagement letter is to inform the auditee of the nature of the engagement and to clarify the responsibilities of the parties involved. The legislation and regulations governing the operations of public sector audits generally mandate the appointment of a public sector auditor and the use of audit engagement letters may not be a widespread practice. Nevertheless, a letter setting out the nature of the engagement or recognizing an engagement not indicated in the legislative mandate may be useful to both parties. Public sector auditors have to give serious consideration to issuing audit engagement letters when undertaking an audit.

2. Paragraphs 18-25 of this ISA deal with the action a private sector auditor may take when there are attempts to change an audit engagement to one which provides a lower level of assurance. In the public sector specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a minister, the legislature or the public if management (including the department head) attempts to limit the scope of the audit.

Appendix: Example of an Engagement Letter

The following is an example of an engagement letter for an audit of general purpose financial statements prepared in accordance with International Financial Reporting Standards. This letter is to be used as a guide in conjunction with the considerations outlined in this ISA and will need to be varied according to individual requirements and circumstances.

To the Board of Directors or the appropriate representative of senior management:

You have requested that we audit the financial statements of …………, which comprise the balance sheet as at ...., and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes. We are pleased to confirm our

acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we expect to provide you with a separate letter concerning any material weaknesses in the design or implementation of internal control over financial reporting that come to our attention during the audit of the financial statements.[1]

We remind you that the responsibility for the preparation of financial statements that present fairly the financial position, financial performance and cash flows of the company in accordance with International Financial Reporting Standards is that of the management of the company. Our auditors' report will explain that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework and this responsibility includes:

- Designing, implementing and maintaining internal control relevant to the preparation of financial statements that are free from misstatement, whether due to fraud or error;
- Selecting and applying appropriate accounting policies; and
- Making accounting estimates that are appropriate in the circumstances.

AUDITING

[1] In some jurisdictions, the auditor may have responsibilities to report separately on the entity's internal control. In such circumstances, the auditor reports on that responsibility as required in that jurisdiction. The reference in the auditor's report on the financial statements to the fact that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control may not be appropriate in such circumstances.

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

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

[*Insert additional information here regarding fee arrangements and billings, as appropriate.]*

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

XYZ & Co.

Acknowledged on behalf of ABC Company by

(signed)
....
Name and Title
Date

INTERNATIONAL STANDARD ON AUDITING 220

QUALITY CONTROL FOR AUDITS OF HISTORICAL FINANCIAL INFORMATION

(Effective for audits of historical financial information for periods beginning on or after June 15, 2005)

CONTENTS

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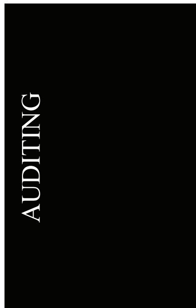
International Standard on Auditing (ISA) 220, "Quality Control for Audits of Historical Financial Information" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.



Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on specific responsibilities of firm personnel regarding quality control procedures for audits of historical financial information, including audits of financial statements. This ISA is to be read in conjunction with Parts A and B of the IFAC *Code of Ethics for Professional Accountants* (the IFAC Code).

2. **The engagement team should implement quality control procedures that are applicable to the individual audit engagement.**

3. Under International Standard on Quality Control (ISQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements," a firm has an obligation to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that the auditors' reports issued by the firm or engagement partners are appropriate in the circumstances.

4. Engagement teams:

   (a) Implement quality control procedures that are applicable to the audit engagement;

   (b) Provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence; and

   (c) Are entitled to rely on the firm's systems (for example, in relation to capabilities and competence of personnel through their recruitment and formal training; independence through the accumulation and communication of relevant independence information; maintenance of client relationships through acceptance and continuance systems; and adherence to regulatory and legal requirements through the monitoring process), unless information provided by the firm or other parties suggests otherwise.

Definitions

5. In this ISA, the following terms have the meanings attributed below:

   (a) "Engagement partner" – the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

(b) "Engagement quality control review" – a process designed to provide an objective evaluation, before the auditor's report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the auditor's report.

(c) "Engagement quality control reviewer" – a partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the auditor's report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the auditor's report.

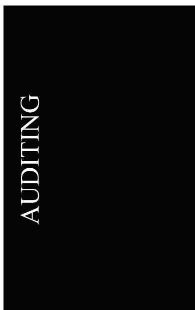
(d) "Engagement team" – all personnel performing an audit engagement, including any experts contracted by the firm in connection with that audit engagement.

(e) "Firm"* – a sole practitioner, partnership or corporation or other entity of professional accountants.

(f) "Inspection" – in relation to completed audit engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.

(g) "Listed entity"* – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.

(h) "Monitoring" – a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.



(i) "Network firm"* – an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.

(j) "Partner" – any individual with authority to bind the firm with respect to the performance of a professional services engagement.

(k) "Personnel" – partners and staff.

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* As defined in the IFAC *Code of Ethics for Professional Accountants* (the Code) issued in June 2005. The definitions of the terms "firm" and "network firm" in the Code were revised in June 2006. At the same time a definition of the term "network" was added to the Code. These definitions are effective for assurance reports dated on or after December 31, 2008.

(l) "Professional standards" – IAASB Engagement Standards, as defined in the IAASB's "Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services," and relevant ethical requirements, which ordinarily comprise Parts A and B of the IFAC Code and relevant national ethical requirements.

(m) "Reasonable assurance" – in the context of this ISA, a high, but not absolute, level of assurance.

(n) "Staff" – professionals, other than partners, including any experts the firm employs.

(o) "Suitably qualified external person" – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits of historical financial information or of an organization that provides relevant quality control services.

Leadership Responsibilities for Quality on Audits

6. **The engagement partner should take responsibility for the overall quality on each audit engagement to which that partner is assigned.**

7. The engagement partner sets an example regarding audit quality to the other members of the engagement team through all stages of the audit engagement. Ordinarily, this example is provided through the actions of the engagement partner and through appropriate messages to the engagement team. Such actions and messages emphasize:

   (a) The importance of:

      (i) Performing work that complies with professional standards and regulatory and legal requirements;

      (ii) Complying with the firm's quality control policies and procedures as applicable; and

      (iii) Issuing auditors' reports that are appropriate in the circumstances; and

   (b) The fact that quality is essential in performing audit engagements.

Ethical Requirements

8. **The engagement partner should consider whether members of the engagement team have complied with ethical requirements.**

9. Ethical requirements relating to audit engagements ordinarily comprise Parts A and B of the IFAC Code together with national requirements that

are more restrictive. The IFAC Code establishes the fundamental principles of professional ethics, which include:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behavior.

10. The engagement partner remains alert for evidence of non-compliance with ethical requirements. Inquiry and observation regarding ethical matters amongst the engagement partner and other members of the engagement team occur as necessary throughout the audit engagement. If matters come to the engagement partner's attention through the firm's systems or otherwise that indicate that members of the engagement team have not complied with ethical requirements, the partner, in consultation with others in the firm, determines the appropriate action.

11. The engagement partner and, where appropriate, other members of the engagement team, document issues identified and how they were resolved.

Independence

12. **The engagement partner should form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner should:**

(a) **Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;**

(b) **Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement;**

(c) **Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards. The engagement partner should promptly report to the firm any failure to resolve the matter for appropriate action; and**

(d) **Document conclusions on independence and any relevant discussions with the firm that support these conclusions.**

13. The engagement partner may identify a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level. In that case, the engagement partner consults within the firm to determine appropriate action, which may include eliminating the

activity or interest that creates the threat, or withdrawing from the audit engagement. Such discussion and conclusions are documented.

Acceptance and Continuance of Client Relationships and Specific Audit Engagements

14. **The engagement partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and specific audit engagements have been followed, and that conclusions reached in this regard are appropriate and have been documented.**

15. The engagement partner may or may not initiate the decision-making process for acceptance or continuance regarding the audit engagement. Regardless of whether the engagement partner initiated that process, the partner determines whether the most recent decision remains appropriate.

16. Acceptance and continuance of client relationships and specific audit engagements include considering:

    - The integrity of the principal owners, key management and those charged with governance of the entity;
    - Whether the engagement team is competent to perform the audit engagement and has the necessary time and resources; and
    - Whether the firm and the engagement team can comply with ethical requirements.

    Where issues arise out of any of these considerations, the engagement team conducts the appropriate consultations set out in paragraphs 30-33, and documents how issues were resolved.

17. Deciding whether to continue a client relationship includes consideration of significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship. For example, a client may have started to expand its business operations into an area where the firm does not possess the necessary knowledge or expertise.

18. **Where the engagement partner obtains information that would have caused the firm to decline the audit engagement if that information had been available earlier, the engagement partner should communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.**

Assignment of Engagement Teams

19. **The engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with professional**

standards and regulatory and legal requirements, and to enable an auditor's report that is appropriate in the circumstances to be issued.

20. The appropriate capabilities and competence expected of the engagement team as a whole include the following:

    - An understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
    - An understanding of professional standards and regulatory and legal requirements.
    - Appropriate technical knowledge, including knowledge of relevant information technology.
    - Knowledge of relevant industries in which the client operates.
    - Ability to apply professional judgment.
    - An understanding of the firm's quality control policies and procedures.

Engagement Performance

21. **The engagement partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the auditor's report that is issued to be appropriate in the circumstances.**

22. The engagement partner directs the audit engagement by informing the members of the engagement team of:

    (a) Their responsibilities;

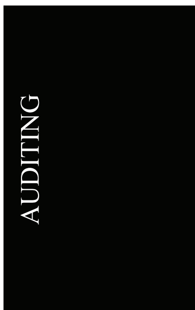
    (b) The nature of the entity's business;

    (c) Risk-related issues;

    (d) Problems that may arise; and

    (e) The detailed approach to the performance of the engagement.

    The engagement team's responsibilities include maintaining an objective state of mind and an appropriate level of professional skepticism, and performing the work delegated to them in accordance with the ethical principle of due care. Members of the engagement team are encouraged to raise questions with more experienced team members. Appropriate communication occurs within the engagement team.



23. It is important that all members of the engagement team understand the objectives of the work they are to perform. Appropriate team-working and

training are necessary to assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

24. Supervision includes the following:

- Tracking the progress of the audit engagement.
- Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the audit engagement.
- Addressing significant issues arising during the audit engagement, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

25. Review responsibilities are determined on the basis that more experienced team members, including the engagement partner, review work performed by less experienced team members. Reviewers consider whether:

(a) The work has been performed in accordance with professional standards and regulatory and legal requirements;

(b) Significant matters have been raised for further consideration;

(c) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

(d) There is a need to revise the nature, timing and extent of work performed;

(e) The work performed supports the conclusions reached and is appropriately documented;

(f) The evidence obtained is sufficient and appropriate to support the auditor's report; and

(g) The objectives of the engagement procedures have been achieved.

26. **Before the auditor's report is issued, the engagement partner, through review of the audit documentation and discussion with the engagement team, should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.**

27. The engagement partner conducts timely reviews at appropriate stages during the engagement. This allows significant matters to be resolved on a

timely basis to the engagement partner's satisfaction before the auditor's report is issued. The reviews cover critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement, significant risks, and other areas the engagement partner considers important. The engagement partner need not review all audit documentation. However, the partner documents the extent and timing of the reviews. Issues arising from the reviews are resolved to the satisfaction of the engagement partner.

28. A new engagement partner taking over an audit during the engagement reviews the work performed to the date of the change. The review procedures are sufficient to satisfy the new engagement partner that the work performed to the date of the review has been planned and performed in accordance with professional standards and regulatory and legal requirements.

29. Where more than one partner is involved in the conduct of an audit engagement, it is important that the responsibilities of the respective partners are clearly defined and understood by the engagement team.

Consultation

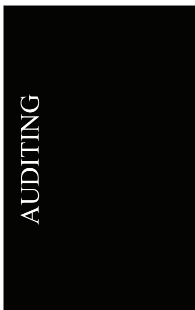
30. **The engagement partner should:**

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

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

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

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



31. Effective consultation with other professionals requires that those consulted be given all the relevant facts that will enable them to provide informed advice on technical, ethical or other matters. Where appropriate, the engagement team consults individuals with appropriate knowledge, seniority and experience within the firm or, where applicable, outside the firm. Conclusions resulting from consultations are appropriately documented and implemented.

32. It may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. They may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services.

33. The documentation of consultations with other professionals that involve difficult or contentious matters is agreed by both the individual seeking consultation and the individual consulted. The documentation is sufficiently complete and detailed to enable an understanding of:

    (a) The issue on which consultation was sought; and

    (b) The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Differences of Opinion

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

35. As necessary, the engagement partner informs members of the engagement team that they may bring matters involving differences of opinion to the attention of the engagement partner or others within the firm as appropriate without fear of reprisals.

Engagement Quality Control Review

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

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

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

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

    For other audit engagements where an engagement quality control review is performed, the engagement partner follows the requirements set out in subparagraphs (a)-(c).

37. Where, at the start of the engagement, an engagement quality control review is not considered necessary, the engagement partner is alert for changes in circumstances that would require such a review.

38. **An engagement quality control review should include an objective evaluation of:**

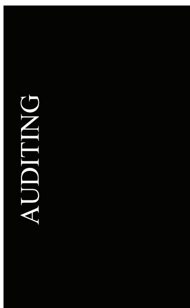
    (a) **The significant judgments made by the engagement team; and**

    (b) **The conclusions reached in formulating the auditor's report.**

39. An engagement quality control review ordinarily involves discussion with the engagement partner, a review of the financial information and the auditor's report, and, in particular, consideration of whether the auditor's report is appropriate. It also involves a review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions they reached. The extent of the review depends on the complexity of the audit engagement and the risk that the auditor's report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

40. An engagement quality control review for audits of financial statements of listed entities includes considering the following:

    - The engagement team's evaluation of the firm's independence in relation to the specific audit engagement.
    - Significant risks identified during the engagement (in accordance with ISA 315, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement"), and the responses to those risks (in accordance with ISA 330, "Auditor's Procedures in Response to Assessed Risks"), including the engagement team's assessment of, and response to, the risk of fraud.
    - Judgments made, particularly with respect to materiality and significant risks.
    - Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
    - The significance and disposition of corrected and uncorrected misstatements identified during the audit.
    - The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
    - Whether audit documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached.
    - The appropriateness of the auditor's report to be issued.



Engagement quality control reviews for audits of historical financial information other than audits of financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

Monitoring

41. ISQC 1 requires the firm to establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. The engagement partner considers the results of the monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms. The engagement partner considers:

    (a) Whether deficiencies noted in that information may affect the audit engagement; and

    (b) Whether the measures the firm took to rectify the situation are sufficient in the context of that audit.

42. A deficiency in the firm's system of quality control does not indicate that a particular audit engagement was not performed in accordance with professional standards and regulatory and legal requirements, or that the auditor's report was not appropriate.

Effective Date

43. This ISA is effective for audits of historical financial information for periods beginning on or after June 15, 2005.

Public Sector Perspective

1. Some of the terms in the ISA, such as "engagement partner" and "firm," should be read as referring to their public sector equivalents. However, with limited exceptions, there is no public sector equivalent of "listed entities," although there may be audits of particularly significant public sector entities which should be subject to the listed entity requirements of mandatory rotation of the engagement partner (or equivalent) and engagement quality control review. There are no fixed objective criteria on which this determination of significance should be based. However, such an assessment should encompass an evaluation of all factors relevant to the audited entity. Such factors include size, complexity, commercial risk, parliamentary or media interest and the number and range of stakeholders affected.

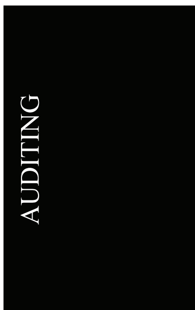
2. However, in many jurisdictions there is a single statutorily appointed auditor-general who acts in a role equivalent to that of "engagement

partner" and who has overall responsibility for public sector audits. In such circumstances, where applicable, the engagement reviewer should be selected having regard to the need for independence and objectivity.

3. *In the public sector, auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the considerations regarding the acceptance and continuance of client relationships and specific engagements, as set out in paragraphs 16-17 of this ISA, may not be relevant.*

4. *Similarly, the independence of public sector auditors may be protected by statutory measures. However, public sector auditors or audit firms carrying out public sector audits on behalf of the statutory auditor may, depending on the terms of the mandate in a particular jurisdiction, need to adapt their approach in order to ensure compliance with the spirit of paragraphs 12 and 13. This may include, where the public sector auditor's mandate does not permit withdrawal from the engagement, disclosure through a public report, of circumstances that have arisen that would, if they were in the private sector, lead the auditor to withdraw.*

5. *Paragraph 20 sets out capabilities and competence expected of the engagement team. Additional capabilities may be required in public sector audits, dependent upon the terms of the mandate in a particular jurisdiction. Such additional capabilities may include an understanding of the applicable reporting arrangements, including reporting to a representative body, for example, Parliament, House of Representatives, Legislature or in the public interest. The wider scope of a public sector audit may include, for example, some aspects of performance auditing or a comprehensive assessment of the arrangements for ensuring legality and preventing and detecting fraud and corruption.*



INTERNATIONAL STANDARD ON AUDITING 230

AUDIT DOCUMENTATION

(Effective for audits of financial information for periods beginning on or after June 15, 2006)*

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International Standard on Auditing (ISA) 230, "Audit Documentation" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 230 gave rise to conforming amendments to ISQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Service Engagements," ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," and ISA 330, "The Auditor's Procedures in Response to Assessed Risks." The conforming amendments to ISQC 1, and ISAs 200 and 330 have been incorporated in the text of those Standards.

The IAASB's clarity drafting conventions have been applied to ISA 230. ISA 230 (Redrafted), "Audit Documentation" can be found in Part II of the Handbook of International Auditing, Assurance, and Ethics Pronouncements. It is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on audit documentation. The Appendix lists other ISAs containing subject matter-specific documentation requirements and guidance. Laws or regulations may establish additional documentation requirements.

2. **The auditor should prepare, on a timely basis, audit documentation that provides:**

   (a) **A sufficient and appropriate record of the basis for the auditor's report; and**

   (b) **Evidence that the audit was performed in accordance with ISAs and applicable legal and regulatory requirements.**

3. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared at the time the work is performed is likely to be more accurate than documentation prepared subsequently.

4. Compliance with the requirements of this ISA together with the specific documentation requirements of other relevant ISAs is ordinarily sufficient to achieve the objectives in paragraph 2.

5. In addition to these objectives, audit documentation serves a number of purposes, including:

   (a) Assisting the audit team to plan and perform the audit;

   (b) Assisting members of the audit team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA 220, "Quality Control for Audits of Historical Financial Information;"

   (c) Enabling the audit team to be accountable for its work;

   (d) Retaining a record of matters of continuing significance to future audits;

   (e) Enabling an experienced auditor to conduct quality control reviews and inspections[1] in accordance with ISQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements;" and

AUDITING

[1] As defined in ISA 220, "Quality Control for Audits of Historical Financial Information."

(f) Enabling an experienced auditor to conduct external inspections in accordance with applicable legal, regulatory or other requirements.

Definitions

6. In this ISA:

   (a) "Audit documentation" means the record of audit procedures performed,[2] relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used); and

   (b) "Experienced auditor" means an individual (whether internal or external to the firm) who has a reasonable understanding of (i) audit processes, (ii) ISAs and applicable legal and regulatory requirements, (iii) the business environment in which the entity operates, and (iv) auditing and financial reporting issues relevant to the entity's industry.

Nature of Audit Documentation

7. Audit documentation may be recorded on paper or on electronic or other media. It includes, for example, audit programs, analyses, issues memoranda, summaries of significant matters, letters of confirmation and representation, checklists, and correspondence (including e-mail) concerning significant matters. Abstracts or copies of the entity's records, for example, significant and specific contracts and agreements, may be included as part of audit documentation if considered appropriate. Audit documentation, however, is not a substitute for the entity's accounting records. The audit documentation for a specific audit engagement is assembled in an audit file.

8. The auditor ordinarily excludes from audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

Form, Content and Extent of Audit Documentation

9. **The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:**

   (a) **The nature, timing, and extent of the audit procedures performed to comply with ISAs and applicable legal and regulatory requirements;**

[2] Audit procedures performed include audit planning, as addressed in ISA 300, "Planning an Audit of Financial Statements."

(b) **The results of the audit procedures and the audit evidence obtained; and**

(c) **Significant matters arising during the audit and the conclusions reached thereon.**

10. The form, content and extent of audit documentation depend on factors such as:

- The nature of the audit procedures to be performed;
- The identified risks of material misstatement;
- The extent of judgment required in performing the work and evaluating the results;
- The significance of the audit evidence obtained;
- The nature and extent of exceptions identified;
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained; and
- The audit methodology and tools used.

It is, however, neither necessary nor practicable to document every matter the auditor considers during the audit.

11. Oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

Documentation of the Identifying Characteristics of Specific Items or Matters Being Tested

12. **In documenting the nature, timing and extent of audit procedures performed, the auditor should record the identifying characteristics of the specific items or matters being tested.**

13. Recording the identifying characteristics serves a number of purposes. For example, it enables the audit team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter being tested. For example:

- For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
- For a procedure requiring selection or review of all items over a specific

amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).

- For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period from April 1 to September 30, starting with report number 12345 and selecting every 125th report).
- For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
- For an observation procedure, the auditor may record the process or subject matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

Significant Matters

14. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Significant matters include, amongst others:
    - Matters that give rise to significant risks (as defined in ISA 315, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement").
    - Results of audit procedures indicating (a) that the financial information could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
    - Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
    - Findings that could result in a modification to the auditor's report.

15. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters.

16. **The auditor should document discussions of significant matters with management and others on a timely basis.**

17. The audit documentation includes records of the significant matters discussed, and when and with whom the discussions took place. It is not limited to records prepared by the auditor but may include other appropriate records such as agreed minutes of meetings prepared by the entity's personnel. Others with whom the auditor may discuss significant matters include those charged with governance, other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

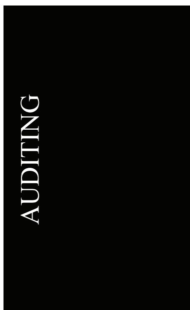
18. **If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor should document how the auditor addressed the contradiction or inconsistency in forming the final conclusion.**

19. The documentation of how the auditor addressed the contradiction or inconsistency, however, does not imply that the auditor needs to retain documentation that is incorrect or superseded.

Documentation of Departures from Basic Principles or Essential Procedures

20. The basic principles and essential procedures in ISAs are designed to assist the auditor in meeting the overall objective of the audit. Accordingly, other than in exceptional circumstances, the auditor complies with each basic principle and essential procedure that is relevant in the circumstances of the audit.

21. **Where, in exceptional circumstances, the auditor judges it necessary to depart from a basic principle or an essential procedure that is relevant in the circumstances of the audit, the auditor should document how the alternative audit procedures performed achieve the objective of the audit, and, unless otherwise clear, the reasons for the departure.** This involves the auditor documenting how the alternative audit procedures performed were sufficient and appropriate to replace that basic principle or essential procedure.



22. The documentation requirement does not apply to basic principles and essential procedures that are not relevant in the circumstances, i.e., where the circumstances envisaged in the specified basic principle or essential procedure do not apply. For example, in a continuing engagement, nothing in ISA 510, "Initial Engagements—Opening Balances," is relevant. Similarly, if an ISA includes conditional requirements, they are not relevant if the specified conditions do not exist (for example, the requirement to modify the auditor's report where there is a limitation of scope).

Identification of Preparer and Reviewer

23. **In documenting the nature, timing and extent of audit procedures performed, the auditor should record:**

    (a) **Who performed the audit work and the date such work was completed; and**

(b) **Who reviewed the audit work performed and the date and extent of such review.**[3]

24. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The audit documentation, however, evidences who reviewed specified elements of the audit work performed and when.

Assembly of the Final Audit File

25. **The auditor should complete the assembly of the final audit file on a timely basis after the date of the auditor's report.**

26. ISQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. As ISQC 1 indicates, 60 days after the date of the auditor's report is ordinarily an appropriate time limit within which to complete the assembly of the final audit file.

27. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the audit team before the date of the auditor's report.

28. **After the assembly of the final audit file has been completed, the auditor should not delete or discard audit documentation before the end of its retention period.**

29. ISQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. As ISQC 1 indicates, the retention period for audit engagements ordinarily is no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report.

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[3] Paragraph 26 of ISA 220 establishes the requirement for the auditor to review the audit work performed through review of the audit documentation, which involves the auditor documenting the extent and timing of the reviews. Paragraph 25 of ISA 220 describes the nature of a review of work performed.

30. **When the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor should, regardless of the nature of the modifications or additions, document:**

    (a) **When and by whom they were made, and (where applicable) reviewed;**

    (b) **The specific reasons for making them; and**

    (c) **Their effect, if any, on the auditor's conclusions.**

Changes to Audit Documentation in Exceptional Circumstances after the Date of the Auditor's Report

31. **When exceptional circumstances arise after the date of the auditor's report that require the auditor to perform new or additional audit procedures or that lead the auditor to reach new conclusions, the auditor should document:**

    (a) **The circumstances encountered;**

    (b) **The new or additional audit procedures performed, audit evidence obtained, and conclusions reached; and**

    (c) **When and by whom the resulting changes to audit documentation were made, and (where applicable) reviewed.**

32. Such exceptional circumstances include the discovery of facts regarding the audited financial information that existed at the date of the auditor's report that might have affected the auditor's report had the auditor then been aware of them.

Effective Date

33. This ISA is effective for audits of financial information for periods beginning on or after June 15, 2006.

Appendix

Specific Audit Documentation Requirements and Guidance in Other ISAs

The following lists the main paragraphs that contain specific documentation requirements and guidance in other ISAs:

- ISA 210, "Terms of Audit Engagements"–Paragraph 5
- ISA 220, "Quality Control for Audits of Historical Financial Information"–Paragraphs 11-14, 16, 25, 27, 30, 31 and 33
- ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements"–Paragraphs 60 and 107-111
- ISA 250, "Consideration of Laws and Regulations"–Paragraph 28
- ISA 260, "Communication of Audit Matters with Those Charged with Governance"–Paragraph 16
- ISA 300, "Planning an Audit of Financial Statements"–Paragraphs 22-26
- ISA 315, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement"–Paragraphs 122 and 123
- ISA 330, "The Auditor's Procedures in Response to Assessed Risks"–Paragraphs 73, 73a and 73b
- ISA 505, "External Confirmations"–Paragraph 33
- ISA 580, "Management Representations"–Paragraph 10
- ISA 600, "Using the Work of Another Auditor"–Paragraph 14

INTERNATIONAL STANDARD ON AUDITING 240

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

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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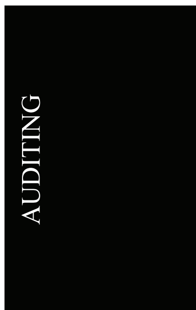

* The IAASB's clarity drafting conventions have been applied to ISA 240. ISA 240 (Redrafted), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" can be found in Part II of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements*. It is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Appendix 1: Examples of Fraud Risk Factors

Appendix 2: Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

Appendix 3: Examples of Circumstances that Indicate the Possibility of Fraud

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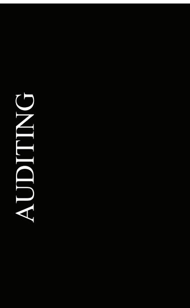
International Standard on Auditing (ISA) 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibility to consider fraud in an audit of financial statements[1] and expand on how the standards and guidance in ISA 315, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" are to be applied in relation to the risks of material misstatement due to fraud. The standards and guidance in this ISA are intended to be integrated into the overall audit process.

2. This standard:

   - Distinguishes fraud from error and describes the two types of fraud that are relevant to the auditor, that is, misstatements resulting from misappropriation of assets and misstatements resulting from fraudulent financial reporting; describes the respective responsibilities of those charged with governance and the management of the entity for the prevention and detection of fraud, describes the inherent limitations of an audit in the context of fraud, and sets out the responsibilities of the auditor for detecting material misstatements due to fraud;
   - Requires the auditor to maintain an attitude of professional skepticism recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance;
   - Requires members of the engagement team to discuss the susceptibility of the entity's financial statements to material misstatement due to fraud and requires the engagement partner to consider which matters are to be communicated to members of the engagement team not involved in the discussion;
   - Requires the auditor to:
     - Perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud;
     - Identify and assess the risks of material misstatement due to fraud at the financial statement level and the assertion level; and for those assessed risks that could result in a material misstatement due to fraud, evaluate the design of the entity's related controls, including relevant control activities, and to determine whether they have been implemented;



[1] The auditor's responsibility to consider laws and regulations in an audit of financial statements is established in ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements."

- ◦ Determine overall responses to address the risks of material misstatement due to fraud at the financial statement level and consider the assignment and supervision of personnel; consider the accounting policies used by the entity and incorporate an element of unpredictability in the selection of the nature, timing and extent of the audit procedures to be performed;
- ◦ Design and perform audit procedures to respond to the risk of management override of controls;
- ◦ Determine responses to address the assessed risks of material misstatement due to fraud;
- ◦ Consider whether an identified misstatement may be indicative of fraud;
- ◦ Obtain written representations from management relating to fraud; and
- ◦ Communicate with management and those charged with governance;

- Provides guidance on communications with regulatory and enforcement authorities;
- Provides guidance 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; and
- Establishes documentation requirements.

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

Characteristics of Fraud

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.

5. The term "error" refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as the following:

   - A mistake in gathering or processing data from which financial statements are prepared.
   - An incorrect accounting estimate arising from oversight or misinterpretation of facts.

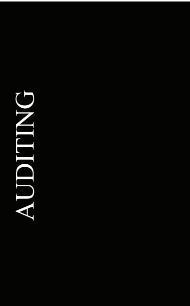
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.

6. The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, for the purposes of this ISA, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud;" fraud involving only employees of the entity is referred to as "employee fraud." In either case, there may be collusion within the entity or with third parties outside of the entity.

7. Two types of intentional misstatements are relevant to the auditor, that is, misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

8. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. 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.



9. 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.

10. 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.

11. Misappropriation of assets involves the theft of an entity's assets and 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. 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.

12. Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Individuals may have an incentive to misappropriate assets for example, because the individuals are living beyond their means. Fraudulent financial reporting may be committed because

management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target – particularly since the consequences to management for failing to meet financial goals can be significant. A perceived opportunity for fraudulent financial reporting or misappropriation of assets 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.

Responsibilities of Those Charged with Governance and of Management

13. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management. The respective responsibilities of those charged with governance and of management may vary by entity and from country to country. In some entities, the governance structure may be more informal as those charged with governance may be the same individuals as management of the entity.

14. 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. Such a culture, based on a strong set of core values, is communicated and demonstrated by management and by those charged with governance and provides the foundation for employees as to how the entity conducts its business. Creating a culture of honesty and ethical behavior includes setting the proper tone; creating a positive workplace environment; hiring, training and promoting appropriate employees; requiring periodic confirmation by employees of their responsibilities and taking appropriate action in response to actual, suspected or alleged fraud.

15. It is the responsibility of those charged with governance of the entity 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.

16. It is the responsibility of management, with oversight from those charged with governance, to establish a control environment and maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the entity's business. This responsibility includes establishing and maintaining controls pertaining to the entity's objective of preparing financial statements that give a true and fair view (or are presented fairly in all material respects) in accordance with the applicable financial reporting framework 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.

Inherent Limitations of an Audit in the Context of Fraud

17. As described in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," 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. 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.

18. 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 designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by 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.

19. Furthermore, the risk of the auditor 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 and present fraudulent financial information. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either direct employees to do something or solicit their help to assist in carrying out a fraud, with or without the employees' knowledge.

20. 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. This is particularly the case for certain kinds of intentional misstatements, since 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. 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.

Responsibilities of the Auditor for Detecting Material Misstatement Due to Fraud

21. An auditor conducting an audit in accordance with ISAs obtains 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 to the auditor is persuasive rather than conclusive in nature.

22. When obtaining reasonable assurance, an auditor maintains an attitude of professional skepticism throughout the audit, considers the potential for management override of controls and recognizes 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. The remainder of this ISA provides additional guidance on considering the risks of fraud in an audit and designing procedures to detect material misstatements due to fraud.

Professional Skepticism

23. As required by ISA 200, the auditor plans and performs an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. Due to the

characteristics of fraud, the auditor's attitude of professional skepticism is particularly important when considering the risks of material misstatement due to fraud. 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.

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

25. As discussed in ISA 315, the auditor's previous experience with the entity contributes to an understanding of the entity. However, although the auditor cannot be expected to fully disregard past experience with the entity about the honesty and integrity of management and those charged with governance, the maintenance of an attitude of professional skepticism is important because there may have been changes in circumstances. When making inquiries and performing other audit procedures, the auditor exercises professional skepticism and is not satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. With respect to those charged with governance, maintaining an attitude of professional skepticism means that the auditor carefully considers the reasonableness of responses to inquiries of those charged with governance, and other information obtained from them, in light of all other evidence obtained during the audit.

26. 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. Furthermore, an auditor may not discover the existence of a modification to the terms contained in a document, for example through a side agreement that management or a third party has not disclosed to the auditor. During the audit, the auditor considers the reliability of the information to be used as audit evidence including consideration of controls over its preparation and maintenance where relevant. Unless the auditor has reason to believe the contrary, the auditor ordinarily accepts records and documents as genuine. However, 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 investigates further, for example confirming directly with the third party or considering using the work of an expert to assess the document's authenticity.

Discussion Among the Engagement Team

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

28. ISA 315 requires members of the engagement team to discuss the susceptibility of the entity to material misstatement of the financial statements. This discussion places particular emphasis on the susceptibility of the entity's financial statements to material misstatement due to fraud. The discussion includes the engagement partner who uses professional judgment, prior experience with the entity and knowledge of current developments to determine which other members of the engagement team are included in the discussion. Ordinarily, the discussion involves the key members of the engagement team. The discussion 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.

29. **The engagement partner should consider which matters are to be communicated to members of the engagement team not involved in the discussion**. All of the members of the engagement team do not necessarily need to be informed of all of the decisions reached in the discussion. For example, a member of the engagement team involved in audit of a component of the entity may not need to know the decisions reached regarding another component of the entity.

30. The discussion occurs with a questioning mind setting aside any beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. The discussion ordinarily includes:

    - 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; and
- A consideration of the risk of management override of controls.

31. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud is an important part of the audit. It enables the auditor to consider an appropriate response to the susceptibility of the entity's financial statements to material misstatement due to fraud 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. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, the engagement partner, having personally conducted the planning of the audit, considers the susceptibility of the entity's financial statements to material misstatement due to fraud.

32. It is important that after the initial discussion while planning the audit, and also at intervals throughout the audit, engagement team members continue to communicate and share information obtained that may affect the assessment of risks of material misstatement due to fraud or the audit procedures performed to address these risks. For example, for some entities it may be appropriate to update the discussion when reviewing the entity's interim financial information.

Risk Assessment Procedures

33. As required by ISA 315, to obtain an understanding of the entity and its environment, including its internal control, the auditor performs risk assessment procedures. As part of this work the auditor performs the following procedures to obtain information that is used to identify the risks of material misstatement due to fraud:

(a) Makes inquiries of management, of those charged with governance, and of others within the entity as appropriate and obtains an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud and the internal control that management has established to mitigate these risks.

(b) Considers whether one or more fraud risk factors are present.

(c) Considers any unusual or unexpected relationships that have been identified in performing analytical procedures.

(d) Considers other information that may be helpful in identifying the risks of material misstatement due to fraud.

Inquiries and Obtaining an Understanding of Oversight Exercised by Those Charged with Governance

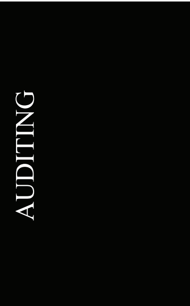
34. **When obtaining an understanding of the entity and its environment, including its internal control, the auditor should make inquiries of management regarding:**

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

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

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

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



35. As management is responsible for the entity's internal control and for the preparation of the financial statements, 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. In some entities, particularly smaller entities, the focus of the assessment may be on the risks of employee fraud or misappropriation of assets. 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.

36. In a small owner managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity, thereby compensating for the generally more limited opportunities for segregation of duties. On the other hand, the owner-manager may be more able to override controls because of the informal system of internal control. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

37. When making inquiries as part of obtaining an understanding of management's process for identifying and responding to the risks of fraud in the entity, the auditor inquires about the process to respond to internal or external allegations of fraud affecting the entity. For entities with multiple locations, the auditor inquires about the nature and extent of monitoring of operating locations or business segments and whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist.

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

39. Although the auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud, 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, in addition to management, may be useful in providing the auditor with a perspective that is different from management and those responsible for the financial reporting process. Such inquiries may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated. The auditor uses professional judgment in determining those others within the entity to whom inquiries are directed and the extent of such inquiries. In making this determination the auditor considers whether others within the entity may be able to provide information that will be helpful to the auditor in identifying the risks of material misstatement due to fraud.

40. The auditor makes inquiries of internal audit personnel, for those entities that have an internal audit function. The inquiries address the views of the internal auditors regarding the risks of fraud, whether during the year the internal auditors have performed any procedures to detect fraud, whether management has satisfactorily responded to any findings resulting from these procedures, and whether the internal auditors have knowledge of any actual, suspected or alleged fraud.

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

    - Operating personnel not directly involved in the financial reporting process;
    - Employees with different levels of authority;
    - Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees;
    - In-house legal counsel;
    - Chief ethics officer or equivalent person; and
    - The person or persons charged with dealing with allegations of fraud.

42. When evaluating management's responses to inquiries, the auditor maintains an attitude of professional skepticism recognizing that management is often in the best position to perpetrate fraud. Therefore, the auditor uses professional judgment in deciding when it is necessary to corroborate responses to inquiries with other information. When responses to inquiries are inconsistent, the auditor seeks to resolve the inconsistencies.

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

44. 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 internal control the entity has established to mitigate specific risks of fraud that the entity has identified. 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.[2] Those charged with governance include management when management performs such functions, such as may be the case in smaller entities.

45. Obtaining 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, may provide insights regarding the

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[2] 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.

susceptibility of the entity to management fraud, the adequacy of such internal control and the competence and integrity of management. The auditor may obtain this understanding by performing procedures such as attending meetings where such discussions take place, reading the minutes from such meetings or by making inquiries of those charged with governance.

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

47. The auditor makes inquiries of those charged with governance in part to corroborate the responses to the inquiries from management. When responses to these inquiries are inconsistent, the auditor obtains additional audit evidence to resolve the inconsistencies. Inquiries of those charged with governance may also assist the auditor in identifying risks of material misstatement due to fraud.

Consideration of Fraud Risk Factors

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

49. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, when obtaining an understanding of the entity and its environment, including its internal control, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. Such events or conditions are referred to as "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.

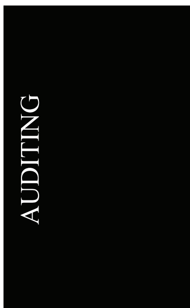
    While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor's assessment of the risks of material misstatement.

50. 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 auditor exercises professional judgment in

determining 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.

51. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1 to this ISA. 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. The auditor also has to be alert for risk factors specific to the entity that are not included in Appendix 1. Not all of the examples in Appendix 1 are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, with different ownership characteristics, in different industries, or because of other differing characteristics or circumstances.

52. 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, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of those charged with governance and of the internal audit function and 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. 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.



Consideration of Unusual or Unexpected Relationships

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

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

54. Analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. In performing analytical procedures the auditor develops expectations about plausible relationships that are reasonably expected to exist based on the auditor's understanding of the entity and its environment, including its internal control. When a comparison of those expectations with recorded amounts, or with ratios developed from recorded amounts, yields unusual or unexpected relationships, the auditor considers those results in identifying risks of material misstatement due to fraud. Analytical procedures include procedures related to revenue accounts with the objective of identifying unusual or unexpected relationships that may indicate risks of material misstatement due to fraudulent financial reporting, such as, for example, fictitious sales or significant returns from customers that might indicate undisclosed side agreements.

Consideration of Other Information

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

56. In addition to information obtained from applying analytical procedures, the auditor considers other information obtained about the entity and its environment that may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members described in paragraphs 27-32 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.

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

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

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

58. To assess the risks of material misstatement due to fraud the auditor uses professional judgment and:

    (a) Identifies risks of fraud by considering the information obtained through performing risk assessment procedures and by considering the classes of transactions, account balances and disclosures in the financial statements;

    (b) Relates the identified risks of fraud to what can go wrong at the assertion level; and

    (c) Considers the likely magnitude of the potential misstatement including the possibility that the risk might give rise to multiple misstatements and the likelihood of the risk occurring.

59. It is important for the auditor to obtain an understanding of the controls that management has designed and implemented to prevent and detect fraud because in designing and implementing such 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. The auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. This may often be the case in small entities where the owner provides day-to-day supervision of operations. Information from obtaining this understanding may also be useful in identifying fraud risk factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

Risks of Fraud in Revenue Recognition

60. Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor ordinarily presumes that there are risks of fraud in revenue recognition and considers which types of revenue, revenue transactions or assertions may give rise to such risks. Those assessed risks of material misstatement due to fraud related to revenue recognition are significant risks to be addressed in accordance with paragraphs 57 and 61. Appendix 2 includes examples of responses to the auditor's assessment of the risk of material misstatement due to fraudulent financial reporting resulting from revenue recognition. If the auditor has not identified, in a particular circumstance, revenue recognition as a risk of material misstatement due to fraud, the auditor documents the reasons supporting the auditor's conclusion as required by paragraph 110.

Responses to the Risks of Material Misstatement Due to Fraud

61. **The auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level and should design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks at the assertion level.**

62. ISA 330 requires the auditor to perform substantive procedures that are specifically responsive to risks that are assessed as significant risks.

63. The auditor responds to the risks of material misstatement due to fraud in the following ways:

    (a) A response that has an overall effect on how the audit is conducted, that is, increased professional skepticism and a response involving more general considerations apart from the specific procedures otherwise planned.

    (b) A response to identified risks at the assertion level involving the nature, timing and extent of audit procedures to be performed.

    (c) A response to identified risks involving the performance of certain audit procedures to address the risks of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur.

64. The response to address the assessed risks of material misstatement due to fraud may affect the auditor's professional skepticism in the following ways:

    (a) Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.

    (b) Increased recognition of the need to corroborate management explanations or representations concerning material matters.

65. The auditor may conclude that it would not be practicable to design audit procedures that sufficiently address the risks of material misstatement due to fraud. In such circumstances the auditor considers the implications for the audit (see paragraphs 89 and 103).

Overall Responses

66. **In determining overall responses to address the risks of material misstatement due to fraud at the financial statement level the auditor should:**

    (a) **Consider the assignment and supervision of personnel;**

    (b) **Consider the accounting policies used by the entity; and**

(c) **Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.**

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

68. The auditor considers management's selection and application of significant accounting policies, particularly those related to subjective measurements and complex transactions. The auditor considers whether the selection and application of accounting policies may be indicative of fraudulent financial reporting resulting from 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.

69. Individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. Therefore, the auditor incorporates an element of unpredictability in the selection of the nature, extent and timing of audit procedures to be performed. This 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, and 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

70. 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.

71. 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.

72. 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

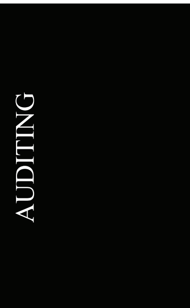
changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

73. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud are presented in Appendix 2 to this ISA. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.

Audit Procedures Responsive to Management Override of Controls

74. As noted in paragraph 19, management is in a unique position to perpetrate fraud because of management's ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. While the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities and is a significant risk of material misstatement due to fraud. Accordingly, in addition to overall responses to address the risks of material misstatement due to fraud and responses to address the assessed risks of material misstatement due to fraud at the assertion level, the auditor performs audit procedures to respond to the risk of management override of controls.

75. Paragraphs 76-82 set out the audit procedures required to respond to risk of management override of controls. However, the auditor also considers whether there are risks of management override of controls for which the auditor needs to perform procedures other than those specifically referred to in these paragraphs.



76. **To respond to the risk of management override of controls, the auditor should design and perform audit procedures to:**

(a) **Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements;**

(b) **Review accounting estimates for biases that could result in material misstatement due to fraud; and**

(c) **Obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside of the normal course of business for the entity, or that otherwise**

appear to be unusual given the auditor's understanding of the entity and its environment.

Journal Entries and Other Adjustments

77. 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. In designing and performing audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements the auditor:

    (a) Obtains an understanding of the entity's financial reporting process and the controls over journal entries and other adjustments;

    (b) Evaluates the design of the controls over journal entries and other adjustments and determines whether they have been implemented;

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

    (d) Determines the timing of the testing; and

    (e) Identifies and selects journal entries and other adjustments for testing.

78. For the purposes of 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 auditor considers the following:

    - *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.

79. 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, the auditor considers whether there is also a need to test journal entries and other adjustments throughout the period.

Accounting Estimates

80. 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. In reviewing accounting estimates for biases that could result in material misstatement due to fraud the auditor:

(a) Considers 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 reconsiders the estimates taken as a whole; and

(b) Performs a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. The objective of this review is to determine whether there is an indication of a possible bias on the part of management, and 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.

81. If the auditor identifies a possible bias on the part of management in making accounting estimates, the auditor evaluates whether the circumstances producing such a bias represent a risk of material misstatement due to fraud. The auditor considers whether, in making accounting estimates, management's actions appear to understate or overstate 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.

Business Rationale for Significant Transactions

82. The auditor obtains an understanding of the business rationale for significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit. The purpose of obtaining this understanding is to consider 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. In gaining such an understanding the auditor considers the following:

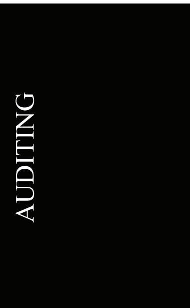
- Whether the form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Whether management has discussed the nature of and accounting for such transactions with those charged with governance of the entity, and whether there is adequate documentation.

- Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Whether transactions that involve non-consolidated related parties, including special purpose entities, have been properly reviewed and approved by those charged with governance of the entity.
- Whether 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

83. As required by ISA 330, the auditor, based on the audit procedures performed and the audit evidence obtained, evaluates 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. As part of this evaluation, the auditor considers whether there has been appropriate communication with other engagement team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

84. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures information may come to the auditor's attention that differs significantly from the information on which the assessment of the risks of material misstatement due to fraud was based. For example, the auditor may become aware of discrepancies in accounting records or conflicting or missing evidence. Also, relationships between the auditor and management may become problematic or unusual. Appendix 3 to this ISA contains examples of circumstances that may indicate the possibility of fraud.



85. **The auditor should 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 statement as a whole are consistent with the auditor's knowledge of the business indicate a previously unrecognized risk of material misstatement due to fraud.** 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.

86. **When the auditor identifies a misstatement, the auditor should consider whether such a misstatement may be indicative of fraud and if there is such an indication, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.**

87. The auditor cannot assume that an instance of fraud is an isolated occurrence. The auditor also considers whether misstatements identified may be indicative of a higher risk of material misstatement due to fraud at a specific location. For example, 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.

88. If the auditor believes that a misstatement is or may be the result of fraud, but the effect of the misstatement is not material to the financial statements, the auditor evaluates the implications, especially those dealing with the organizational position of the individual(s) involved. For example, fraud involving a misappropriation of cash from a small petty cash fund normally would be of little significance to the auditor in assessing the risks of material misstatement due to fraud because both the manner of operating the fund and its size would tend to establish a limit on the amount of potential loss, and the custodianship of such funds normally is entrusted to a non-management employee. Conversely, if the matter involves higher-level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management. In such circumstances, the auditor re-evaluates 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 also reconsiders the reliability of evidence previously obtained since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. The auditor also considers the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence.

89. **When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should consider the implications for the audit.** ISA 320, "Audit Materiality" and ISA 701, "Modifications to the Independent Auditor's Report" provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's report.

Management Representations

90. **The auditor should 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.**

91. ISA 580, "Management Representations" provides 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.

92. 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

93. **If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters as soon as practicable to the appropriate level of management.**

94. 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.

95. **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 should communicate these matters to those charged with governance as soon as practicable.

96. The auditor's communication with those charged with governance may be made orally or in writing. ISA 260, "Communication of Audit Matters with Those Charged with Governance" 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 considers whether it is necessary to also report such matters in writing. If the auditor suspects fraud involving management, the auditor communicates these suspicions to those charged with governance and also discusses with them the nature, timing and extent of audit procedures necessary to complete the audit.

97. If the integrity or honesty of management or those charged with governance is doubted, the auditor considers seeking legal advice to assist in the determination of the appropriate course of action.

98. At an early stage in the audit, the auditor reaches an understanding with those charged with governance about the nature and extent of the auditor's communications regarding fraud that the auditor becomes aware of involving employees other than management that does not result in a material misstatement.

99. **The auditor should make those charged with governance and management aware, as soon as practicable, and at the appropriate level of responsibility, of material weaknesses in the design or implementation of internal control to prevent and detect fraud which may have come to the auditor's attention.**

100. If the auditor identifies a risk of material misstatement of the financial statements due to fraud, which management has either not controlled, or for

which the relevant control is inadequate, or if in the auditor's judgment there is a material weakness in management's risk assessment process, the auditor includes such internal control deficiencies in the communication of audit matters of governance interest (see ISA 260).

101. **The auditor should consider whether there are any other matters related to fraud to be discussed with those charged with governance of the entity.**[3] Such matters 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.
- A failure by management 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

102. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. The auditor considers obtaining legal advice to determine the appropriate course of action in such circumstances. 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. For example, 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.

AUDITING

[3] For a discussion of these matters, see ISA 260, "Communication of Audit Matters with Those Charged with Governance."

Auditor Unable to Continue the Engagement

103. **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 should:**

   (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.**

104. Such exceptional circumstances can arise, for example, when:

   (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.

105. 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.

106. 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 considers seeking 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.[4]

Documentation

107. **The documentation of the auditor's understanding of the entity and its environment and the auditor's assessment of the risks of material misstatement required by paragraph 122 of ISA 315 should include:**

    (a) **The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and**

    (b) **The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.**

108. **The documentation of the auditor's responses to the assessed risks of material misstatement required by paragraph 73 of ISA 330 should include:**

    (a) **The overall responses to the assessed risks of material misstatements due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and**

    (b) **The results of the audit procedures, including those designed to address the risk of management override of controls.**

109. **The auditor should document communications about fraud made to management, those charged with governance, regulators and others.**

110. **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 should document the reasons for that conclusion.**

111. The extent to which these matters are documented is for the auditor to determine using professional judgment.

AUDITING

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

Effective Date

112. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.

Public Sector Perspective

1. ISA 240 is applicable in all material respects to audits of public sector entities.

2. In the public sector the scope and nature of the audit relating to the prevention and detection of fraud may be affected by legislation, regulation, ordinances or ministerial directives. The terms of the mandate may be a factor that the auditor needs to take into account when exercising judgment.

3. 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 in line with paragraph 102 of the ISA.

4. In many cases in the public sector the option of withdrawing from the engagement as suggested in paragraph 103 of the ISA may not be available to the auditor due to the nature of the mandate or public interest considerations.

Appendix 1

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

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following:
    - 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.

2. 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.

3. 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.[5]
    - Personal guarantees of debts of the entity.

4. 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

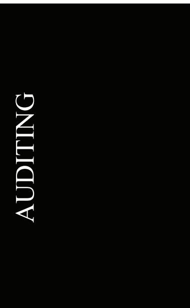
1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

    - Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.

[5] 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.

- 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.

2. 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.
3. 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.
4. 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

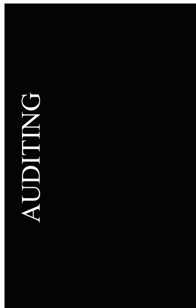
Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Some of the risk factors related to misstatements 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

1. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
2. 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

1. 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.



2. 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

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

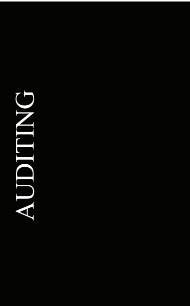
- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in 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

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 the following:

- 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 the following:

- 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 the following:

- 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 includes the following:

- 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.

INTERNATIONAL STANDARD ON AUDITING 250

CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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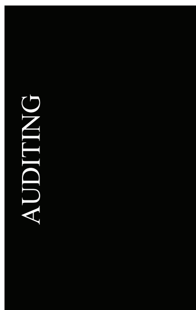
International Standard on Auditing (ISA) 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.



* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 250. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 250.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibility to consider laws and regulations in an audit of financial statements.

2. **When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements.** However, an audit cannot be expected to detect noncompliance with all laws and regulations. Detection of noncompliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

3. The term "noncompliance" as used in this ISA refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts, include transactions entered into by, or in the name of, the entity or on its behalf by its management or employees. For the purpose of this ISA, noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by the entity's management or employees.

4. Whether an act constitutes noncompliance is a legal determination that is ordinarily beyond the auditor's professional competence. The auditor's training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor's attention may constitute noncompliance with laws and regulations. The determination as to whether a particular act constitutes or is likely to constitute noncompliance is generally based on the advice of an informed expert qualified to practice law but ultimately can only be determined by a court of law.

5. Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations determine the form or content of an entity's financial statements or the amounts to be recorded or disclosures to be made in financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are only subject to the many laws and regulations that generally relate to the operating aspects of the business (such as those related to occupational safety and health and equal employment). Noncompliance with laws and regulations could result in financial consequences for the entity such as fines, litigation, etc. Generally, the further removed noncompliance is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of it or to recognize its possible noncompliance.

6. Laws and regulations vary from country to country. National accounting and auditing standards are therefore likely to be more specific as to the relevance of laws and regulations to an audit.

7. This ISA applies to audits of financial statements and does not apply to other engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

8. Guidance on the auditor's responsibility to consider fraud and error in an audit of financial statements is provided in ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements."

Responsibility of Management for the Compliance with Laws and Regulations

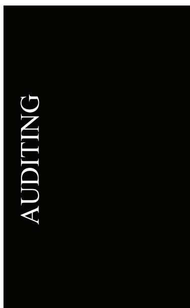
9. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of noncompliance rests with management.

10. The following policies and procedures, among others, may assist management in discharging its responsibilities for the prevention and detection of noncompliance:

    - Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
    - Instituting and operating appropriate internal control.
    - Developing, publicizing and following a code of conduct.
    - Ensuring employees are properly trained and understand the code of conduct.
    - Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
    - Engaging legal advisors to assist in monitoring legal requirements.
    - Maintaining a register of significant laws with which the entity has to comply within its particular industry and a record of complaints.

    In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

    - An internal audit function.
    - An audit committee.



The Auditor's Consideration of Compliance with Laws and Regulations

11. The auditor is not, and cannot be held responsible for preventing noncompliance. The fact that an annual audit is carried out may, however, act as a deterrent.

12. An audit is subject to the 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. This risk is higher with regard to material misstatements resulting from noncompliance with laws and regulations due to factors such as the following:

    - There are many laws and regulations, relating principally to the operating aspects of the entity, that typically do not have a material effect on the financial statements and are not captured by the entity's information systems relevant to financial reporting.
    - The effectiveness of audit procedures is affected by the inherent limitations of internal control and by the use of testing.
    - Much of the audit evidence obtained by the auditor is persuasive rather than conclusive in nature.
    - Noncompliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, senior management override of controls or intentional misrepresentations being made to the auditor.

13. **In accordance with ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" the auditor should plan and perform the audit with an attitude of professional skepticism recognizing that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations.**

14. In accordance with specific statutory requirements, the auditor may be specifically required to report as part of the audit of the financial statements whether the entity complies with certain provisions of laws or regulations. In these circumstances, the auditor would plan to test for compliance with these provisions of the laws and regulations.

15. **In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework.**

16. In obtaining this general understanding, the auditor would particularly recognize that some laws and regulations may give rise to business risks that have a fundamental effect on the operations of the entity. That is,

noncompliance with certain laws and regulations may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, noncompliance with the requirements of the entity's license or other title to perform its operations could have such an impact (for example, for a bank, noncompliance with capital or investment requirements).

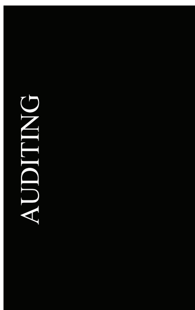
17. To obtain the general understanding of laws and regulations, the auditor would ordinarily:

    - Use the existing understanding of the entity's industry, regulatory and other external factors;
    - Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations;
    - Inquire of management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
    - Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments; and
    - Discuss the legal and regulatory framework with auditors of subsidiaries in other countries (for example, if the subsidiary is required to adhere to the securities regulations of the parent company).

18. **After obtaining the general understanding, the auditor should perform further audit procedures to help identify instances of noncompliance with those laws and regulations where noncompliance should be considered when preparing financial statements, specifically:**

    (a) **Inquiring of management as to whether the entity is in compliance with such laws and regulations; and**

    (b) **Inspecting correspondence with the relevant licensing or regulatory authorities.**



19. **Further, the auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor should have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made.**

20. Such laws and regulations would be well established and known to the entity and within the industry; they would be considered on a recurring basis each time financial statements are issued. These laws and regulations, may relate, for example, to the form and content of financial statements, including industry

specific requirements; accounting for transactions under government contracts; or the accrual or recognition of expenses for income taxes or pension costs.

21. Other than as described in paragraphs 18-20, the auditor does not perform other audit procedures on the entity's compliance with laws and regulations since this would be outside the scope of an audit of financial statements.

22. **The auditor should be alert to the fact that audit procedures applied for the purpose of forming an opinion on the financial statements may bring instances of possible noncompliance with laws and regulations to the auditor's attention.** For example, such audit procedures include reading minutes; inquiring of the entity's management and legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of classes of transactions, account balances, or disclosures.

23. **The auditor should obtain written representations that management has disclosed to the auditor all known actual or possible noncompliance with laws and regulations whose effects should be considered when preparing financial statements.**

24. In the absence of audit evidence to the contrary, the auditor is entitled to assume the entity is in compliance with these laws and regulations.

Audit Procedures when Noncompliance is Discovered

25. The Appendix to this ISA sets out examples of the type of information that might come to the auditor's attention that may indicate noncompliance.

26. **When the auditor becomes aware of information concerning a possible instance of noncompliance, the auditor should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect on the financial statements.**

27. When evaluating the possible effect on the financial statements, the auditor considers:

    - The potential financial consequences, such as fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations and litigation.
    - Whether the potential financial consequences require disclosure.
    - Whether the potential financial consequences are so serious as to call into question the true and fair view (fair presentation) given by the financial statements.

28. **When the auditor believes there may be noncompliance, the auditor should document the findings and discuss them with management.**

Documentation of findings would include copies of records and documents and making minutes of conversations, if appropriate.

29. If management does not provide satisfactory information that it is in fact in compliance, the auditor would consult with the entity's lawyer about the application of the laws and regulations to the circumstances and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's lawyer or when the auditor is not satisfied with the opinion, the auditor would consider consulting the auditor's own lawyer as to whether a violation of a law or regulation is involved, the possible legal consequences and what further action, if any, the auditor would take.

30. **When adequate information about the suspected noncompliance cannot be obtained, the auditor should consider the effect of the lack of sufficient appropriate audit evidence on the auditor's report**.

31. **The auditor should consider the implications of noncompliance in relation to other aspects of the audit, particularly the reliability of management representations.** In this regard, the auditor reconsiders the risk assessment and the validity of management representations, in case of noncompliance not detected by the entity's internal controls or not included in management representations. The implications of particular instances of noncompliance discovered by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved.

Reporting of Noncompliance

To Management

32. **The auditor should, as soon as practicable, either communicate with those charged with governance, or obtain audit evidence that they are appropriately informed, regarding noncompliance that comes to the auditor's attention**. However, the auditor need not do so for matters that are clearly inconsequential or trivial and may reach agreement in advance on the nature of such matters to be communicated.

33. **If in the auditor's judgment the noncompliance is believed to be intentional and material, the auditor should communicate the finding without delay.**

34. **If the auditor suspects that members of senior management, including members of the board of directors, are involved in noncompliance, the auditor should report the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or a supervisory board.** Where no higher authority exists, or if the auditor believes that the report may not be acted upon or is unsure as to the person to whom to report, the auditor would consider seeking legal advice.

To the Users of the Auditor's Report on the Financial Statements

35. **If the auditor concludes that the noncompliance has a material effect on the financial statements, and has not been properly reflected in the financial statements, the auditor should express a qualified or an adverse opinion.**

36. **If the auditor is precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether noncompliance that may be material to the financial statements, has, or is likely to have, occurred, the auditor should express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit.**

37. **If the auditor is unable to determine whether noncompliance has occurred because of limitations imposed by the circumstances rather than by the entity, the auditor should consider the effect on the auditor's report.**

To Regulatory and Enforcement Authorities

38. The auditor's duty of confidentiality would ordinarily preclude reporting noncompliance to a third party. However, in certain circumstances, that duty of confidentiality is overridden by statute, law or by courts of law (for example, in some countries the auditor is required to report noncompliance by financial institutions to the supervisory authorities). The auditor may need to seek legal advice in such circumstances, giving due consideration to the auditor's responsibility to the public interest.

Withdrawal from the Engagement

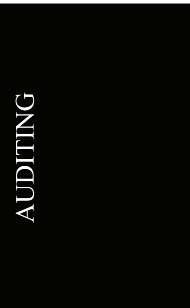
39. The auditor may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action that the auditor considers necessary in the circumstances, even when the noncompliance is not material to the financial statements. Factors that would affect the auditor's conclusion include the implications of the involvement of the highest authority within the entity which may affect the reliability of management representations, and the effects on the auditor of continuing association with the entity. In reaching such a conclusion, the auditor would ordinarily seek legal advice.

40. **As stated in the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants, on receipt of an inquiry from the proposed auditor, the existing auditor should advise whether there are any professional reasons why the proposed auditor should not accept the appointment.** The extent to which an existing auditor can discuss the affairs of a client with a proposed auditor will depend on whether the client's permission to do so has been obtained and/or the legal or ethical requirements that apply in each country relating to such disclosure. If there are any such reasons or other matters which need to be disclosed, the existing auditor would, taking account

of the legal and ethical constraints, including where appropriate permission of the client, give details of the information and discuss freely with the proposed auditor all matters relevant to the appointment. **If permission from the client to discuss its affairs with the proposed auditor is denied by the client, that fact should be disclosed to the proposed auditor.**

Public Sector Perspective

1. *Many public sector engagements include additional audit responsibilities with respect to consideration of laws and regulations. Even if the auditor's responsibilities do not extend beyond those of the private sector auditor, reporting responsibilities may be different as the public sector auditor may be obliged to report on instances of noncompliance to governing authorities or to report them in the audit report. In respect to public sector entities, the Public Sector Committee (PSC)[1] has supplemented the guidance included in this ISA in its Study 3, "Auditing for Compliance with Authorities—A Public Sector Perspective."*



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

Appendix

Indications that Noncompliance May Have Occurred

Examples of the type of information that may come to the auditor's attention that may indicate that noncompliance with laws or regulations has occurred are listed below:

- Investigation by government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' checks payable to bearer or transfers to numbered bank accounts.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorized transactions or improperly recorded transactions.
- Media comment.

INTERNATIONAL STANDARD ON AUDITING 260

COMMUNICATION OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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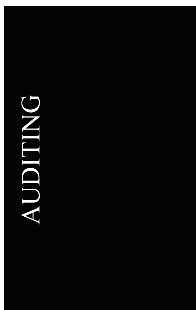
International Standard on Auditing (ISA) 260, "Communication of Audit Matters With Those Charged With Governance" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.



* ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 260. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 260.

ISA 260 has been revised. The IAASB's clarity drafting conventions have been applied to the revised ISA. ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance" can be found in Part II of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements*. It is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on communication of audit matters arising from the audit of financial statements between the auditor and those charged with governance of an entity. These communications relate to audit matters of governance interest as defined in this ISA. This ISA does not provide guidance on communications by the auditor to parties outside the entity, for example, external regulatory or supervisory agencies.

2. **The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity.**

3. For the purposes of this ISA, "governance" is the term used to describe the role of persons entrusted with the supervision, control and direction of an entity.[1] Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, with regard to reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties. Those charged with governance include management only when it performs such functions.

4. For the purpose of this ISA, "audit matters of governance interest" are those that arise from the audit of financial statements and, in the opinion of the auditor, are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. Audit matters of governance interest include only those matters that have come to the attention of the auditor as a result of the performance of the audit. The auditor is not required, in an audit in accordance with ISAs, to design audit procedures for the specific purpose of identifying matters of governance interest.

Relevant Persons

5. **The auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated.**

6. The structures of governance vary from country to country reflecting cultural and legal backgrounds. For example, in some countries, the supervision function, and the management function are legally separated into different

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[1] Principles of corporate governance have been developed by many countries as a point of reference for the establishment of good corporate behavior. Such principles generally focus on publicly traded companies; however, they may also serve to improve governance in other forms of entities. There is no single model of good corporate governance. Board structures and practices vary from country to country. A common principle is that the entity should have in place a governance structure which enables the board to exercise objective judgment on corporate affairs, including financial reporting, independent in particular from management.

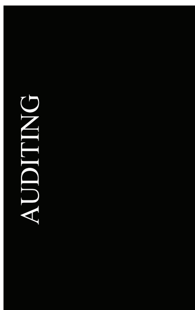
bodies, such as a supervisory (wholly or mainly non-executive) board and a management (executive) board. In other countries, both functions are the legal responsibility of a single, unitary board, although there may be an audit committee that assists that board in its governance responsibilities with respect to financial reporting.

7. This diversity makes it difficult to establish a universal identification of the persons who are charged with governance and with whom the auditor communicates audit matters of governance interest. The auditor uses judgment to determine those persons with whom audit matters of governance interest are communicated, taking into account the governance structure of the entity, the circumstances of the engagement and any relevant legislation. The auditor also considers the legal responsibilities of those persons. For example, in entities with supervisory boards or with audit committees, the relevant persons may be those bodies. However, in entities where a unitary board has established an audit committee, the auditor may decide to communicate with the audit committee, or with the whole board, depending on the importance of the audit matters of governance interest.

8. When the entity's governance structure is not well defined, or those charged with governance are not clearly identified by the circumstances of the engagement, or by legislation, the auditor comes to an agreement with the entity about with whom audit matters of governance interest are to be communicated. Examples include some owner-managed entities, some not for profit organizations, and some government agencies.

9. To avoid misunderstandings, an audit engagement letter may explain that the auditor will communicate only those matters of governance interest that come to attention as a result of the performance of an audit and that the auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest. The engagement letter may also:

    - Describe the form in which any communications on audit matters of governance interest will be made;
    - Identify the relevant persons with whom such communications will be made; and
    - Identify any specific audit matters of governance interest which it has been agreed are to be communicated.



10. The effectiveness of communications is enhanced by developing a constructive working relationship between the auditor and those charged with governance. This relationship is developed while maintaining an attitude of professional independence and objectivity.

Audit Matters of Governance Interest to be Communicated

11. **The auditor should consider audit matters of governance interest that arise from the audit of the financial statements and communicate them with those charged with governance**. Ordinarily such matters include the following: [2]

    - The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements.
    - The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements.
    - The potential effect on the financial statements of any material risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements.
    - Audit adjustments, whether or not recorded by the entity that have, or could have, a material effect on the entity's financial statements.
    - Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern.
    - Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter.
    - Expected modifications to the auditor's report.
    - Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management.
    - Any other matters agreed upon in the terms of the audit engagement.

11a. **The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.**

11b. The uncorrected misstatement communicated to those charged with governance need not include the misstatement below a designated amount.

[2] The list of matters is not intended to be all-inclusive. In addition, other ISAs discuss specific situations where the auditor is required to communicate certain matters with those charged with governance.

12. As part of the auditor's communications, those charged with governance are informed that:

    (a) The auditor's communications of matters include only those audit matters of governance interest that have come to the attention of the auditor as a result of the performance of the audit; and

    (b) An audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. Accordingly, the audit does not ordinarily identify all such matters.

Timing of Communications

13. **The auditor should communicate audit matters of governance interest on a timely basis.** This enables those charged with governance to take appropriate action.

14. In order to achieve timely communications, the auditor discusses with those charged with governance the basis and timing of such communications. In certain cases, because of the nature of the matter, the auditor may communicate that matter sooner than previously agreed.

Forms of Communications

15. The auditor's communications with those charged with governance may be made orally or in writing. The auditor's decision whether to communicate orally or in writing is affected by factors such as the following:

    - The size, operating structure, legal structure, and communications processes of the entity being audited.
    - The nature, sensitivity and significance of the audit matters of governance interest to be communicated.
    - The arrangements made with respect to periodic meetings or reporting of audit matters of governance interest.
    - The amount of on-going contact and dialogue the auditor has with those charged with governance.

16. When audit matters of governance interest are communicated orally, the auditor documents in the working papers the matters communicated and any responses to those matters. This documentation may take the form of a copy of the minutes of the auditor's discussion with those charged with governance. In certain circumstances, depending on the nature, sensitivity, and significance of the matter, it may be advisable for the auditor to confirm in writing with those charged with governance any oral communications on audit matters of governance interest.

17. Ordinarily, the auditor initially discusses audit matters of governance interest with management, except where those matters relate to questions of management competence or integrity. These initial discussions with management are important in order to clarify facts and issues, and to give management an opportunity to provide further information. If management agrees to communicate a matter of governance interest with those charged with governance, the auditor may not need to repeat the communications, provided that the auditor is satisfied that such communications have effectively and appropriately been made.

Other Matters

18. If the auditor considers that a modification of the auditor's report on the financial statements is required, as described in ISA 701, "Modifications to the Independent Auditor's Report," communications between the auditor and those charged with governance cannot be regarded as a substitute.

19. The auditor considers whether audit matters of governance interest previously communicated may have an effect on the current year's financial statements. The auditor considers whether the point continues to be a matter of governance interest and whether to communicate the matter again with those charged with governance.

Confidentiality

20. The requirements of national professional accountancy bodies, legislation or regulation may impose obligations of confidentiality that restrict the auditor's communications of audit matters of governance interest. The auditor refers to such requirements, laws and regulations before communicating with those charged with governance. In some circumstances, the potential conflicts with the auditor's ethical and legal obligations of confidentiality and reporting may be complex. In these cases, the auditor may wish to consult with legal counsel.

Laws and Regulations

21. The requirements of national professional accountancy bodies, legislation or regulation may impose obligations on the auditor to make communications on governance related matters. These additional communications requirements are not covered by this ISA; however, they may affect the content, form and timing of communications with those charged with governance.

Effective Date

22. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2004.

Public Sector Perspective

1. *While the basic principles contained in this ISA apply to the audit of financial statements in the public sector, the legislation giving rise to the audit mandate may specify the nature, content and form of the communications with those charged with governance of the entity.*

2. *For public sector audits, the types of matters that may be of interest to the governing body may be broader than the types of matters discussed in the ISA, which are directly related to the audit of financial statements. Public sector auditors' mandates may require them to report matters that come to their attention that relate to:*

   (a) *Compliance with legislative or regulatory requirements and related authorities;*

   (b) *Adequacy of internal control; and*

   (c) *Economy, efficiency and effectiveness of programs, projects and activities.*

3. *For public sector auditors, the auditors' written communications may be placed on the public record. For that reason, the public sector auditor needs to be aware that their written communications may be distributed to a wider audience than solely those persons charged with governance of the entity.*

INTERNATIONAL STANDARD ON AUDITING 300

PLANNING AN AUDIT OF FINANCIAL STATEMENTS

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 300, "Planning an Audit of Financial Statements," should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* The IAASB's clarity drafting conventions have been applied to ISA 300. ISA 300 (Redrafted), "Planning an Audit of Financial Statements" can be found in Part II of the Handbook of International Auditing, Assurance, and Ethics Pronouncements. It is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the considerations and activities applicable to planning an audit of financial statements. This ISA is framed in the context of recurring audits. In addition, matters the auditor considers in initial audit engagements are included in paragraphs 28 and 29.

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

3. 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. Planning involves the engagement partner and other key members of the engagement team to benefit from their experience and insight and to enhance the effectiveness and efficiency of the planning process.

4. Adequate planning helps to ensure that appropriate attention is devoted to important areas of the audit, that potential problems are identified and resolved on a timely basis and that the audit engagement is properly organized and managed in order to be performed in an effective and efficient manner. Adequate planning also assists in the proper assignment of work to engagement team members, facilitates the direction and supervision of engagement team members and the review of their work, and assists, 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 auditor's previous experience with the entity, and changes in circumstances that occur during the audit engagement.

5. 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. However, in planning an audit, the auditor considers the timing of certain planning activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, the auditor plans the discussion among engagement team members,[1] 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

AUDITING

[1] ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," paragraphs 14-19, provide guidance on the engagement team's discussion of the susceptibility of the entity to material misstatements of the financial statements. ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," paragraphs 27-32, provide guidance on the emphasis given during this discussion to the susceptibility of the entity's financial statements to material misstatement due to fraud.

of materiality, the involvement of experts and the performance of other risk assessment procedures prior to identifying and assessing the risks of material misstatement and performing further audit procedures at the assertion level for classes of transactions, account balances, and disclosures that are responsive to those risks.

Preliminary Engagement Activities

6. **The auditor should perform the following activities at the beginning of the current audit engagement:**

   - **Perform procedures regarding the continuance of the client relationship and the specific audit engagement** (see ISA 220, "Quality Control for Audits of Historical Financial Information" for additional guidance).

   - **Evaluate compliance with ethical requirements, including independence** (see ISA 220 for additional guidance).

   - **Establish an understanding of the terms of the engagement** (see ISA 210, "Terms of Audit Engagements" for additional guidance).

   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. However, the auditor's initial procedures on both client continuance and evaluation of ethical requirements (including independence) are performed prior to performing 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.

7. The purpose of performing these preliminary engagement activities is to help ensure that the auditor has considered any 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. Performing these preliminary engagement activities helps to ensure that the auditor plans 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.

Planning Activities

The Overall Audit Strategy

8. **The auditor should establish the overall audit strategy for the audit.**

9. The overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The establishment of the overall audit strategy involves:

   (a) Determining the characteristics of the engagement that define its scope, such as the financial reporting framework used, industry-specific reporting requirements and the locations of the components of the entity;

   (b) Ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, such as deadlines for interim and final reporting, and key dates for expected communications with management and those charged with governance; and

   (c) Considering the important factors that will determine the focus of the engagement team's efforts, such as determination of appropriate materiality levels, preliminary identification of areas where there may be higher risks of material misstatement, preliminary identification of material components and account balances, evaluation of whether the auditor may plan to obtain evidence regarding the effectiveness of internal control, and identification of recent significant entity-specific, industry, financial reporting or other relevant developments.

   In developing the overall audit strategy, the auditor also considers the results of preliminary engagement activities (see paragraphs 6 and 7) and, where practicable, experience gained on other engagements performed for the entity. The Appendix to this ISA lists examples of matters the auditor may consider in establishing the overall audit strategy for an engagement.

10. 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. The overall audit strategy sets out clearly, in response to the matters identified in paragraph 9, and subject to the completion of the auditor's risk assessment procedures:

    (a) 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;

    (b) 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;

(c) When these resources are deployed, such as whether at an interim audit stage or at key cut-off dates; and

(d) 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.

11. Once the overall audit strategy has been established, the auditor is able to start the development of a more detailed audit plan 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 auditor ordinarily establishes the overall audit strategy before developing 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. Paragraphs 14 and 15 provide further guidance on developing the audit plan.

12. In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the audit 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 and changed 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

13. **The auditor should develop an audit plan for the audit in order to reduce audit risk to an acceptably low level.**

14. The audit plan is more detailed than the overall audit strategy and includes the nature, timing and extent of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Documentation of the audit plan 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.

15. The audit plan 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, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement;"
    - 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, "The Auditor's Procedures in Response to Assessed Risks." The plan for further audit procedures reflects the auditor's decision whether to test the operating effectiveness of controls, and the nature, timing and extent of planned substantive procedures; and
    - Such other audit procedures required to be carried out for the engagement in order to comply with ISAs (for example, seeking direct communication with the entity's lawyers).

    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 more detailed audit plan of all remaining further audit procedures.

Changes to Planning Decisions During the Course of the Audit

16. **The overall audit strategy and the audit plan should be updated and changed as necessary during the course of the audit.**

17. Planning an audit is a continual and iterative process throughout the audit engagement. 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, and thereby the resulting planned nature, timing and extent of further audit procedures. Information may come to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, the auditor may obtain audit evidence through the performance of substantive procedures that contradicts the audit evidence obtained with respect to the testing of the operating effectiveness of controls. In such circumstances, the auditor re-evaluates the planned audit procedures, 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.

Direction, Supervision and Review

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

19. 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 audit, the risks of material misstatement, and the capabilities and competence of personnel performing the audit work. ISA 220 contains detailed guidance on the direction, supervision and review of audit work.

20. The auditor plans the nature, timing and extent of direction and supervision of engagement team members based on the assessed risk of material misstatement. As the assessed risk of material misstatement increases, a given area of the audit, the auditor ordinarily increases the extent and timeliness of direction and supervision of engagement team members and performs a more detailed review of their work. Similarly, the auditor plans the nature, timing and extent of review of the engagement team's work based on the capabilities and competence of the individual team members performing the audit work.

21. In audits of small entities, an audit may be carried out entirely by the audit engagement partner (who may be a sole practitioner). In such situations, questions of direction and supervision of engagement team members and review of their work do not arise as the audit engagement partner, having personally conducted all aspects of the work, is aware of all material issues. The audit engagement partner (or sole practitioner) nevertheless needs to be satisfied that the audit has been conducted in accordance with ISAs. 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

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

23. The auditor's documentation of the overall audit strategy records 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.

24. The auditor's documentation of the audit plan is sufficient to demonstrate 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. The auditor may use standard audit programs or audit completion checklists. However, when such standard programs or checklists are used, the auditor appropriately tailors them to reflect the particular engagement circumstances.

25. The auditor's documentation of any significant changes to the originally planned overall audit strategy and to the detailed audit plan includes the reasons for the significant changes and the auditor's response to the events, conditions, or results of audit procedures that resulted in such changes. For example, the auditor may significantly change the planned overall audit strategy and the audit plan as a result of a material business combination or the identification of a material misstatement of the financial statements. 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 the overall strategy and audit plan finally adopted for the audit and demonstrates the appropriate response to significant changes occurring during the audit.

26. The form and extent of documentation depend on such matters as the size and complexity of the entity, materiality, the extent of other documentation, and the circumstances of the specific audit engagement.

Communications with Those Charged with Governance and Management

27. The auditor may discuss elements of planning with those charged with governance and the entity's management. These discussions may be a part of overall communications required to be made to those charged with governance of the entity or may be made to improve the effectiveness and efficiency of the audit. Discussions with those charged with governance ordinarily include the overall audit strategy and timing of the audit, including any limitations thereon, or any additional requirements. Discussions with management often occur to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussions of matters included in the overall audit strategy or audit plan occur, care is required in order to not compromise the effectiveness of the audit. For example, the auditor considers whether discussing the nature and timing of detailed audit procedures with management compromises the effectiveness of the audit by making the audit procedures too predictable.

Additional Considerations in Initial Audit Engagements

28. **The auditor should perform the following activities prior to starting an initial audit:**

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

    (b) **Communicate with the previous auditor, where there has been a change of auditors, in compliance with relevant ethical requirements.**

29. 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 paragraph 2 of 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).

Effective Date

30. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.

Public Sector Perspective

1. *This ISA is applicable in all material respects to audits of public sector entities.*

2. *Some of the terms used in this ISA such as "engagement partner" and "firm" should be read as referring to their public sector equivalents.*

3. *Paragraph 6 of this ISA refers to ISA 210, "Terms of Audit Engagements," and ISA 220, "Quality Control for Audits of Historical Financial Information." The Public Sector Perspectives to those ISAs contain a discussion of their applicability to audits of public sector entities, and are therefore relevant to the application of this ISA in the public sector.*

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. The examples provided cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required to be performed by other ISAs, not all matters are relevant to every audit engagement and the list is not necessarily complete. In addition, the auditor may consider these matters in an order different from that shown below.

Scope of the Audit Engagement

The auditor may consider the following matters when establishing the scope of the audit engagement:

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in 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 Communications Required

The auditor may consider the following matters when ascertaining the reporting objectives of the engagement, the timing of the audit and the 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.

Direction of the Audit

The auditor may consider the following matters when setting the direction of the audit:

- With respect to materiality:

   - 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.

INTERNATIONAL STANDARD ON AUDITING 315

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

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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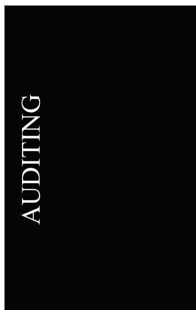
International Standard on Auditing (ISA) 315, "Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.



* The IAASB's clarity drafting conventions have been applied to ISA 315. ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" can be found in Part II of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements*. It is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and to provide guidance on obtaining an understanding of the entity and its environment, including its internal control, and on assessing the risks of material misstatement in a financial statement audit. The importance of the auditor's risk assessment as a basis for further audit procedures is discussed in the explanation of audit risk in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements."

2. **The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.** ISA 500, "Audit Evidence," requires the auditor to use assertions in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. This ISA requires the auditor to make risk assessments at the financial statement and assertion levels based on an appropriate understanding of the entity and its environment, including its internal control. ISA 330, "The Auditor's Procedures in Response to Assessed Risks" discusses the auditor's responsibility to determine overall responses and to design and perform further audit procedures whose nature, timing, and extent are responsive to the risk assessments. The requirements and guidance of this ISA are to be applied in conjunction with the requirements and guidance provided in other ISAs. In particular, further guidance in relation to the auditor's responsibility to assess the risks of material misstatement due to fraud is discussed in ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements."

3. The following is an overview of the requirements of this standard:

   - *Risk assessment procedures and sources of information about the entity and its environment, including its internal control.* This section explains the audit procedures that the auditor is required to perform to obtain the understanding of the entity and its environment, including its internal control (risk assessment procedures). It also requires discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement.

   - *Understanding the entity and its environment, including its internal control*. This section requires the auditor to understand specified aspects of the entity and its environment, and components of its internal control, in order to identify and assess the risks of material misstatement.

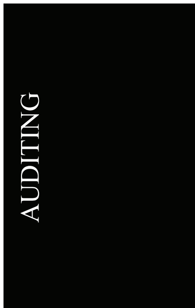
   - *Assessing the risks of material misstatement*. This section requires the auditor to identify and assess the risks of material misstatement at the financial statement and assertion levels. The auditor:

    - Identifies risks by considering the entity and its environment, including relevant controls, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
    - Relates the identified risks to what can go wrong at the assertion level; and
    - Considers the significance and likelihood of the risks.

  This section also requires the auditor to determine whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. The auditor is required to evaluate the design of the entity's controls, including relevant control activities, over such risks and determine whether they have been implemented.

- *Communicating with those charged with governance and management.* This section deals with matters relating to internal control that the auditor communicates to those charged with governance and management.
- *Documentation*. This section establishes related documentation requirements.

4. Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with ISAs. In particular, that 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 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.



5. The auditor uses professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess the risks of material misstatement of the financial statements and to design and perform further audit procedures. The depth of the overall understanding that is required by the auditor in performing the audit is less than that possessed by management in managing the entity.

Risk Assessment Procedures and Sources of Information About the Entity and Its Environment, Including Its Internal Control

6. Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. As described in ISA 500, audit procedures to obtain an understanding are referred to as "risk assessment procedures" because some of the information obtained by performing such procedures may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, in performing risk assessment procedures, 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 audit 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.

Risk Assessment Procedures

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

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

   (b) **Analytical procedures; and**

   (c) **Observation and inspection.**

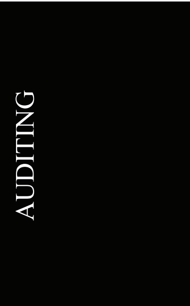
   The auditor is not required to perform all the risk assessment procedures described above for each aspect of the understanding described in paragraph 20. However, all the risk assessment procedures are performed by the auditor in the course of obtaining the required understanding.

8. In addition, the auditor performs other audit procedures where the information obtained may be helpful in identifying risks of material misstatement. For example, the auditor may consider 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 may also be useful in obtaining information about the entity.

9. Although much of the information the auditor obtains by inquiries can be obtained from management and those responsible for financial reporting, inquiries of others within the entity, such as production and internal audit personnel, and other employees with different levels of authority, may be useful in providing the auditor with a different perspective in identifying risks of material misstatement. In determining others within the entity to whom inquiries may be directed, and the extent of those inquiries, the auditor considers what information may be obtained that helps the auditor in identifying risks of material misstatement. For example:

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



10. Analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. In performing analytical procedures as risk assessment procedures, the auditor develops expectations about plausible relationships that are reasonably expected to exist. When comparison of those expectations with recorded amounts or ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor considers those results in identifying risks of material misstatement. However, when such analytical procedures use data aggregated at a high level (which is often the situation), the results of those analytical procedures only

provide a broad initial indication about whether a material misstatement may exist. Accordingly, the auditor considers the results of such analytical procedures along with other information gathered in identifying the risks of material misstatement. See ISA 520, "Analytical Procedures" for additional guidance on the use of analytical procedures.

11. Observation and inspection may support inquiries of management and others, and also provide information about the entity and its environment. Such audit procedures ordinarily include the following:

    - Observation of entity activities and operations.
    - Inspection of documents (such as business plans and strategies), records, and internal control manuals.
    - Reading 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).
    - Visits to the entity's premises and plant facilities.
    - Tracing transactions through the information system relevant to financial reporting (walk-throughs).

12. **When the auditor intends to use information about the entity and its environment obtained in prior periods, the auditor should determine whether changes have occurred that may affect the relevance of such information in the current audit.** For continuing engagements, the auditor's previous experience with the entity contributes to the understanding of the entity. For example, audit procedures performed in previous audits ordinarily provide audit evidence about the entity's organizational structure, business and controls, as well as information about past misstatements and whether or not they were corrected on a timely basis, which assists the auditor in assessing risks of material misstatement in the current audit. However, such information may have been rendered irrelevant by changes in the entity or its environment. The auditor makes inquiries and performs other appropriate audit procedures, such as walk-throughs of systems, to determine whether changes have occurred that may affect the relevance of such information.

13. When relevant to the audit, the auditor also considers other information such as that obtained from the auditor's client acceptance or continuance process or, where practicable, experience gained on other engagements performed for the entity, for example, engagements to review interim financial information.

Discussion Among the Engagement Team

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

15. The objective of this discussion is for members of the engagement team to gain a better understanding of the potential for material misstatements of the financial statements resulting from fraud or error in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures.

16. 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, and for the team members to exchange information about the business risks[1] to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement. As required by ISA 240, particular emphasis is given to the susceptibility of the entity's financial statements to material misstatement due to fraud. The discussion also addresses application of the applicable financial reporting framework to the entity's facts and circumstances.

17. Professional judgment is used to determine which members of the engagement team are included in the discussion, how and when it occurs, and the extent of the discussion. The key members of the engagement team are ordinarily involved in the discussion; however, it is not necessary for all team members to have a comprehensive knowledge of all aspects of the audit. The extent of the discussion is influenced by the roles, experience, and information needs of the engagement team members. In a multi-location audit, for example, there may be multiple discussions that involve the key members of the engagement team in each significant location. Another factor to consider in planning the discussions is whether to include experts assigned to the engagement team. For example, the auditor may determine that including a professional possessing specialist information technology (IT)[2] or other skills is needed on the engagement team and therefore includes that individual in the discussion.

18. As required by ISA 200, the auditor plans and performs the audit with an attitude of professional skepticism. The discussion among the engagement team members emphasizes the need to maintain professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications.

19. Depending on the circumstances of the audit, there may be further discussions in order to facilitate the ongoing exchange of information between engagement team members regarding the susceptibility of the entity's financial statements

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1 See paragraph 30.

2 Information technology (IT) encompasses automated means of originating, processing, storing and communicating information, and includes recording devices, communication systems, computer systems (including hardware and software components and data), and other electronic devices.

to material misstatements. The purpose is for engagement team members to communicate and share information obtained throughout the audit that may affect the assessment of the risks of material misstatement due to fraud or error or the audit procedures performed to address the risks.

Understanding the Entity and Its Environment, Including Its Internal Control

20. The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

    (a) Industry, regulatory, and other external factors, including the applicable financial reporting framework.

    (b) Nature of the entity, including the entity's selection and application of accounting policies.

    (c) Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.

    (d) Measurement and review of the entity's financial performance.

    (e) Internal control.

    Appendix 1 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (a) through (d) above. Appendix 2 contains a detailed explanation of the internal control components.

21. The nature, timing, and extent of the risk assessment procedures performed depend on the circumstances of the engagement such as the size and complexity of the entity and the auditor's experience with it. In addition, identifying significant changes in any of the above aspects of the entity from prior periods is particularly important in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

Industry, Regulatory and Other External Factors, Including the Applicable Financial Reporting Framework

22. **The auditor should obtain an understanding of relevant industry, regulatory, and other external factors including the applicable financial reporting framework.** These factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments; the regulatory environment encompassing, among other matters, the applicable financial reporting framework, the legal and political environment, and environmental requirements affecting the industry and the entity; and other external factors such as general economic conditions. See ISA 250, "Consideration of Laws and Regulations in an Audit of Financial

Statements" for additional requirements related to the legal and regulatory framework applicable to the entity and the industry.

23. 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, the auditor considers whether the engagement team includes members with sufficient relevant knowledge and experience.

24. Legislative and regulatory requirements often determine the applicable financial reporting framework to be used by management in preparing the entity's financial statements. In most cases, the applicable financial reporting framework will be that of the jurisdiction in which the entity is registered or operates and the auditor is based, and the auditor and the entity will have a common understanding of that framework. In some cases there may be no local financial reporting framework, in which case the entity's choice will be governed by local practice, industry practice, user needs, or other factors. For example, the entity's competitors may apply International Financial Reporting Standards (IFRS) and the entity may determine that IFRS are also appropriate for its financial reporting requirements. The auditor considers whether local regulations specify certain financial reporting requirements for the industry in which the entity operates, since the financial statements may be materially misstated in the context of the applicable financial reporting framework if management fails to prepare the financial statements in accordance with such regulations.

Nature of the Entity

25. **The auditor should obtain an understanding of the nature of the entity.** The nature of an entity refers to the entity's operations, its ownership and governance, the types of investments that it is making and plans to make, the way that the entity is structured and how it is financed. An understanding of the nature of an entity enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

26. The entity may have a complex structure with subsidiaries or other components in multiple locations. In addition to the difficulties of consolidation in such cases, other issues with complex structures that may give rise to risks of material misstatement include: the allocation of goodwill to business segments, and its impairment; whether investments are joint ventures, subsidiaries, or investments accounted for using the equity method; and whether special-purpose entities are accounted for appropriately.

27. An understanding of the ownership and relations between owners and other people or entities is also important in determining whether related party

transactions have been identified and accounted for appropriately. ISA 550, "Related Parties" provides additional guidance on the auditor's considerations relevant to related parties.

28. **The auditor should obtain an understanding of the entity's selection and application of accounting policies and consider whether they are appropriate for its business and consistent with the applicable financial reporting framework and accounting polices used in the relevant industry.** The understanding encompasses 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; and changes in the entity's accounting policies. The auditor also identifies financial reporting standards and regulations that are new to the entity and considers when and how the entity will adopt such requirements. Where the entity has changed its selection of or method of applying a significant accounting policy, the auditor considers the reasons for the change and whether it is appropriate and consistent with the requirements of the applicable financial reporting framework.

29. The presentation of financial statements in conformity with the applicable financial reporting framework includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the basis of amounts set forth. The auditor considers whether the entity has disclosed a particular matter appropriately in light of the circumstances and facts of which the auditor is aware at the time.

Objectives and Strategies and Related Business Risks

30. **The auditor should obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements.** The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the operational approaches by which management intends to achieve its objectives. Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic and the entity's strategies and objectives change over time.

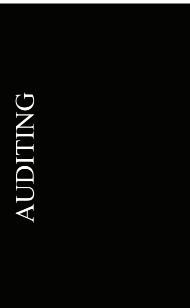
31. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk particularly may arise from change or complexity, though a failure to recognize the need for change

may also give rise to risk. Change may arise, for example, from the development of new products that may fail; from an inadequate market, even if successfully developed; or from flaws that may result in liabilities and reputational risk. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks.

32. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement. A business risk may have an immediate consequence for the risk of misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statements as a whole. For example, the business risk arising from a contracting customer base due to industry consolidation 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. The auditor's consideration of whether a business risk may result in material misstatement is, therefore, made in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are given in Appendix 3.

33. 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 paragraphs 76-79.

34. 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

35. **The auditor should obtain an understanding of the measurement and review of the entity's financial performance.** Performance measures and their review indicate to the auditor aspects of the entity's performance that management and others consider to be of importance. Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.

36. Management's measurement and review of the entity's financial performance is to be distinguished from the monitoring of controls (discussed as a

component of internal control in paragraphs 96-99), though their purposes may overlap. Monitoring of controls, however, 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), but in some cases performance indicators also provide information that enables management to identify deficiencies in internal control.

37. Internally-generated information used by management for this purpose may include key performance indicators (financial and non-financial), budgets, variance analysis, segment information and divisional, departmental or other level performance reports, and comparisons of an entity's performance with that of competitors. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may provide information useful to the auditor's understanding of the entity and its environment. Such reports often are obtained from the entity being audited.

38. Internal measures may highlight unexpected results or trends requiring management's inquiry of others in order 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.

39. Much of the information used in performance measurement may be produced by the entity's information system. If management assumes that data used for reviewing the entity's performance are accurate without having a basis for that assumption, errors may exist in the information, potentially leading management to incorrect conclusions about performance. When the auditor intends to make use of the performance measures for the purpose of the audit (for example, for analytical procedures), the auditor considers whether the information related to management's review of the entity's performance provides a reliable basis and is sufficiently precise for such a purpose. If making use of performance measures, the auditor considers whether they are precise enough to detect material misstatements.

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

Internal Control

41. **The auditor should obtain an understanding of internal control relevant to the audit.** The auditor uses the understanding of internal control to identify types of potential misstatements, consider factors that affect the risks of material misstatement, and design the nature, timing, and extent of further audit procedures. Internal control relevant to the audit is discussed in paragraphs 47-53 below. In addition, the depth of the understanding is discussed in paragraphs 54-56 below.

42. Internal control is the process designed and effected 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. It follows that internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives.

43. Internal control, as discussed in this ISA, consists of the following components:

    (a) The control environment.

    (b) The entity's risk assessment process.

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

    (d) Control activities.

    (e) Monitoring of controls.

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

44. The division of internal control into the five components 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. Also, the auditor's primary consideration is whether, and how, a specific control prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures, and their related assertions, rather than its classification into any particular component. Accordingly, 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.

45. The way in which internal control is designed and implemented varies with an entity's size and complexity. Specifically, 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. For some entities, in particular very small entities, the owner-manager[3] may perform functions which in a larger entity would be regarded as belonging to several of the components of internal control. Therefore, the components of internal control may not be clearly distinguished within smaller entities, but their underlying purposes are equally valid.

46. For the purposes of this ISA, the term "internal control" encompasses all five components of internal control stated above. In addition, the term "controls" refers to one or more of the components, or any aspect thereof.

Controls Relevant to the Audit

47. 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.

48. Ordinarily, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements for external purposes that give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework and the management of risk that may give rise to a material misstatement in those financial statements. It is a matter of the auditor's professional judgment, subject to the requirements of this ISA, whether a control, individually or in combination with others, is relevant to the auditor's considerations in assessing the risks of material misstatement and designing and performing further procedures in response to assessed risks. In exercising that judgment, the auditor considers the circumstances, the applicable component and factors such as the following:

- 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.

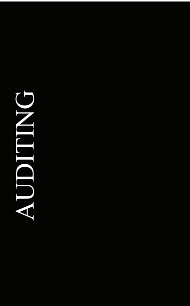
3 This ISA uses the term "owner-manager" to indicate the proprietors of entities who are involved in the running of the entity on a day-to-day basis.

49. Controls over the completeness and accuracy of information produced by the entity may also be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. The auditor's previous experience with the entity and information obtained in understanding the entity and its environment and throughout the audit assists the auditor in identifying controls 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.

50. Controls relating to operations and compliance objectives may, however, be relevant to an audit if they pertain to data the auditor evaluates or uses in applying audit procedures. For example, controls pertaining to non-financial data that the auditor uses in analytical procedures, such as production statistics, or controls pertaining to detecting non-compliance with laws and regulations that may have a direct and material effect on the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

51. 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 a commercial airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit.

52. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. In obtaining an understanding of each of the components of internal control, the auditor's consideration of safeguarding controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, controls to prevent the excessive use of materials in production generally are not relevant to a financial statement audit.



53. Controls relevant to the audit may exist in any of the components of internal control and a further discussion of controls relevant to the audit is included under the heading of each internal control component below. In addition, paragraphs 113 and 115 discuss certain risks for which the auditor is required to evaluate the design of the entity's controls over such risks and determine whether they have been implemented.

Depth of Understanding of Internal Control

54. Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Further explanation is contained in the discussion of each internal control component below. Implementation of a control means that the control exists and that the entity is using it. The auditor considers the design of a control in determining whether to consider its implementation. An improperly designed control may represent a material weakness[4] in the entity's internal control and the auditor considers whether to communicate this to those charged with governance and management as required by paragraph 120.

55. 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, and tracing transactions through the information system relevant to financial reporting. Inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented.

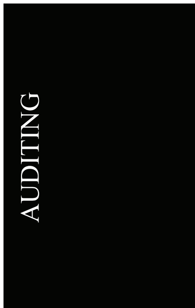
56. Obtaining an understanding of an entity's controls is not sufficient to serve as testing the operating effectiveness of controls, unless there is some automation that provides for the consistent application of the operation of the control (manual and automated elements of internal control relevant to the audit are further described below). For example, obtaining audit evidence about the implementation of a manually operated control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, IT enables an entity to process large volumes of data consistently and enhances the entity's ability to monitor the performance of control activities and to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems. Therefore, because of the inherent consistency of IT processing, 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.

[4] A material weakness in internal control is one that could have a material effect on the financial statements.

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

57. Most entities make use of IT systems for financial reporting and operational purposes. However, even when IT is extensively used, there will be manual elements to the systems. The balance between manual and automated elements varies. In certain cases, particularly smaller, less complex entities, the systems may be primarily manual. In other cases, the extent of automation may vary with some systems substantially automated with few related manual elements and others, even within the same entity, predominantly manual. As a result, an entity's system of internal control is likely to contain manual and automated elements, the characteristics of which are relevant to the auditor's risk assessment and further audit procedures based thereon.

58. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported.[5] 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 such paper documents as purchase orders, invoices, shipping documents, and related accounting records. 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.



59. Generally, IT provides potential benefits of effectiveness and efficiency for an entity's internal control because it enables 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;

5 Paragraph 9 of Appendix 2 defines initiation, recording, processing, and reporting as used throughout this ISA.

- 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.

60. 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.

61. Manual aspects of systems may be more suitable where judgment and discretion are required such as for the following circumstances:

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

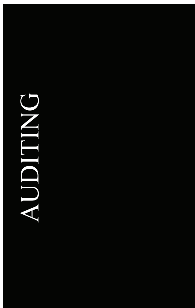
62. Manual controls are performed by people, and therefore pose specific risks to the entity's internal control. Manual controls may be less reliable than automated controls because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency 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.

63. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. Therefore in understanding internal control, the auditor considers whether the entity has responded adequately to the risks arising from the use of IT or manual systems by establishing effective controls.

Limitations of Internal Control

64. 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 failures, such as simple errors or mistakes. For example, if an entity's information system personnel do not completely understand how an order entry system processes sales transactions, they may erroneously design changes to the system to process sales for a new line of products. On the other hand, such changes may be correctly designed but misunderstood by individuals who translate the design into program code. Errors also may occur in the use of information produced by IT. For example, automated controls may be designed to report transactions over a specified amount for management review, but individuals responsible for conducting the review may not understand the purpose of such reports and, accordingly, may fail to review them or investigate unusual items.



65. 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.

66. 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. The potential for override of controls by the owner-manager depends to a great extent on the control environment and in particular, the owner-manager's attitudes about the importance of internal control.

Control Environment

67. **The auditor should obtain an understanding of the control environment.** 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. It is the foundation for effective internal control, providing discipline and structure.

68. The primary responsibility for the prevention and detection of fraud and error rests with both those charged with governance and the management of an entity. In evaluating the design of the control environment and determining whether it has been implemented, the auditor understands how management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior, and established appropriate controls to prevent and detect fraud and error within the entity.

69. In evaluating the design of the entity's control environment, the auditor considers the following elements and how they have been incorporated into the entity's processes:

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

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

    (c) Participation by those charged with governance – independence from management, their experience and stature, the extent of their involvement and scrutiny of activities, the information they receive, 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 – management's approach to taking and managing business risks, and management's attitudes and actions toward financial reporting, information processing and accounting functions and personnel.

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

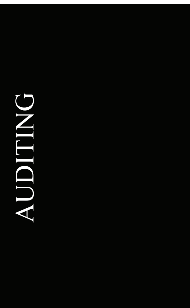
    (f) Assignment of authority and responsibility – how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.

(g) Human resource policies and practices – recruitment, orientation, training, evaluating, counseling, promoting, compensating and remedial actions.

70. In understanding the control environment elements, the auditor also considers whether they have been implemented. Ordinarily, the auditor obtains relevant audit evidence through a combination of inquiries and other risk assessment procedures, for example, 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 determines whether 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 or condones violations of, or authorizes exceptions to the code.

71. Audit evidence for elements of the control environment may not be available in documentary form, in particular for smaller entities where communication between management and other personnel may be informal, yet effective. For example, management's commitment to ethical values and competence are often implemented through the behavior and attitude they demonstrate in managing the entity's business instead of in a written code of conduct. Consequently, management's attitudes, awareness and actions are of particular importance in the design of a smaller entity's control environment. In addition, the role of those charged with governance is often undertaken by the owner-manager where there are no other owners.

72. The overall responsibilities of those charged with governance are recognized in codes of practice and other regulations or guidance produced for the benefit of those charged with governance. It is one, but not the only, role of those charged with governance to counterbalance pressures on management in relation to financial reporting. For example, the basis for management remuneration may place stress on management arising from the conflicting demands of fair reporting and the perceived benefits of improved results. In understanding the design of the control environment, the auditor considers such matters as the independence of the directors and their ability to evaluate the actions of management. The auditor also considers whether there is an audit committee that understands the entity's business transactions and evaluates whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework.



73. The nature of an entity's control environment is such that it has a pervasive effect on assessing the risks of material misstatement. For example, owner-manager controls may mitigate a lack of segregation of duties in a small business, or an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities. The

auditor's evaluation of the design of the entity's control environment includes considering 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 example, human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may not mitigate a strong bias by top management to overstate earnings. Changes in the control environment may affect the relevance of information obtained in prior audits. For example, management's decision to commit additional resources for training and awareness of financial reporting activities may reduce the risk of errors in processing financial information. Alternatively, management's failure to commit sufficient resources to address security risks presented by IT may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or by allowing unauthorized transactions to be processed.

74. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement and as explained in paragraph 5 of ISA 330, influences the nature, timing, and extent of the auditor's further procedures. 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 and therefore be negative factors in the auditor's assessment of the risks of material misstatement, in particular in relation to fraud.

75. The control environment in itself does not prevent, or detect and correct, a material misstatement in classes of transactions, account balances, and disclosures and related assertions. The auditor, therefore, ordinarily considers the effect of other components along with the control environment when assessing the risks of material misstatement; for example, the monitoring of controls and the operation of specific control activities.

The Entity's Risk Assessment Process

76. **The auditor should obtain an understanding of the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.** The process is described as the "entity's risk assessment process" and forms the basis for how management determines the risks to be managed.

77. In evaluating the design and implementation of the entity's risk assessment process, the auditor determines how management identifies business risks relevant to financial reporting, estimates the significance of the risks, assesses the likelihood of their occurrence, and decides upon actions to manage them. If the entity's risk assessment process is appropriate to the circumstances, it assists the auditor in identifying risks of material misstatement.

78. The auditor inquires about business risks that management has identified and considers whether they may result in material misstatement. During the audit, the auditor may identify risks of material misstatement that management failed to identify. In such cases, the auditor considers whether there was an underlying risk of a kind that should have been identified by the entity's risk assessment process, and if so, why that process failed to do so 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 communicates to those charged with governance as required by paragraph 120.

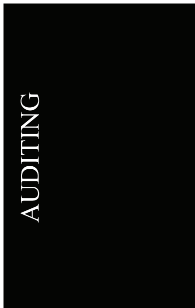
79. In a smaller entity, management may not have a formal risk assessment process as described in paragraph 76. For such entities, the auditor discusses with management how risks to the business are identified by management and how they are addressed.

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

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

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

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



82. In obtaining this understanding, the auditor considers the procedures used to transfer information from transaction processing systems to general ledger or financial reporting systems. The auditor also understands the entity's procedures to 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.

83. 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.

84. 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 an asset impairment. In manual, paper-based general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. However, when automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may be more easily identified through the use of computer-assisted audit techniques.

85. Preparation of the entity's financial statements include procedures that are designed to ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

86. In obtaining an understanding, the auditor considers risks of material misstatement associated with inappropriate override of controls over journal entries and the controls surrounding non-standard journal entries. For example, 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, the auditor maintains an awareness that when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

87. The auditor also understands how the incorrect processing of transactions is resolved, for example, whether there is an automated suspense file and how it is used by the entity to ensure that suspense items are cleared out on a timely basis, and how system overrides or bypasses to controls are processed and accounted for.

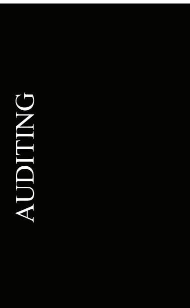
88. The auditor obtains an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's

circumstances. This includes obtaining an understanding of how transactions originate within the entity's business processes. 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.

89. **The auditor should understand how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting.** Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting and may take such forms as policy manuals and financial reporting manuals. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on. The auditor's understanding of communication pertaining to financial reporting matters also includes communications between management and those charged with governance, particularly the audit committee, as well as external communications such as those with regulatory authorities.

Control Activities

90. **The auditor should obtain a sufficient understanding of control activities to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks**. Control activities are the policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. 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.

91. In obtaining an understanding of control activities, the auditor's primary consideration is whether, and how, a specific control activity, individually or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures. Control activities relevant to the audit are those for which the auditor considers

it necessary to obtain an understanding in order to assess risks of material misstatement at the assertion level and to design and perform further audit procedures responsive to the assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. 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 achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

92. The auditor considers the knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. In considering whether control activities are relevant to the audit, the auditor considers the risks the auditor has identified that may give rise to material misstatement. Also, control activities are relevant to the audit if the auditor is required to evaluate them as discussed in paragraphs 113 and 115.

93. **The auditor should obtain an understanding of how the entity has responded to risks arising from IT.** The use of IT affects the way that control activities are implemented. The auditor considers whether the entity has responded adequately to the risks arising from IT by establishing effective general IT-controls and application controls. 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.

94. General IT-controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. 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.
- Access security.
- Application system acquisition, development, and maintenance.

They are generally implemented to deal with the risks referred to in paragraph 60 above.

95. Application controls are manual or automated procedures that typically operate at a business process level. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting

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

Monitoring of Controls

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

97. 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 modified for changes in conditions. 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.

98. 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.

99. 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. The auditor obtains 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. When the auditor intends to make use of the entity's information produced for monitoring activities, such as internal auditors' reports, the auditor considers whether the information provides a reliable basis and is sufficiently detailed for the auditor's purpose.

Assessing the Risks of Material Misstatement

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

- Identifies risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
- Relates the identified risks to what can go wrong at the assertion level;
- Considers whether the risks are of a magnitude that could result in a material misstatement of the financial statements; and
- Considers the likelihood that the risks could result in a material misstatement of the financial statements.

101. The auditor uses 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, as audit evidence to support the risk assessment. The auditor uses the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.

102. The auditor determines whether the identified risks of material misstatement relate to specific classes of transactions, account balances, and disclosures and related assertions, or whether they 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.

103. The nature of the risks arising from a weak control environment is such that they are not likely to be confined to specific individual risks of material misstatement in particular classes of transactions, account balances, and disclosures. Rather, 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.

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

105. 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.

106. 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.

107. 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. In such circumstances, the auditor considers a qualification or disclaimer of opinion, but in some cases the auditor's only recourse may be to withdraw from the engagement.

Significant Risks that Require Special Audit Consideration

108. **As part of the risk assessment as described in paragraph 100, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as "significant risks").** In addition, ISA 330, paragraphs 44 and 51 describe the consequences for further audit procedures of identifying a risk as significant.

109. 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 excludes the effect of identified controls related to the risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because they have lower inherent risks. On the other hand, significant risks are often derived from business risks that may result in a material misstatement. In considering the nature of the risks, the auditor considers a number of matters, including the following:

- Whether the risk is a risk of fraud.
- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.
- The complexity of transactions.

- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risk especially those involving a wide range of measurement uncertainty.
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

110. 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.

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

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

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

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

113. **For significant risks, to the extent the auditor has not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented.** An understanding of the entity's controls related to significant risks is required to provide the auditor with adequate information to develop an effective audit approach. Management ought to be aware of significant risks; however, risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls. Therefore, the auditor's understanding of whether the entity has designed and implemented controls for such significant risks includes whether and how management responds to the risks and whether control activities such as a review of assumptions by senior management or experts, formal processes for estimations or approval by those charged with governance have been

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

114. If management has not appropriately responded by implementing controls over significant risks and if, as a result, the auditor judges that there is a material weakness in the entity's internal control, the auditor communicates this matter to those charged with governance as required by paragraph 120. In these circumstances, the auditor also considers the implications for the auditor's risk assessment.

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

115. **As part of the risk assessment as described in paragraph 100, the auditor should evaluate the design and determine the implementation of the entity's controls, including relevant control activities, over those risks for which, in the auditor's judgment, it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures.** The consequences for further audit procedures of identifying such risks are described in paragraph 25 of ISA 330.

116. The understanding of the entity's information system relevant to financial reporting enables the auditor to identify risks of material misstatement that relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements; these include risks of inaccurate or incomplete processing. Ordinarily, such risks relate to significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

117. The characteristics of routine day-to-day business transactions often permit highly automated processing with little or no manual intervention. In such circumstances, it may not be possible to perform only substantive procedures in relation to the risk. For example, in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported electronically such as in an integrated system, the auditor may determine that it is not possible to design effective substantive procedures that by themselves would provide sufficient appropriate audit evidence that relevant classes of transactions or account balances, are not materially misstated. 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.

118. Examples of situations where the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence that certain assertions are not materially misstated include the following:

- An entity that conducts its business using IT to initiate orders for the purchase and delivery of goods based on predetermined rules of what to order and in what quantities and to pay the related accounts payable based on system-generated decisions initiated upon the confirmed receipt of goods and terms of payment. No other documentation of orders placed or goods received is produced or maintained, other than through the IT system.
- An entity that provides services to customers via electronic media (for example, an Internet service provider or a telecommunications company) and uses IT to create a log of the services provided to its customers, initiate and process its billings for the services and automatically record such amounts in electronic accounting records that are part of the system used to produce the entity's financial statements.

Revision of Risk Assessment

119. 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 particular, the risk assessment may be based on an expectation that controls are operating effectively to prevent, or detect and correct, a material misstatement at the assertion level. In performing tests of controls to obtain audit evidence about their operating effectiveness, the auditor may obtain audit evidence that controls are 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 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 revises the assessment and modifies the further planned audit procedures accordingly. See paragraphs 66 and 70 of ISA 330 for further guidance.

Communicating with Those Charged with Governance and Management

120. **The auditor should make those charged with governance or management aware, as soon as practicable, and at an appropriate level of responsibility,**

of material weaknesses in the design or implementation of internal control which have come to the auditor's attention.

121. If the auditor identifies risks of material misstatement which the entity has either not controlled, or for which the relevant control is inadequate, or if in the auditor's judgment there is a material weakness in the entity's risk assessment process, then the auditor includes such internal control weaknesses in the communication of audit matters of governance interest. See ISA 260, "Communications of Audit Matters with Those Charged with Governance."

Documentation

122. **The auditor should document:**

(a) **The discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, and the significant decisions reached;**

(b) **Key elements of the understanding obtained regarding each of the aspects of the entity and its environment identified in paragraph 20, including each of the internal control components identified in paragraph 43, to assess the risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures;**

(c) **The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 100; and**

(d) **The risks identified and related controls evaluated as a result of the requirements in paragraphs 113 and 115.**

123. The manner in which these matters are documented is for the auditor to determine using professional judgment. In particular, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures (see paragraph 73 of ISA 330 for additional guidance). Examples of common techniques, used alone or in combination include narrative descriptions, questionnaires, check lists and flow charts. Such techniques may also be useful in documenting the auditor's assessment of the risks of material misstatement at the overall financial statement and assertions level. The form and extent of this documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the specific audit methodology and technology used in the course of the audit. For example, documentation of the understanding of a complex information system in which a large volume of transactions are electronically initiated, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an

information system making limited or no use of IT or for which few transactions are processed (for example, long-term debt), documentation in the form of a memorandum may be sufficient. 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. ISA 230, "Audit Documentation" provides guidance regarding documentation in the context of the audit of financial statements.

Effective Date

124. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.

Public Sector Perspective

1. *When carrying out audits of public sector entities, the auditor takes into account the legislative framework and any other relevant regulations, ordinances or ministerial directives that affect the audit mandate and any other special auditing requirements. Therefore in obtaining an understanding of the regulatory framework as required in paragraph 22 of this ISA, auditors will have regard to the legislation and proper authority governing the operation of an entity. Similarly in respect of paragraph 30 of this ISA the auditor should be aware that the "management objectives" of public sector entities may be influenced by concerns regarding public accountability and may include objectives which have their source in legislation, regulations, government ordinances, and ministerial directives.*

2. *Paragraphs 47-53 of this ISA explain the controls relevant to the audit. 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.*

3. *Paragraphs 120 and 121 of this ISA deals with communication of weaknesses. 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.*

Appendix 1

Understanding the Entity and Its Environment

This appendix provides additional guidance on matters the auditor may consider when obtaining an understanding of the industry, regulatory, and other external factors that affect the entity, including the applicable financial reporting framework; the nature of the entity; objectives and strategies and related business risks; and measurement and review of the entity's financial performance. The examples provided cover a broad range of matters applicable to many engagements; however, not all matters are relevant to every engagement and the list of examples is not necessarily complete. Additional guidance on internal control is contained in Appendix 2.

Industry, Regulatory and Other External Factors, Including the Applicable Financial Reporting Framework

Examples of matters an auditor may consider include the following:

- Industry conditions
  - 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
- Regulatory environment
  - Accounting principles and industry specific practices
  - Regulatory framework for a regulated industry
  - Legislation and regulation that significantly affect the entity's operations
    - Regulatory requirements
    - Direct supervisory activities
  - Taxation (corporate and other)
  - Government policies currently affecting the conduct of the entity's business
    - Monetary, including foreign exchange controls
    - Fiscal
    - Financial incentives (for example, government aid programs)
    - Tariffs, trade restrictions
  - Environmental requirements affecting the industry and the entity's business

- Other external factors currently affecting the entity's business
  - General level of economic activity (for example, recession, growth)
  - Interest rates and availability of financing
  - Inflation, currency revaluation

Nature of the Entity

Examples of matters an auditor may consider include the following:

Business Operations

- Nature of revenue sources (for example, manufacturer, wholesaler, banking, insurance or other financial services, import/export trading, utility, transportation, and technology products and services)
- Products or services and markets (for example, major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes)
- Conduct of operations (for example, stages and methods of production, business segments, delivery or products and services, details of declining or expanding operations)
- Alliances, joint ventures, and outsourcing activities
- Involvement in electronic commerce, including Internet sales and marketing activities
- Geographic dispersion and industry segmentation
- Location of production facilities, warehouses, and offices
- Key customers
- Important suppliers of goods and services (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time")
- Employment (for example, by location, supply, wage levels, 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

- Acquisitions, mergers or disposals of business activities (planned or recently executed)

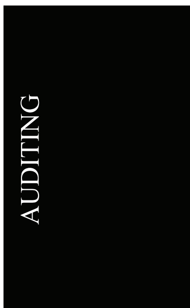
- Investments and dispositions of securities and loans
- Capital investment activities, including investments in plant and equipment and technology, and any recent or planned changes
- Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities

Financing

- Group structure – major subsidiaries and associated entities, including consolidated and non-consolidated structures
- Debt structure, including covenants, restrictions, guarantees, and off-balance-sheet financing arrangements
- Leasing of property, plant or equipment for use in the business
- Beneficial owners (local, foreign, business reputation and experience)
- Related parties
- Use of derivative financial instruments

Financial Reporting

- Accounting principles and industry specific practices
- Revenue recognition practices
- Accounting for fair values
- Inventories (for example, locations, quantities)
- Foreign currency assets, liabilities and transactions
- Industry-specific significant categories (for example, loans and investments for banks, accounts receivable and inventory for manufacturers, research and development for pharmaceuticals)
- Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation)
- Financial statement presentation and disclosure



Objectives and Strategies and Related Business Risks

Examples of matters an auditor may consider include the following:

- Existence of objectives (i.e., how the entity addresses industry, regulatory and other external factors) relating to, for example, the following:
    - Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry)

- ◦ New products and services (a potential related business risk might be, for example, that there is increased product liability)
- ◦ Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated)
- ◦ New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs)
- ◦ Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure)
- ◦ Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements)
- ◦ Use of IT (a potential related business risk might be, for example, that systems and processes are 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)

Measurement and Review of the Entity's Financial Performance

Examples of matters an auditor may consider include the following:

- Key ratios and operating statistics
- Key performance indicators
- Employee performance measures and incentive compensation policies
- Trends
- Use of forecasts, budgets and variance analysis
- Analyst reports and credit rating reports
- Competitor analysis
- Period-on-period financial performance (revenue growth, profitability, leverage)

Appendix 2

Internal Control Components

1. As set out in paragraph 43 and described in paragraphs 67-99, internal control consists of the following components:

   (a) The control environment;

   (b) The entity's risk assessment process;

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

   (d) Control activities; and

   (e) Monitoring of controls.

   This appendix further explains the above components as they relate to a financial statement audit.

Control Environment

2. The control environment includes the attitudes, awareness, and actions of management and those charged with governance concerning the entity's internal control and its importance in the entity. The control environment also includes the governance and management functions and sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure.

3. The control environment encompasses the following elements:

   (a) *Communication and enforcement of integrity and ethical values*. The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment which influence the effectiveness of the design, administration, and monitoring of other components of internal control. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity values and behavioral standards to personnel through policy statements and codes of conduct and by example.

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

the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) *Participation by those charged with governance*. An entity's control consciousness is influenced significantly by those charged with governance. Attributes of those charged with governance include independence from management, their experience and stature, the extent of their involvement and scrutiny of activities, the appropriateness of their actions, the information they receive, the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors. The importance of responsibilities of those charged with governance is recognized in codes of practice and other regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and 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. Such characteristics may include the following: management's approach to taking and monitoring business risks; management's attitudes and actions toward financial reporting (conservative or aggressive selection from available alternative accounting principles, and conscientiousness and conservatism with which accounting estimates are developed); and management's attitudes toward information processing and accounting functions and personnel.

(e) *Organizational structure*. An entity's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and reviewed. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. An entity develops an organizational structure suited to its needs. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.

(f) *Assignment of authority and responsibility*. This factor includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established. It also includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it includes policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and

contribute to those objectives, and recognize how and for what they will be held accountable.

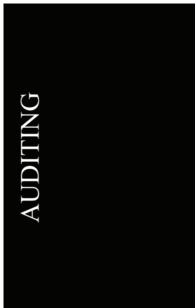
(g) *Human resource policies and practices*. Human resource policies and practices relate to recruitment, orientation, training, evaluating, counseling, promoting, compensating, and remedial actions. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, 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.

Application to Small Entities

4. Small entities may implement the control environment elements differently than larger entities. 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.

Entity's Risk Assessment Process

5. An entity's risk assessment process is its process for identifying and responding to business risks and the results thereof. For financial reporting purposes, the entity's risk assessment process includes how management identifies 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 manage them. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.



6. Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should be managed. 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.

Application to Small Entities

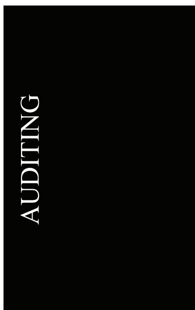
7. The basic concepts of the entity's risk assessment process are relevant to every entity, regardless of size, but the risk assessment process is likely to be less formal and less structured in small entities than in larger ones. All entities should have established financial reporting objectives, but they may be recognized implicitly rather than explicitly in small entities. Management may be aware of risks related to these objectives without the use of a formal process but through direct personal involvement with employees and outside parties.

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

8. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. Many information systems make extensive use of information technology (IT).

9. The information system relevant to financial reporting objectives, which includes the financial reporting system, consists of the procedures and records established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Transactions may be initiated manually or automatically by programmed procedures. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation, whether performed by automated or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that the entity uses in measuring and reviewing the entity's financial performance and in other functions. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

10. Accordingly, an information 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.



11. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on.

12. Communication takes 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.

Application to Small Entities

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

Control Activities

14. Control activities are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels.

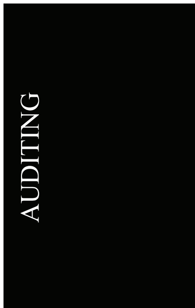
15. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

    - *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, such as a bank's consumer loan manager's review of reports by branch, region, and loan type for loan approvals and collections.

    - *Information processing*. A variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are application controls and general IT-controls. Application controls apply to the processing of individual applications. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. 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. General IT-controls 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. General IT-controls commonly include controls over data center and network operations; system software acquisition, change and maintenance; access security; and application system acquisition, development, and maintenance. These controls apply to mainframe, miniframe, and end-user environments. Examples of such 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*. These activities encompass the physical security of assets, including adequate safeguards such as secured facilities over access to assets and records; authorization for access to computer programs and data files; and periodic counting and comparison with amounts shown on control records (for example comparing the results of cash, security and inventory counts with accounting records). The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation. For example, these controls would ordinarily not be relevant when any inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit.
- *Segregation of duties*. Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets 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. Examples of segregation of duties include reporting, reviewing and approving reconciliations, and approval and control of documents.



16. 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.

Application to Small Entities

17. 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. 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 or, if that is not possible, to use management oversight of the incompatible activities to achieve control objectives.

Monitoring of Controls

18. 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.

19. Monitoring of controls is a process to assess the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. Monitoring is done to ensure that controls continue to operate effectively. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them. Monitoring of controls is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two.

20. Ongoing monitoring activities are built into the normal recurring activities of an entity and include regular management and supervisory activities. Managers of sales, purchasing, and production at divisional and corporate levels are in touch with operations and may question reports that differ significantly from their knowledge of operations.

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

22. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of

improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Application to Small Entities

23. Ongoing monitoring activities of small entities are more likely to be informal and are typically performed as a part of the overall management of the entity's operations. Management's close involvement in operations often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the control.

Appendix 3

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.

INTERNATIONAL STANDARD ON AUDITING 320

AUDIT MATERIALITY

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 320, "Audit Materiality" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 320. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 320.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the concept of materiality and its relationship with audit risk.

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

3. "Materiality" is defined in the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" in the following terms:

   Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Materiality

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

5. In designing the audit plan, the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. However, both the amount (quantity) and nature (quality) of misstatements need to be considered. Examples of qualitative misstatements would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description, and failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.

6. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. For example, an error in a month end procedure could be an indication of a potential material misstatement if that error is repeated each month.

7. The auditor considers materiality at both the overall financial statement level and in relation to classes of transactions, account balances, and disclosures. Materiality may be influenced by considerations such as legal and regulatory requirements and considerations relating to classes of transactions, account

balances, and disclosures and their relationships. This process may result in different materiality levels depending on the aspect of the financial statements being considered.

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

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

    (b) **Evaluating the effect of misstatements.**

The Relationship Between Materiality and Audit Risk

9. When planning the audit, the auditor considers what would make the financial statements materially misstated. The auditor's understanding of the entity and its environment establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing the risks of material misstatement of the financial statements and responding to those risks throughout the audit. It also assists the auditor to establish materiality and in evaluating whether the judgment about materiality remains appropriate as the audit progresses. The auditor's assessment of materiality, related to classes of transactions, account balances, and disclosures, helps the auditor decide such questions as what items to examine and whether to use sampling and substantive analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to reduce audit risk to an acceptably low level.

10. There is an inverse relationship between materiality and the level of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this by either:

    (a) Reducing the assessed risk of material misstatement, where this is possible, and supporting the reduced level by carrying out extended or additional tests of control; or

    (b) Reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

Materiality and Audit Risk in Evaluating Audit Evidence

11. The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from at the time of evaluating the results of audit procedures. This could be because of a change in circumstances or because of a change in the auditor's knowledge as a result of performing audit procedures. For example, if audit procedures are performed prior to

period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally, the auditor may, in planning the audit work, intentionally set the acceptable materiality level at a lower level than is intended to be used to evaluate the results of the audit. This may be done to reduce the likelihood of undiscovered misstatements and to provide the auditor with a margin of safety when evaluating the effect of misstatements discovered during the audit.

Evaluating the Effect of Misstatements

12. **In evaluating whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material.**

13. The aggregate of uncorrected misstatements comprises:

    (a) Specific misstatements identified by the auditor including the net effect of uncorrected misstatements identified during the audit of previous periods; and

    (b) The auditor's best estimate of other misstatements which cannot be specifically identified (i.e., projected errors).

14. The auditor needs to consider whether the aggregate of uncorrected misstatements is material. If the auditor concludes that the misstatements may be material, the auditor needs to consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements. In any event, management may want to adjust the financial statements for the misstatements identified.

15. **If management refuses to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should consider the appropriate modification to the auditor's report in accordance with ISA 701, "Modifications to the Independent Auditor's Report."**

16. If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, the auditor would consider whether it is likely that undetected misstatements, when taken with aggregate uncorrected misstatements could exceed materiality level. Thus, as aggregate uncorrected misstatements approach the materiality level the auditor would consider reducing audit risk by performing additional audit procedures or by requesting management to adjust the financial statements for identified misstatements.

Communication of Errors

17. **If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with ISA 260, "Communication of Audit Matters with Those Charged with Governance."**

Public Sector Perspective

1. *In assessing materiality, the public sector auditor must, in addition to exercising professional judgment, consider any legislation or regulation which may impact that assessment. In the public sector, materiality is also based on the "context and nature" of an item and includes, for example, sensitivity as well as value. Sensitivity covers a variety of matters such as compliance with authorities, legislative concern or public interest.*

INTERNATIONAL STANDARD ON AUDITING 330

THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS

(Effective for audits of financial statements for periods beginning on or after June 15, 2006)*

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International Standard on Auditing (ISA) 330, "The Auditor's Procedures in Response to Assessed Risks" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" which sets out the application and authority of ISAs.

AUDITING

* ISA 230, "Audit Documentation" gave rise to conforming amendments to ISA 330. These amendments are effective for audits of financial statements for periods beginning on or after June 15, 2006 and have been incorporated in the text of ISA 330.

The IAASB's clarity drafting conventions have been applied to ISA 330. ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks" can be found in Part II of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements*. It is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on determining overall responses and designing and performing further audit procedures to respond to the assessed risks of material misstatement at the financial statement and assertion levels in a financial statement audit. The auditor's understanding of the entity and its environment, including its internal control, and assessment of the risks of material misstatement are described in ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement."

2. The following is an overview of the requirements of this standard:

    - *Overall responses*. This section requires the auditor to determine overall responses to address risks of material misstatement at the financial statement level and provides guidance on the nature of those responses.

    - *Audit procedures responsive to risks of material misstatement at the assertion level*. This section requires the auditor to design and perform further audit procedures, including tests of the operating effectiveness of controls, when relevant or required, and substantive procedures, whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level. In addition, this section includes matters the auditor considers in determining the nature, timing, and extent of such audit procedures.

    - *Evaluating the sufficiency and appropriateness of audit evidence obtained*. This section requires the auditor to evaluate whether the risk assessment remains appropriate and to conclude whether sufficient appropriate audit evidence has been obtained.

    - *Documentation*. This section establishes related documentation requirements.

3. **In order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to assessed risks at the financial statement level, and should design and perform further audit procedures to respond to assessed risks at the assertion level.** The overall responses and the nature, timing, and extent of the further audit procedures are matters for the professional judgment of the auditor. In addition to the requirements of this ISA, the auditor also complies with the requirements and guidance in ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" in responding to assessed risks of material misstatement due to fraud.

Overall Responses

4. **The auditor should determine overall responses to address the risks of material misstatement at the financial statement level.** Such responses may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with special skills or using experts,[1] providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

5. The assessment of the risks of material misstatement at the financial statement level 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. If there are weaknesses in the control environment, the auditor ordinarily conducts more audit procedures as of the period end rather than at an interim date, seeks more extensive audit evidence from substantive procedures, modifies the nature of audit procedures to obtain more persuasive audit evidence, or increases the number of locations to be included in the audit scope.

6. 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

7. **The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level**. 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. In designing further audit procedures, the auditor considers such matters as the following:

   - The significance of the risk.
   - The likelihood that a material misstatement will occur.

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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.

- The characteristics of the class of transactions, account balance, or disclosure involved.
- The nature of the specific controls used by the entity and in particular whether they are manual or automated.
- Whether the auditor expects to obtain audit evidence to determine if the entity's controls are effective in preventing, or detecting and correcting, material misstatements.

The nature of the audit procedures is of most importance in responding to the assessed risks.

8. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In some cases, 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. In other cases, the auditor may determine that 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 the operating effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive procedures for the relevant assertion would be effective in reducing the risk of material misstatement to an acceptably low level. Often the auditor may determine that a combined approach using both tests of the operating effectiveness of controls and substantive procedures is an effective approach. Irrespective of the approach selected, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure as required by paragraph 49.

9. 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 such cases, in addition to the matters referred to in paragraph 8 above, the auditor considers whether in the absence of controls it is possible to obtain sufficient appropriate audit evidence.

Considering the Nature, Timing, and Extent of Further Audit Procedures

Nature

10. The nature of further audit procedures refers to their purpose (tests of controls or substantive procedures) and their type, that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedures. 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.

11. The auditor's selection of audit procedures is based on the assessment of risk. The higher the auditor's assessment of risk, the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures. This 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.

12. In determining the audit procedures to be performed, the auditor considers the reasons for the assessment of the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure. This includes considering both the particular characteristics of each class of transactions, account balance, or disclosure (i.e., the inherent risks) and whether the auditor's risk assessment takes account of the entity's controls (i.e., the control risk). For example, if the auditor considers that there is a lower risk that a material misstatement may occur because of the particular characteristics of a class of transactions without consideration of the related controls, the auditor may determine that substantive analytical procedures alone may provide sufficient appropriate audit evidence. On the other hand, if the auditor expects that there is a lower risk that a material misstatement may arise because an entity has effective controls and the auditor intends to design substantive procedures based on the effective operation of those controls, then the auditor performs tests of controls to obtain audit evidence about their operating effectiveness. 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.

13. The auditor is required to obtain audit evidence about the accuracy and completeness of information produced by the entity's information system when that information is used in performing audit procedures. For example, if the auditor uses non-financial information or budget data produced by the entity's information system in performing audit procedures, such as substantive analytical procedures or tests of controls, the auditor obtains audit evidence about the accuracy and completeness of such information. See ISA 500, "Audit Evidence" paragraph 11 for further guidance.

Timing

14. Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies.

15. 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). 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. If the auditor performs tests of controls or substantive procedures prior to period end, the auditor considers the additional evidence required for the remaining period (see paragraphs 37-38 and 56-61).

16. In considering when to perform audit procedures, the auditor also considers such matters as 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.

17. Certain audit procedures can be performed only at or after period end, for example, agreeing the financial statements to the accounting records and examining adjustments made during the course of preparing the financial statements. If there is a risk that the entity may have entered into improper sales contracts or transactions may not have been finalized at period end, the auditor performs procedures to respond to that specific risk. For example, when transactions are individually material or an error in cutoff may lead to a material misstatement, the auditor ordinarily inspects transactions near the period end.

Extent

18. Extent includes the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. 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. In particular, the auditor ordinarily increases the extent of audit procedures as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit

procedure itself is relevant to the specific risk; therefore, the nature of the audit procedure is the most important consideration.

19. The use of computer-assisted audit techniques (CAATs) 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.

20. Valid conclusions may ordinarily be drawn using sampling approaches. However, if the quantity of selections made from a population is too small, the sampling approach selected is not appropriate to achieve the specific audit objective, or if exceptions are not appropriately followed up, there will be an unacceptable risk that the auditor's conclusion based on a sample may be different from the conclusion reached if the entire population was subjected to the same audit procedure. ISA 530, "Audit Sampling and Other Means of Testing" contains guidance on the use of sampling.

21. This standard regards the use of different audit procedures in combination as an aspect of the nature of testing as discussed above. However, the auditor considers whether the extent of testing is appropriate when performing different audit procedures in combination.

Tests of Controls

22. The auditor is required to perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.

23. **When the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit.** See paragraphs 39-44 below for discussion of using audit evidence about the operating effectiveness of controls obtained in prior audits.

24. The auditor's assessment of risk of material misstatement at the assertion level may include an expectation of the operating effectiveness of controls, in which case the auditor performs tests of controls to obtain audit evidence as to their operating effectiveness. Tests of the operating effectiveness 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. Paragraphs 104-106 of ISA 315 discuss the identification of controls at the assertion level likely to prevent, or detect and correct, a material misstatement in a class of transactions, account balance or disclosure.

25. **When, in accordance with paragraph 115 of ISA 315, the auditor has determined that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, the auditor should perform tests of relevant controls to obtain audit evidence about their operating effectiveness.** For example, as discussed in paragraph 115 of ISA 315, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system.

26. Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor determines that the relevant controls exist and that the entity is using them. When performing tests of the operating effectiveness of controls, the auditor obtains audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor considers each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

27. Although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented 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 may have made 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, and 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. In such circumstances, the auditor considers whether the audit evidence provided by those audit procedures is sufficient.

Nature of Tests of Controls

28. The auditor selects audit procedures to obtain assurance about the operating effectiveness of controls. As the planned level of assurance increases, the

auditor seeks more reliable audit evidence. In circumstances when the auditor adopts an approach consisting primarily of tests of controls, in particular related to those risks where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures, the auditor ordinarily performs tests of controls to obtain a higher level of assurance about their operating effectiveness.

29. **The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls.** Although different from obtaining an understanding of the design and implementation of controls, tests of the operating effectiveness of controls ordinarily include the same types of audit procedures used to evaluate the design and implementation of controls, and may also include reperformance of the application of the control by the auditor. Since inquiry alone is not sufficient, the auditor uses a combination of audit procedures to obtain sufficient appropriate audit evidence regarding the operating effectiveness of controls. Those controls subject to testing by performing inquiry combined with inspection or reperformance ordinarily provide more assurance than those controls for which the audit evidence consists solely of inquiry and observation. For example, an auditor may inquire about and observe the entity's procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor ordinarily supplements the observation with inquiries of entity personnel, and may also inspect documentation about the operation of such controls at other times during the audit period in order to obtain sufficient appropriate audit evidence.

30. The nature of the particular control influences the type of audit procedure required to obtain audit evidence about whether the control was operating effectively at relevant times during the period under audit. For some controls, operating effectiveness is evidenced by documentation. In such circumstances, the auditor may decide to inspect the documentation to obtain audit evidence about operating effectiveness. For other controls, however, such 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.

31. In designing tests of controls, the auditor considers the need to obtain audit evidence supporting the effective operation of controls directly related to the assertions as well as other indirect controls on which these controls depend. For example, the auditor may identify a user review of an exception report of credit sales over a customer's authorized credit limit as a direct control related

to an assertion. In such cases, the auditor considers the effectiveness of the user review of the report and also the controls related to the accuracy of the information in the report (for example, the general IT-controls).

32. In the case of an automated application control, because of the inherent consistency of IT processing, audit evidence about the implementation of the control, when considered in combination with audit evidence obtained regarding the operating effectiveness of the entity's general controls (and in particular, change controls) may provide substantial audit evidence about its operating effectiveness during the relevant period.

33. When responding to the risk assessment, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. The objective of tests of controls is to evaluate whether a control operated effectively. The objective of tests of details is to detect material misstatements at the assertion level. Although these objectives are different, both may be accomplished concurrently through performance of 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 examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. The auditor carefully considers the design and evaluation of such tests to accomplish both objectives.

34. The absence of misstatements detected by a substantive procedure does not provide audit evidence that controls related to the assertion being tested are effective. However, misstatements that the auditor detects by performing substantive procedures are considered by the auditor when assessing the operating effectiveness of related controls. A material misstatement detected by the auditor's procedures that was not identified by the entity ordinarily is indicative of the existence of a material weakness in internal control, which is communicated to management and those charged with governance.

Timing of Tests of Controls

35. The timing of tests of controls depends on the auditor's objective and determines the period of reliance on those controls. If the auditor tests controls at a particular time, the auditor only obtains audit evidence that the controls operated effectively at that time However, if the auditor tests controls throughout a period, the auditor obtains audit evidence of the effectiveness of the operation of the controls during that period.

36. 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 requires audit evidence of the effectiveness of a control over a period, audit evidence pertaining only to a point in time may be insufficient and the auditor supplements those tests with other tests of controls that are capable of

providing audit evidence that the control operated effectively at relevant times during the period under audit. Such other tests may consist of tests of the entity's monitoring of controls.

37. **When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor should determine what additional audit evidence should be obtained for the remaining period.** In making that determination, the auditor considers 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, and the control environment. The auditor obtains audit evidence about the nature and extent of any significant changes in internal control, including changes in the information system, processes, and personnel that occur subsequent to the interim period.

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

39. **If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit. The auditor should obtain audit evidence about whether such changes have occurred by performing inquiry in combination with observation or inspection to confirm the understanding of those specific controls**. Paragraph 23 of ISA 500 states that the auditor performs audit procedures to establish the continuing relevance of audit evidence obtained in prior periods when the auditor plans to use the audit evidence in the current period. For example, in performing the prior audit, the auditor may have determined that an automated control was functioning as intended. The auditor obtains audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning, for example, through 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.

40. **If the auditor plans to rely on controls that have changed since they were last tested, the auditor should test the operating effectiveness of such controls in the current audit.** Changes may affect the relevance of the audit evidence obtained in prior periods 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

prior period audit evidence; however, a change that causes data to be accumulated or calculated differently does affect it.

41. **If the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of such controls at least once in every third audit.** As indicated in paragraphs 40 and 44, the auditor may not rely on audit evidence about the operating effectiveness of controls obtained in prior audits for controls that have changed since they were last tested or controls that mitigate a significant risk. The auditor's decision on whether to rely on audit evidence obtained in prior audits for other controls is a matter of professional judgment. In addition, the length of time period between retesting such controls is also a matter of professional judgment, but cannot exceed two years.

42. In considering whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in prior audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor considers 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 (see ISA 315, paragraphs 57-63 for a discussion of specific risks arising from manual and automated elements of a control).
    - 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 from tests of operating effectiveness in prior audits.
    - 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.

    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 ordinarily decrease the period for retesting a control, or result in not relying on audit evidence obtained in prior 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.

43. **When there are a number of controls for which the auditor determines that it is appropriate to use audit evidence obtained in prior audits, the auditor should test the operating effectiveness of some controls each audit.** The purpose of this requirement is to avoid the possibility that the auditor might apply the approach of paragraph 41 to all controls on which the auditor proposes to rely, but test all those controls in a single audit period with no testing of controls in the subsequent two audit periods. In addition to providing audit evidence about the operating effectiveness of the controls being tested in the current audit, performing such tests 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 prior audits. Therefore, when the auditor determines in accordance with paragraphs 39-42 that it is appropriate to use audit evidence obtained in prior audits for a number of controls, the auditor plans to test a sufficient portion of the controls in that population in each audit period, and at a minimum, each control is tested at least every third audit.

44. **When, in accordance with paragraph 108 of ISA 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk and the auditor plans to rely on the operating effectiveness of controls intended to mitigate that significant risk, the auditor should obtain the audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period.** The greater the risk of material misstatement, the more audit evidence the auditor obtains that relevant controls are operating effectively. Accordingly, although the auditor often considers information obtained in prior audits in designing tests of controls to mitigate a significant risk, the auditor does not rely on audit evidence obtained in a prior audit about the operating effectiveness of controls over such risks, but instead obtains the audit evidence about the operating effectiveness of controls over such risks in the current period.

Extent of Tests of Controls

45. The auditor designs tests of controls to obtain sufficient appropriate audit evidence that the controls operated effectively throughout the period of reliance. 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 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.
- The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (and thereby reduce substantive procedures based on the reliance of such control).
- The expected deviation from the control.

46. The more the auditor relies on the operating effectiveness of controls in the assessment of risk, the greater is the extent of the auditor's tests of controls. In addition, as the rate of expected deviation from a control increases, the auditor increases the extent of testing of the control. However, the auditor considers whether the rate of expected deviation indicates that the control will not be sufficient to reduce the risk of material misstatement at the assertion level to that assessed by the auditor. If the rate of expected deviation is expected to be too high, the auditor may determine that tests of controls for a particular assertion may not be effective.

47. 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 considers 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, that the authorized version of the program is used for processing transactions, and that 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.

Substantive Procedures

48. Substantive procedures are performed in order to detect material misstatements at the assertion level, and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures. The

auditor plans and performs substantive procedures to be responsive to the related assessment of the risk of material misstatement.

49. **Irrespective of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for each material class of transactions, account balance, and disclosure.** This requirement reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control including management override. Accordingly, while the auditor may determine that the risk of material misstatement may be reduced to an acceptably low level by performing only tests of controls for a particular assertion related to a class of transactions, account balance or disclosure (see paragraph 8), the auditor always performs substantive procedures for each material class of transactions, account balance, and disclosure.

50. **The auditor's substantive procedures should include the following audit procedures related to the financial statement closing process:**

    - **Agreeing or reconciling the financial statements with the underlying accounting records; and**
    - **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.

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

52. When the approach to significant risks consists only of substantive procedures, the audit procedures appropriate to address such significant risks consist of tests of details only, or a combination of tests of details and substantive analytical procedures The auditor considers the guidance in paragraphs 53-64

in designing the nature, timing, and extent of substantive procedures for significant risks. In order to obtain sufficient appropriate audit evidence, the substantive procedures related to significant risks are most often designed to obtain audit evidence with high reliability.

Nature of Substantive Procedures

53. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Tests of details are ordinarily more appropriate to obtain audit evidence regarding certain assertions about account balances, including existence and valuation. In some situations, the auditor may determine that performing only substantive analytical procedures may be sufficient to reduce the risk of material misstatement to an acceptably low level. For example, the auditor may determine that performing only substantive analytical procedures is responsive to the assessed risk of material misstatement for a class of transactions where the auditor's assessment of risk is supported by obtaining audit evidence from performance of tests of the operating effectiveness of controls. In other situations, the auditor may determine that only tests of details are appropriate, or that a combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

54. The auditor designs tests of details responsive to the assessed risk with the objective of obtaining sufficient appropriate audit evidence to achieve the planned level of assurance at the assertion level. In designing substantive procedures related to the existence or occurrence assertion, the auditor selects from items contained in a financial statement amount and obtains the relevant audit evidence. On the other hand, in designing audit procedures related to the completeness assertion, the auditor selects from audit evidence indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included. For example, the auditor might inspect subsequent cash disbursements to determine whether any purchases had been omitted from accounts payable.

55. In designing substantive analytical procedures, the auditor considers such matters as the following:

    - The suitability of using substantive analytical procedures given the assertions.
    - The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed.
    - Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.
    - The amount of any difference in recorded amounts from expected values that is acceptable.

The auditor considers testing the controls, if any, over the entity's preparation of information used by the auditor in applying analytical procedures. When such controls are effective, the auditor has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. Alternatively, the auditor may consider whether the information was subjected to audit testing in the current or prior period. In determining the audit procedures to apply to the information upon which the expectation for substantive analytical procedures is based, the auditor considers the guidance in paragraph 11 of ISA 500.

Timing of Substantive Procedures

56. **When substantive procedures are performed at an interim date, the auditor should perform further substantive procedures or substantive procedures combined with tests of controls to cover the remaining period that provide a reasonable basis for extending the audit conclusions from the interim date to the period end**.

57. In some circumstances, substantive procedures may be performed at an interim date. This 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. In considering whether to perform substantive procedures at an interim date, the auditor considers such factors as the following:

- 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.

58. Although the auditor is not required to obtain audit evidence about the operating effectiveness of controls in order to have a reasonable basis for extending audit conclusions from an interim date to the period end, the auditor considers whether performing only substantive procedures to cover the remaining period is sufficient. If the auditor concludes that substantive procedures alone would not be sufficient, tests of the operating effectiveness of relevant controls are performed or the substantive procedures are performed as of the period end.

59. In circumstances where the auditor has identified risks of material misstatement due to fraud, the auditor's response to address those risks may include changing the timing of audit procedures. For example, the auditor might 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 such circumstances, the auditor might conclude that substantive procedures need to be performed at or near the end of the reporting period to address an identified risk of material misstatement due to fraud (see ISA 240).

60. Ordinarily, the auditor compares and reconciles information concerning the balance at the period end with the comparable information at the interim date to identify amounts that appear unusual, investigates any such amounts, and performs substantive analytical procedures or tests of details to test the intervening period. When the auditor plans to perform substantive analytical procedures with respect to the intervening period, the auditor considers whether the period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition. The auditor considers whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate. In addition, the auditor considers whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of: significant unusual transactions or entries (including those at or near period end); other causes of significant fluctuations, or expected fluctuations that did not occur; and changes in the composition of the classes of transactions or account balances. The substantive procedures related to the remaining period depend on whether the auditor has performed tests of controls.

61. If misstatements are detected in classes of transactions or account balances at an interim date, the auditor ordinarily modifies the related assessment of risk and the planned nature, timing, or extent of the substantive procedures covering the remaining period that relate to such classes of transactions or account balances, or extends or repeats such audit procedures at the period end.

62. The use of audit evidence from the performance of substantive procedures in a prior audit is not sufficient to address a risk of material misstatement in the current period. In most cases, audit evidence from the performance of substantive procedures in a prior audit provides little or no audit evidence for the current period. In order for audit evidence obtained in a prior audit to be used in the current period as substantive audit evidence, the audit evidence and the related subject matter must not fundamentally change. An example of audit evidence obtained from the performance of substantive procedures in a prior period that may be relevant in the current year is a legal opinion related to the

structure of a securitization to which no changes have occurred during the current period. As required by paragraph 23 of ISA 500, if the auditor plans to use audit evidence obtained from the performance of substantive procedures in a prior audit, the auditor performs audit procedures during the current period to establish the continuing relevance of the audit evidence.

Extent of the Performance of Substantive Procedures

63. 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 be increased as a result of unsatisfactory results from tests of the operating effectiveness of controls. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

64. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size, which is affected by the risk of material misstatement. However, the auditor also considers other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population as opposed to performing representative sampling or stratifying the population into homogeneous subpopulations for sampling. ISA 530 contains guidance on the use of sampling and other means of selecting items for testing. In designing substantive analytical procedures, the auditor considers the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and the consistency with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount. In designing substantive analytical procedures, the auditor increases the desired level of assurance as the risk of material misstatement increases. ISA 520, "Analytical Procedures" contains guidance on the application of analytical procedures during an audit.

Adequacy of Presentation and Disclosure

65. **The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with the applicable financial reporting framework.** The auditor considers whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information. The presentation of financial statements in conformity with the applicable financial reporting framework also includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

The auditor considers whether management should have disclosed a particular matter in light of the circumstances and facts of which the auditor is aware at the time. In performing the evaluation of the overall presentation of the financial statements, including the related disclosures, the auditor considers the assessed risk of material misstatement at the assertion level. See paragraph 17 of ISA 500 for a description of the assertions related to presentation and disclosure.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

66. **Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.**

67. 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. In addition, 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. Paragraph 119 of ISA 315 contains further guidance on revising the auditor's risk assessment.

68. 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. When such deviations are detected during the performance of tests of controls, the auditor makes specific inquiries to understand these matters and their potential consequences, for example, by inquiring about the timing of personnel changes in key internal control functions. The auditor determines whether the tests of controls performed provide an appropriate basis for reliance on the controls, whether additional tests of controls are necessary, or whether the potential risks of misstatement need to be addressed using substantive procedures.

69. The auditor cannot assume that an instance of fraud or error is an isolated occurrence, and therefore considers how the detection of a misstatement affects the assessed risks of material misstatement. Before the conclusion of the audit, the auditor evaluates whether audit risk has been reduced to an acceptably low level and whether the nature, timing, and extent of the audit procedures may need to be reconsidered. For example, the auditor reconsiders the following:

   - The nature, timing, and extent of substantive procedures.
   - The audit evidence of the operating effectiveness of relevant controls, including the entity's risk assessment process.

70. **The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risk of material misstatement in the financial statements.** In developing an opinion, the auditor considers all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

71. The sufficiency and appropriateness of audit evidence to support the auditor's conclusions throughout the audit are a matter of professional judgment. 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.

72. **If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or a disclaimer of opinion**. See ISA 701, "Modifications to the Independent Auditor's Report" for further guidance.

Documentation

73. **The auditor should document the overall responses to address the assessed risks of material misstatement at the financial statement level and the nature, timing, and extent of the further audit procedures, the linkage of those procedures with the assessed risks at the assertion level, and the results of the audit procedures. In addition, if the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should document the conclusions reached with regard to relying on such controls that were tested in a prior audit.**

73a. **The auditor's documentation should demonstrate that the financial statements agree or reconcile with the underlying accounting records.**

73b. The manner in which the matters referred to in paragraphs 73 and 73a are documented is based on the auditor's professional judgment. ISA 230, "Audit Documentation" establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

Effective Date

74. This ISA is effective for audits of financial statements for periods beginning on or after June 15, 2006.

Public Sector Perspective

1. When carrying out audits of public sector entities, the auditor takes into account the legislative framework and any other relevant regulations, ordinances or ministerial directives that affect the audit mandate and any other special auditing requirements. Such factors might affect, for example, the extent of the auditor's discretion in establishing materiality and judgments on the nature and scope of audit procedures to be applied. Paragraph 3 of this ISA may have to be applied only after giving consideration to such restrictions.

INTERNATIONAL STANDARD ON AUDITING 402

AUDIT CONSIDERATIONS RELATING TO ENTITIES USING SERVICE ORGANIZATIONS

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 402, "Audit Considerations Relating to Entities Using Service Organizations" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

AUDITING

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 402. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 402.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance to an auditor where the entity uses a service organization. This ISA also describes the service organization auditors' reports which may be obtained by the entity's auditors.

2. **The auditor should consider how an entity's use of a service organization affects the entity's internal control so as to identify and assess the risk of material misstatement and to design and perform further audit procedures.**

3. A client may use a service organization such as one that executes transactions and maintains related accountability or records transactions and processes related data (for example, a computer systems service organization). If the entity uses a service organization, certain policies, procedures and records maintained by the service organization may be relevant to the audit of the financial statements of the client.

Considerations of the Auditor

4. A service organization may establish and execute policies and procedures that affect the entity's internal control. These policies and procedures are physically and operationally separate from the entity. When the services provided by the service organization are limited to recording and processing the entity's transactions and the entity retains authorization and maintenance of accountability, the entity may be able to implement effective policies and procedures within its organization. When the service organization executes the entity's transactions and maintains accountability, the entity may deem it necessary to rely on policies and procedures at the service organization.

5. **In obtaining an understanding of the entity and its environment, the auditor should determine the significance of service organization activities to the entity and the relevance to the audit.** In doing so, the auditor obtains an understanding of the following, as appropriate:

   - Nature of the services provided by the service organization.
   - Terms of contract and relationship between the entity and the service organization.
   - Extent to which the entity's internal control interact with the systems at the service organization.
   - The entity's internal control relevant to the service organization activities such as:
     - Those that are applied to the transactions processed by the service organization.

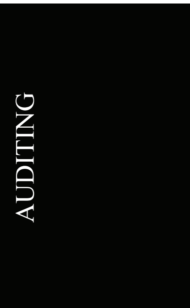
  - How the entity identifies and manages risks related to use of the service organization.

- Service organization's capability and financial strength, including the possible effect of the failure of the service organization on the entity.
- Information about the service organization such as that reflected in user and technical manuals.
- Information available on controls relevant to the service organization's information systems such as general IT-controls and application controls.

6. The auditor would also consider the existence of third-party reports from service organization auditors, internal auditors, or regulatory agencies as a means of obtaining information about the internal control of the service organization and about its operation and effectiveness. When the auditor intends to use work of the internal auditor, ISA 610, "Considering the Work of Internal Auditing" provides guidance on evaluating the adequacy of the internal auditor's work for the auditor's purposes.

6a. The understanding obtained may lead the auditor to decide that the control risk assessment of the risk of material misstatement will not be affected by controls at the service organization; if so, further consideration of this ISA is unnecessary.

7. **If the auditor concludes that the activities of the service organization are significant to the entity and relevant to the audit, the auditor should obtain a sufficient understanding of the service organization and its environment, including its internal control, to identify and assess the risks of material misstatement and design further audit procedures in response to the assessed risks.** The auditor assesses the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures.



8. If the understanding obtained is insufficient, the auditor would consider the need to request the service organization to have its auditor perform such risk assessment procedures to supply the necessary information, or the need to visit the service organization to obtain the information. An auditor wishing to visit a service organization may advise the entity to request the service organization to give the auditor access to the necessary information.

9. The auditor may be able to obtain a sufficient understanding of internal control affected by the service organization by reading the third-party report of the service organization auditor. In addition, when assessing the risks of material misstatement, for assertions affected by the service organization's internal controls, the auditor may also use the service organization auditor's report. **If the auditor uses the report of a service organization auditor, the auditor should consider making inquiries concerning that auditor's professional**

competence in the context of the specific assignment undertaken by the service organization auditor.

10. The auditor obtains audit evidence about the operating effectiveness of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of the service organization's controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level. The auditor may also conclude that it would be efficient to obtain audit evidence from tests of controls. Audit evidence about the operating effectiveness of controls may be obtained by the following:

    - Performing tests of the entity's controls over activities of the service organization.
    - Obtaining a service organization auditor's report that expresses an opinion as to the operating effectiveness of the service organization's internal control for the service organization activities relevant to the audit.
    - Visiting the service organization and performing tests of controls.

Service Organization Auditor's Report

11. **When using a service organization auditor's report, the auditor should consider the nature of and content of that report.**

12. The report of the service organization auditor will ordinarily be one of two types as follows:

    Type A—Report on the Design and Implementation of Internal Control

    (a) A description of the service organization's internal control, ordinarily prepared by the management of the service organization; and

    (b) An opinion by the service organization auditor that:

        (i) The above description is accurate;

        (ii) The internal control is suitably designed to achieve their stated objectives; and

        (iii) The internal controls have been implemented.

    Type B—Report on the Design, Implementation and Operating Effectiveness of Internal Control

    (a) A description of the service organization's internal control, ordinarily prepared by the management of the service organization; and

    (b) An opinion by the service organization auditor that:

        (i) The above description is accurate;

(ii) The internal controls is suitably designed to achieve their stated objectives;

(iii) The internal controls have been implemented; and

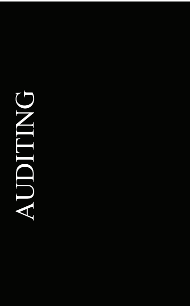
(iv) The internal controls are operating effectively based on the results from the tests of controls. In addition to the opinion on operating effectiveness, the service organization auditor would identify the tests of controls performed and related results.

The report of the service organization auditor will ordinarily contain restrictions as to use (generally to management, the service organization and its customers, and the entity's auditors).

13. **The auditor should consider the scope of work performed by the service organization auditor and should evaluate the usefulness and appropriateness of reports issued by the service organization auditor.**

14. While Type A reports may be useful to the auditor in obtaining an understanding of the internal control, an auditor would not use such reports as audit evidence about the operating effectiveness of controls.

15. In contrast, Type B reports may provide such audit evidence since tests of control have been performed. When a Type B report is to be used as audit evidence about operating effectiveness of controls, the auditor would consider whether the controls tested by the service organization auditor are relevant to the entity's transactions, account balances, and disclosures, and related assertions, and whether the service organization auditor's tests of control and the results are adequate. With respect to the latter, two key considerations are the length of the period covered by the service organization auditor's tests and the time since the performance of those tests.



16. **For those specific tests of control and results that are relevant, the auditor should consider whether the nature, timing and extent of such tests provide sufficient appropriate audit evidence about the operating effectiveness of the internal control to support the auditor's assessed risks of material misstatement.**

17. The auditor of a service organization may be engaged to perform substantive procedures that are of use to the entity's auditor. Such engagements may involve the performance of procedures agreed upon by the entity and its auditor and by the service organization and its auditor.

18. **When the auditor uses a report from the auditor of a service organization, no reference should be made in the entity's auditor's report to the auditor's report on the service organization.**

INTERNATIONAL STANDARD ON AUDITING 500

AUDIT EVIDENCE

(Effective for audits of financial statements for periods
beginning on or after December 15, 2004)

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International Standard on Auditing (ISA) 500, "Audit Evidence" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and to provide guidance on what constitutes audit evidence in an audit of financial statements, the quantity and quality of audit evidence to be obtained, and the audit procedures that auditors use for obtaining that audit evidence.

2. **The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.**

Concept of Audit Evidence

3. "Audit evidence" is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information. Auditors are not expected to address all information that may exist.[1] Audit evidence, which is cumulative in nature, includes audit evidence obtained from audit procedures performed during the course of the audit and may include audit evidence obtained from other sources such as previous audits and a firm's quality control procedures for client acceptance and continuance.

4. Accounting records generally include the records of initial entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in formal journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures. The entries in the accounting records are often initiated, recorded, processed and reported in electronic form. In addition, the accounting records may be part of integrated systems that share data and support all aspects of the entity's financial reporting, operations and compliance objectives.

5. Management is responsible for the preparation of the financial statements based upon the accounting records of the entity. The auditor obtains some audit evidence by testing the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements. However, because accounting records alone do not provide sufficient audit evidence on which to base an audit opinion on the financial statements, the auditor obtains other audit evidence.

[1] See paragraph 14.

6. Other information that the auditor may use as audit evidence includes minutes of meetings; confirmations from third parties; analysts' reports; comparable data about competitors (benchmarking); controls manuals; information obtained by the auditor from such audit procedures as inquiry, observation, and inspection; and other information developed by, or available to, the auditor that permits the auditor to reach conclusions through valid reasoning.

Sufficient Appropriate Audit Evidence

7. Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions. The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of audit evidence are interrelated. However, merely obtaining more audit evidence may not compensate for its poor quality.

8. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of records and documents related to the collection of receivables after the period end may provide audit evidence regarding both existence and valuation, although not necessarily the appropriateness of period-end cutoffs. On the other hand, the auditor often obtains audit evidence from different sources or of a different nature that is relevant to the same assertion. For example, the auditor may analyze the aging of accounts receivable and the subsequent collection of receivables to obtain audit evidence relating to the valuation of the allowance for doubtful accounts. Furthermore, obtaining audit evidence relating to a particular assertion, for example, the physical existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of inventory.

9. The reliability of audit evidence is influenced by its source and by its nature and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of audit evidence can be made; however, such generalizations are subject to important exceptions. Even when audit evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful:

   - Audit evidence is more reliable when it is obtained from independent sources outside the entity.

- Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

10. An audit rarely involves the authentication of documentation, nor is the auditor trained as or expected to be an expert in such authentication. However, the auditor considers the reliability of the information to be used as audit evidence, for example, photocopies, facsimiles, filmed, digitized or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.

11. **When information produced by the entity is used by the auditor to perform audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information.** In order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be sufficiently complete and accurate. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Obtaining audit evidence about the completeness and accuracy of the information produced by the entity's information system may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the production and maintenance of the information. However, in some situations the auditor may determine that additional audit procedures are needed. For example, these additional procedures may include using computer-assisted audit techniques (CAATs) to recalculate the information.

12. The auditor ordinarily obtains more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. In addition, obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor

obtains from a management representation. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor determines what additional audit procedures are necessary to resolve the inconsistency.

13. The auditor considers the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an audit procedure for which there is no alternative.

14. In forming the audit opinion the auditor does not examine all the information available because conclusions ordinarily can be reached by using sampling approaches and other means of selecting items for testing. Also, the auditor ordinarily finds it necessary to rely on audit evidence that is persuasive rather than conclusive; however, to obtain reasonable assurance,[2] the auditor is not satisfied with audit evidence that is less than persuasive. The auditor uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, to support the audit opinion.

The Use of Assertions in Obtaining Audit Evidence

15. Management is responsible for the fair presentation of financial statements that reflect the nature and operations of the entity. In representing that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

16. **The auditor should use assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures.** The auditor uses assertions in assessing risks by considering the different types of potential misstatements that may occur, and thereby designing audit procedures that are responsive to the assessed risks. Other ISAs discuss specific situations where the auditor is required to obtain audit evidence at the assertion level.

17. Assertions used by the auditor fall into the following categories:

    (a) Assertions about classes of transactions and events for the period under audit:

[2] ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" provides discussion of reasonable assurance as it relates to an audit of financial statements.

(i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.

(ii) Completeness—all transactions and events that should have been recorded have been recorded.

(iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

(iv) Cutoff—transactions and events have been recorded in the correct accounting period.

(v) Classification—transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end:

(i) Existence—assets, liabilities, and equity interests exist.

(ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) Assertions about presentation and disclosure:

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

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

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

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

18. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances. As another example, there may not be a separate assertion related to cutoff of transactions and

events when the occurrence and completeness assertions include appropriate consideration of recording transactions in the correct accounting period.

Audit Procedures for Obtaining Audit Evidence

19. The auditor obtains audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to:

    (a) Obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and assertion levels (audit procedures performed for this purpose are referred to in the ISAs as "risk assessment procedures");

    (b) When necessary or when the auditor has determined to do so, test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (audit procedures performed for this purpose are referred to in the ISAs as "tests of controls"); and

    (c) Detect material misstatements at the assertion level (audit procedures performed for this purpose are referred to in the ISAs as "substantive procedures" and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures).

20. The auditor always performs risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion, however, and are supplemented by further audit procedures in the form of tests of controls, when necessary, and substantive procedures.

21. Tests of controls are necessary in two circumstances. When the auditor's risk assessment includes an expectation of the operating effectiveness of controls, the auditor is required to test those controls to support the risk assessment. In addition, when substantive procedures alone do not provide sufficient appropriate audit evidence, the auditor is required to perform tests of controls to obtain audit evidence about their operating effectiveness.

22. The auditor plans and performs substantive procedures to be responsive to the related assessment of the risks of material misstatement, which includes the results of tests of controls, if any. The auditor's risk assessment is judgmental, however, and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control, including the risk of management override, the possibility of human error and the effect of systems changes. Therefore, substantive procedures for material

classes of transactions, account balances, and disclosures are always required to obtain sufficient appropriate audit evidence.

23. The auditor uses one or more types of audit procedures described in paragraphs 26-38 below. These audit procedures, or combinations thereof, may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance.

24. The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. Source documents, such as purchase orders, bills of lading, invoices, and checks, may be replaced with electronic messages. For example, entities may use electronic commerce or image processing systems. In electronic commerce, the entity and its customers or suppliers use connected computers over a public network, such as the Internet, to transact business electronically. Purchase, shipping, billing, cash receipt, and cash disbursement transactions are often consummated entirely by the exchange of electronic messages between the parties. In image processing systems, documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. Certain electronic information may exist at a certain point in time. However, such information may not be retrievable after a specified period of time if files are changed and if backup files do not exist. An entity's data retention policies may require the auditor to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

25. When the information is in electronic form, the auditor may carry out certain of the audit procedures described below through CAATs.

Inspection of Records or Documents

26. Inspection consists of examining records or documents, whether internal or external, in paper form, electronic form, or other media. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records or documents for evidence of authorization.

27. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed

contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of Tangible Assets

28. Inspection of tangible assets consists of physical examination of the assets. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items ordinarily accompanies the observation of inventory counting.

Observation

29. Observation consists of looking at a process or procedure being performed by others. Examples include observation of the counting of inventories by the entity's personnel and observation of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed. See ISA 501, "Audit Evidence—Additional Considerations for Specific Items" for further guidance on observation of the counting of inventory.

Inquiry

30. Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, throughout the entity or outside the entity. Inquiry is an audit procedure that is used extensively throughout the audit and often is complementary to performing other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

31. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

32. The auditor performs audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient audit evidence to detect a material misstatement at the assertion level. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls.

33. Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the

information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions with respect to assets or liabilities, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information about management's intent.

34. In respect of some matters, the auditor obtains written representations from management to confirm responses to oral inquiries. For example, the auditor ordinarily obtains written representations from management on material matters when other sufficient appropriate audit evidence cannot reasonably be expected to exist or when the other audit evidence obtained is of a lower quality. See ISA 580, "Management Representations" for further guidance on written representations.

Confirmation

35. Confirmation, which is a specific type of inquiry, is the process of obtaining a representation of information or of an existing condition directly from a third party. For example, the auditor may seek direct confirmation of receivables by communication with debtors. Confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request is designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. Confirmations also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition. See ISA 505, "External Confirmations" for further guidance on confirmations.

Recalculation

36. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation can be performed through the use of information technology, for example, by obtaining an electronic file from the entity and using CAATs to check the accuracy of the summarization of the file.

Reperformance

37. Reperformance is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, either manually or through the use of CAATs, for example, reperforming the aging of accounts receivable.

Analytical Procedures

38. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. See ISA 520, "Analytical Procedures" for further guidance on analytical procedures.

Effective Date

39. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.

Public Sector Perspective

1. When carrying out audits of public sector entities, the auditor takes into account the legislative framework and any other relevant regulations, ordinances or ministerial directives that affect the audit mandate and any other special auditing requirements. In making assertions about the financial statements, management asserts that transactions and events have been in accordance with legislation or proper authority in addition to the assertions in paragraph 15 of this ISA.

INTERNATIONAL STANDARD ON AUDITING 501

AUDIT EVIDENCE—ADDITIONAL CONSIDERATIONS FOR SPECIFIC ITEMS

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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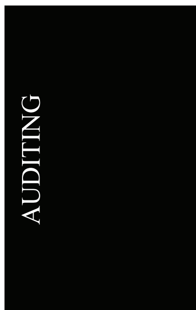
International Standard on Auditing (ISA) 501, "Audit Evidence—Additional Considerations for Specific Items" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" which sets out the application and authority of ISAs.



* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 501. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 501.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance additional to that contained in ISA 500, "Audit Evidence" with respect to certain specific financial statement account balances and other disclosures.

2. Application of the standards and guidance provided in this ISA will assist the auditor in obtaining audit evidence with respect to the specific financial statement account balances and other disclosures addressed.

3. This ISA comprises the following parts:

   (a) Attendance at Physical Inventory Counting.

   (b) Superceded by ISA 505—Part B has been deleted.

   (c) Inquiry Regarding Litigation and Claims.

   (d) Valuation and Disclosure of Long-term Investments.

   (e) Segment Information.

Part A: Attendance at Physical Inventory Counting

4. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements or to ascertain the reliability of the perpetual inventory system.

5. **When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable.** The auditor's attendance serves as a test of controls or substantive procedure over inventory depending on the auditor's risk assessment and planned approach. Such attendance enables the auditor to inspect the inventory, to observe compliance with the operation of management's procedures for recording and controlling the results of the count and to provide audit evidence as to the reliability of management's procedures.

6. **If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and, when necessary, perform audit procedures on intervening transactions.**

7. **Where attendance is impracticable, due to factors such as the nature and location of the inventory, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition to conclude that the auditor need not make reference to a scope limitation.** For example, documentation of the subsequent sale of specific

inventory items acquired or purchased prior to the physical inventory count may provide sufficient appropriate audit evidence.

8. In planning attendance at the physical inventory count or the alternative procedures, the auditor considers the following:
   - The risks of material misstatement related to inventory.
   - The nature of the internal control related to inventory.
   - Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
   - The timing of the count.
   - The locations at which inventory is held.
   - Whether an expert's assistance is needed.

9. When the quantities are to be determined by a physical inventory count and the auditor attends such a count, or when the entity operates a perpetual system and the auditor attends a count one or more times during the year, the auditor would ordinarily observe count procedures and perform test counts.

10. If the entity uses procedures to estimate the physical quantity, such as estimating a coal pile, the auditor would need to be satisfied regarding the reasonableness of those procedures.

11. When inventory is situated in several locations, the auditor would consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the risk of material misstatement at different locations.

12. The auditor would review management's instructions regarding:

    (a) The application of control activities, for example, collection of used stocksheets, accounting for unused stocksheets and count and re-count procedures;

    (b) Accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment; and

    (c) Whether appropriate arrangements are made regarding the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.

13. To obtain audit evidence that management's control activities are adequately implemented, the auditor would observe employees' procedures and perform test counts. When performing test counts, the auditor performs procedures over both the completeness and the accuracy of the count records by tracing items selected from those records to the physical inventory and items selected from the physical inventory to the count records. The auditor considers the extent to

which copies of such count records need to be retained for subsequent audit procedures and comparison.

14. The auditor also considers cutoff procedures including details of the movement of inventory just prior to, during and after the count so that the accounting for such movements can be checked at a later date.

15. For practical reasons, the physical inventory count may be conducted at a date other than period end. This will ordinarily be adequate for audit purposes only when the entity has designed and implemented controls over changes in inventory. The auditor would determine whether, through the performance of appropriate audit procedures, changes in inventory between the count date and period end are correctly recorded.

16. When the entity operates a perpetual inventory system which is used to determine the period end balance, the auditor would evaluate whether, through the performance of additional procedures, the reasons for any significant differences between the physical count and the perpetual inventory records are understood and the records are properly adjusted.

17. The auditor performs audit procedures over the final inventory listing to determine whether it accurately reflects actual inventory counts.

18. When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. Depending on materiality of this inventory the auditor would also consider the following:

    - The integrity and independence of the third party.
    - Observing, or arranging for another auditor to observe, the physical inventory count.
    - Obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is correctly counted and adequately safeguarded.
    - Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts, or obtaining confirmation from other parties when such inventory has been pledged as collateral.

Part B: Superceded by ISA 505 (paragraphs 19-30 have been deleted)

Part C: Procedures Regarding Litigation and Claims

31. Litigation and claims involving an entity may have a material effect on the financial statements and thus may be required to be disclosed and/or provided for in the financial statements.

32. **The auditor should carry out audit procedures in order to become aware of any litigation and claims involving the entity which may result in a material misstatement of the financial statements.** Such procedures would include the following:

    - Make appropriate inquiries of management including obtaining representations.
    - Review minutes of those charged with governance and correspondence with the entity's legal counsel.
    - Examine legal expense accounts.
    - Use any information obtained regarding the entity's business including information obtained from discussions with any in-house legal department.

33. **When the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified or when the auditor believes they may exist, the auditor should seek direct communication with the entity's legal counsel.** Such communication will assist in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable. When the auditor determines that the risk of material misstatement is a significant risk, the auditor evaluates the design of the entity's related controls and determines whether they have been implemented. Paragraphs 108-114 of ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" provides further guidance on the determination of significant risks.

34. **The letter, which should be prepared by management and sent by the auditor, should request the entity's legal counsel to communicate directly with the auditor.** When it is considered unlikely that the entity's legal counsel will respond to a general inquiry, the letter would ordinarily specify the following:

    - A list of litigation and claims.
    - Management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved.
    - A request that the entity's legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's legal counsel to be incomplete or incorrect.

35. The auditor considers the status of legal matters up to the date of the audit report. In some instances, the auditor may need to obtain updated information from entity's legal counsel.

36. In certain circumstances, for example, where the auditor determines that the matter is a significant risk, the matter is complex or there is disagreement between management and the entity's legal counsel, it may be necessary for the auditor to meet with the entity's legal counsel to discuss the likely outcome of litigation and claims. Such meetings would take place with management's permission and, preferably, with a representative of management in attendance.

37. **If management refuses to give the auditor permission to communicate with the entity's legal counsel, this would be a scope limitation and should ordinarily lead to a qualified opinion or a disclaimer of opinion.** Where the entity's legal counsel refuses to respond in an appropriate manner and the auditor is unable to obtain sufficient appropriate audit evidence by applying alternative audit procedures, the auditor would consider whether there is a scope limitation which may lead to a qualified opinion or a disclaimer of opinion.

Part D: Valuation and Disclosure of Long-term Investments

38. **When long-term investments are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding their valuation and disclosure.**

39. Audit procedures regarding long-term investments ordinarily include obtaining audit evidence as to whether the entity has the ability to continue to hold the investments on a long term basis and discussing with management whether the entity will continue to hold the investments as long-term investments and obtaining written representations to that effect.

40. Other audit procedures would ordinarily include considering related financial statements and other information, such as market quotations, which provide an indication of value and comparing such values to the carrying amount of the investments up to the date of the auditor's report.

41. If such values do not exceed the carrying amounts, the auditor would consider whether a write-down is required. If there is an uncertainty as to whether the carrying amount will be recovered, the auditor would consider whether appropriate adjustments and/or disclosures have been made.

Part E: Segment Information

42. **When segment information is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its presentation and disclosure in accordance with the applicable financial reporting framework.**

43. The auditor considers segment information in relation to the financial statements taken as a whole, and is not ordinarily required to apply audit procedures that would be necessary to express an opinion on the segment information standing

alone. However, the concept of materiality encompasses both quantitative and qualitative factors and the auditor's procedures recognize this.

44. Audit procedures regarding segment information ordinarily consist of analytical procedures and other audit procedures as appropriate in the circumstances.

45. The auditor would discuss with management the methods used in determining segment information, and consider whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework and perform audit procedures over the application of such methods. The auditor would consider sales, transfers and charges between segments, elimination of inter-segment amounts, comparisons with budgets and other expected results, for example, operating profits as a percentage of sales, and the allocation of assets and costs among segments including consistency with prior periods and the adequacy of the disclosures with respect to inconsistencies.

INTERNATIONAL STANDARD ON AUDITING 505

EXTERNAL CONFIRMATIONS

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 505, "External Confirmations" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 505. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 505.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's use of external confirmations as a means of obtaining audit evidence.

2. **The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level. In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level.**

3. ISA 500, "Audit Evidence" states that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. It indicates that, while recognizing exceptions may exist, the following generalization about the reliability of audit evidence may be useful:

   - Audit evidence is more reliable when it is obtained from independent sources outside the entity.
   - Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
   - Audit evidence is more reliable when it exists in documentary form.
   - Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

   Accordingly, audit evidence in the form of original written responses to confirmation requests received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other audit procedures, may assist in reducing the risk of material misstatement for the related assertions to an acceptably low level.

4. External confirmation is the process of obtaining and evaluating audit evidence through a representation of information or an existing condition directly from a third party in response to a request for information about a particular item affecting assertions in the financial statements or related disclosures. In deciding to what extent to use external confirmations the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

5. External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is

designed to ask if any modifications have been made to the agreement, and if so what the relevant details are. External confirmations may also be used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition. Other examples of situations where external confirmations may be used include the following:

- Bank balances and other information from bankers.
- Accounts receivable balances.
- Stocks held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments purchased from stockbrokers but not delivered at the balance sheet date.
- Loans from lenders.
- Accounts payable balances.

6. The reliability of the audit evidence obtained by external confirmations depends, among other factors, upon the auditor applying appropriate audit procedures in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

Relationship of External Confirmation Procedures to the Auditor's Assessments of the Risk of Material Misstatement

7. ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" discusses the auditor's responsibility to obtain an understanding of the entity and its environment including its internal control; and to assess the risks of material misstatement. It outlines the audit procedures performed to assess the risks of material misstatements of the financial statements sufficient to design and perform further audit procedures.

8. ISA 330, "The Auditor's Procedures in Response to Assessed Risks" discusses the auditor's responsibility to determine overall responses and to design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement at the financial statement and assertion levels. In particular, ISA 330 indicates that the auditor determines the nature and extent of audit evidence to be obtained from the

performance of substantive procedures in response to the related assessment of the risk of material misstatement, and that, irrespective of the assessed risk of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. These substantive procedures may include the use of external confirmations for certain assertions.

9. Paragraph 11 of ISA 330 indicates that the higher the auditor's assessment of risk, the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures. Consequently as the assessed risk of material misstatement increases, the auditor designs substantive procedures to obtain more reliable and relevant audit evidence, or more persuasive audit evidence, at the assertion level. In these situations, the use of confirmation procedures may be effective in providing sufficient appropriate audit evidence.

10. The lower the assessed risk of material misstatement, the less assurance the auditor needs from substantive procedures to form a conclusion about an assertion. For example, an entity may have a loan that it is repaying according to an agreed schedule, the terms of which the auditor has confirmed in previous years. If the other work carried out by the auditor (including such tests of controls as are necessary) indicates that the terms of the loan have not changed and has lead to the risk of material misstatement over the balance of the loan outstanding being assessed as lower, the auditor might limit substantive procedures to testing details of the payments made, rather than again confirming the balance directly with the lender.

11. When the auditor has identified a risk as being significant (see paragraph 108 of ISA 315), the auditor may give particular consideration to whether confirmations of certain matters may be an appropriate way of reducing the risk of misstatement. For example, unusual or complex transactions may be associated with higher assessed risk than simple transactions. If the entity has entered into an unusual or complex transaction that results in a higher assessed risk of material misstatement, the auditor considers confirming the terms of the transaction with the other parties in addition to examining documentation held by the entity.

Assertions Addressed by External Confirmations

12. ISA 500 requires the use of assertions in assessing risks and designing and performing audit procedures in response to the assessed risks. ISA 500 categorizes the assertions into those relating to classes of transactions, account balances, and disclosures. While external confirmations may provide audit evidence regarding these assertions, the ability of an external confirmation to provide audit evidence relevant to a particular assertion varies.

13. External confirmation of an account receivable provides reliable and relevant audit evidence regarding the existence of the account as at a certain date.

Confirmation also provides audit evidence regarding the operation of cutoff procedures. However, such confirmation does not ordinarily provide all the necessary audit evidence relating to the valuation assertion, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

14. Similarly, in the case of goods held on consignment, external confirmation is likely to provide reliable and relevant audit evidence to support the existence and the rights and obligations assertions, but might not provide audit evidence that supports the valuation assertion.

15. The relevance of external confirmations to auditing a particular assertion is also affected by the objective of the auditor in selecting information for confirmation. For example, when auditing the completeness assertion for accounts payable, the auditor needs to obtain audit evidence that there is no material unrecorded liability. Accordingly, sending confirmation requests to an entity's principal suppliers asking them to provide copies of their statements of account directly to the auditor, even if the records show no amount currently owing to them, will usually be more effective in detecting unrecorded liabilities than selecting accounts for confirmation based on the larger amounts recorded in the accounts payable subsidiary ledger.

16. When obtaining audit evidence for assertions not adequately addressed by confirmations, the auditor considers other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

Design of the External Confirmation Request

17. **The auditor should tailor external confirmation requests to the specific audit objective.** When designing the request, the auditor considers the assertions being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the external confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent, affect the design of the requests because these factors have a direct effect on the reliability of the audit evidence obtained through external confirmation procedures.

18. Also, in designing the request, the auditor considers the type of information respondents will be able to confirm readily since this may affect the response rate and the nature of the audit evidence obtained. For example, certain respondents' information systems may facilitate the external confirmation of single transactions rather than of entire account balances. In addition, respondents may not always be able to confirm certain types of information, such as the overall accounts receivable balance, but may be able to confirm individual invoice amounts within the total balance.

19. Confirmation requests ordinarily include management's authorization to the respondent to disclose the information to the auditor. Respondents may be

more willing to respond to a confirmation request containing management's authorization, and in some cases may be unable to respond unless the request contains management's authorization.

Use of Positive and Negative Confirmations

20. The auditor may use positive or negative external confirmation requests or a combination of both.

21. A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information. A response to a positive confirmation request is ordinarily expected to provide reliable audit evidence. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct. The auditor is not ordinarily able to detect whether this has occurred. The auditor may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the respondents.

22. A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response has been received to a negative confirmation request, the auditor remains aware that there will be no explicit audit evidence that intended third parties have received the confirmation requests and verified that the information contained therein is correct. Accordingly, the use of negative confirmation requests ordinarily provides less reliable audit evidence than the use of positive confirmation requests, and the auditor considers performing other substantive procedures to supplement the use of negative confirmations.

23. Negative confirmation requests may be used to reduce the risk of material misstatement to an acceptable level when:

    (a) The assessed risk of material misstatement is lower;

    (b) A large number of small balances is involved;

    (c) A substantial number of errors is not expected; and

    (d) The auditor has no reason to believe that respondents will disregard these requests.

24. A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance comprises a small number of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large

balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

Management Requests

25. **When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain audit evidence to support the validity of management's requests. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should apply alternative audit procedures to obtain sufficient appropriate audit evidence regarding that matter.**

26. **If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report.**

27. When considering the reasons provided by management, the auditor applies an attitude of professional skepticism and considers whether the request has any implications regarding management's integrity. The auditor considers whether management's request may indicate the possible existence of fraud or error. If the auditor believes that fraud or error exists, the auditor applies the guidance in ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements." The auditor also considers whether the alternative audit procedures will provide sufficient appropriate audit evidence regarding that matter.

Characteristics of Respondents

28. The reliability of audit evidence provided by a confirmation is affected by the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor attempts to ensure, where practicable, that the confirmation request is directed to an appropriate individual. For example, when confirming that a covenant related to an entity's long-term debt has been waived, the auditor directs the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.

29. The auditor also assesses whether certain parties may not provide an objective or unbiased response to a confirmation request. Information about the respondent's competence, knowledge, motivation, ability or willingness to respond may come to the auditor's attention. The auditor considers the effect of such information on designing the confirmation request and evaluating the results, including determining whether additional audit procedures are necessary. The auditor also considers whether there is sufficient basis for

concluding that the confirmation request is being sent to a respondent from whom the auditor can expect a response that will provide sufficient appropriate audit evidence. For example, the auditor may encounter significant unusual year-end transactions that have a material effect on the financial statements, the transactions being with a third party that is economically dependent upon the entity. In such circumstances, the auditor considers whether the third party may be motivated to provide an inaccurate response.

The External Confirmation Process

30. **When performing confirmation procedures, the auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests.** Control is maintained over communications between the intended recipients and the auditor to minimize the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. The auditor ensures that it is the auditor who sends out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies are sent directly to the auditor. The auditor considers whether replies have come from the purported senders.

No Response to a Positive Confirmation Request

31. **The auditor should perform alternative audit procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide audit evidence about the assertions that the confirmation request was intended to provide.**

32. Where no response is received, the auditor ordinarily contacts the recipient of the request to elicit a response. Where the auditor is unable to obtain a response, the auditor uses alternative audit procedures. The nature of alternative audit procedures varies according to the account and assertion in question. In the examination of accounts receivable, alternative audit procedures may include examination of subsequent cash receipts, examination of shipping documentation or other client documentation to provide audit evidence for the existence assertion, and examination of sales near the period-end to provide audit evidence for the cutoff assertion. In the examination of accounts payable, alternative audit procedures may include examination of subsequent cash disbursements or correspondence from third parties to provide audit evidence of the existence assertion, and examination of other records, such as goods received notes, to provide audit evidence of the completeness assertion.

Reliability of Responses Received

33. The auditor considers whether there is any indication that external confirmations received may not be reliable. The auditor considers the response's authenticity and performs audit procedures to dispel any concern. The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor requests the purported sender to mail the original confirmation directly to the auditor. With ever-increasing use of technology, the auditor considers validating the source of replies received in electronic format (for example, fax or electronic mail). Oral confirmations are documented in the work papers. If the information in the oral confirmations is significant, the auditor requests the parties involved to submit written confirmation of the specific information directly to the auditor.

Causes and Frequency of Exceptions

34. **When the auditor forms a conclusion that the confirmation process and alternative audit procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should perform additional audit procedures to obtain sufficient appropriate audit evidence.**

    In forming the conclusion, the auditor considers the:

    (a) Reliability of the confirmations and alternative audit procedures;

    (b) Nature of any exceptions, including the implications, both quantitative and qualitative of those exceptions; and

    (c) Audit evidence provided by other audit procedures.

    Based on this evaluation, the auditor determines whether additional audit procedures are needed to obtain sufficient appropriate audit evidence.

35. The auditor also considers the causes and frequency of exceptions reported by respondents. An exception may indicate a misstatement in the entity's records, in which case, the auditor determines the reasons for the misstatement and assesses whether it has a material effect on the financial statements. If an exception indicates a misstatement, the auditor reconsiders the nature, timing and extent of audit procedures necessary to provide the audit evidence required.

Evaluating the Results of the Confirmation Process

36. **The auditor should evaluate whether the results of the external confirmation process together with the results from any other audit procedures performed, provide sufficient appropriate audit evidence regarding the assertion being audited.** In conducting this evaluation the

auditor considers the guidance provided by ISA 330 and ISA 530, "Audit Sampling and Other Selective Procedures."

External Confirmations Prior to the Year-end

37. When the auditor uses confirmation as at a date prior to the balance sheet to obtain audit evidence to support an assertion, the auditor obtains sufficient appropriate audit evidence that transactions relevant to the assertion in the intervening period have not been materially misstated. Depending on the assessed risk of material misstatement, the auditor may decide to confirm balances at a date other than the period end, for example, when the audit is to be completed within a short time after the balance sheet date. As with all types of pre-year-end work, the auditor considers the need to obtain further audit evidence relating to the remainder of the period. ISA 330 provides additional guidance when audit procedures are performed at an interim date.

Effective Date

38. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.

INTERNATIONAL STANDARD ON AUDITING 510

INITIAL ENGAGEMENTS—OPENING BALANCES

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 510, "Initial Engagements—Opening Balances" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 510. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 510.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance regarding opening balances when the financial statements are audited for the first time or when the financial statements for the prior period were audited by another auditor. This ISA would also be considered when the auditor becomes aware of contingencies and commitments existing at the beginning of the period. Guidance on the audit and reporting requirements regarding comparatives is provided in ISA 710, "Comparatives."

2. **For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:**

   (a) **The opening balances do not contain misstatements that materially affect the current period's financial statements;**

   (b) **The prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated; and**

   (c) **Appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately presented and disclosed.**

3. "Opening balances" means those account balances which exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of:

   (a) Transactions of prior periods; and

   (b) Accounting policies applied in the prior period.

   In an initial audit engagement, the auditor will not have previously obtained audit evidence supporting such opening balances.

AUDITING

Audit Procedures

4. The sufficiency and appropriateness of the audit evidence the auditor will need to obtain regarding opening balances depends on such matters as the following:

   - The accounting policies followed by the entity.
   - Whether the prior period's financial statements were audited, and if so whether the auditor's report was modified.
   - The nature of the accounts and the risk of material misstatement in the current period's financial statements.
   - The materiality of the opening balances relative to the current period's financial statements.

5. The auditor will need to consider whether opening balances reflect the application of appropriate accounting policies and that those policies are consistently applied in the current period's financial statements. When there are any changes in the accounting policies or application thereof, the auditor would consider whether they are appropriate and properly accounted for and adequately presented and disclosed.

6. When the prior period's financial statements were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by reviewing the predecessor auditor's working papers. In these circumstances, the current auditor would also consider the professional competence and independence of the predecessor auditor. If the prior period's auditor's report was modified, the auditor would pay particular attention in the current period to the matter which resulted in the modification.

7. Prior to communicating with the predecessor auditor, the current auditor will need to consider the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants.

8. When the prior period's financial statements were not audited or when the auditor is not able to be satisfied by using the audit procedures described in paragraph 6, the auditor will need to perform other audit procedures such as those discussed in paragraphs 9 and 10.

9. For current assets and liabilities some audit evidence can ordinarily be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period. In the case of inventories; however, it is more difficult for the auditor to be satisfied as to inventory on hand at the beginning of the period. Therefore, additional audit procedures are ordinarily necessary such as observing a current physical inventory taking and reconciling it back to the opening inventory quantities, performing audit procedures on the valuation of the opening inventory items, and performing audit procedures on gross profit and cutoff. A combination of these audit procedures may provide sufficient appropriate audit evidence.

10. For noncurrent assets and liabilities, such as fixed assets, investments and long-term debt, the auditor will ordinarily examine the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain confirmation of opening balances with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

Audit Conclusions and Reporting

11. **If, after performing audit procedures including those set out above, the auditor is unable to obtain sufficient appropriate audit evidence concerning opening balances, the auditor's report should include:**

    (a) **A qualified opinion,** for example:

    "We did not observe the counting of the physical inventory stated at XXX as at December 31, 19X1, since that date was prior to our appointment as auditors. We were unable to satisfy ourselves as to the inventory quantities at that date by other audit procedures.

    In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to observe the counting of physical inventory and satisfy ourselves as to the opening balance of inventory, the financial statements give a true and fair view of (present fairly, in all material respects,) the financial position of ... as at December 31, 19X2 and the results of its operations and its cash flows for the year then ended in accordance with ...;"

    (b) **A disclaimer of opinion; or**

    (c) **In those jurisdictions where it is permitted, an opinion which is qualified or disclaimed regarding the results of operations and unqualified regarding financial position,** for example:

    "We did not observe the counting of the physical inventory stated at XXX as at December 31, 19X1, since that date was prior to our appointment as auditors. We were unable to satisfy ourselves as to the inventory quantities at that date by other audit procedures.

    Because of the significance of the above matter in relation to the results of the Company's operations for the year to December 31, 19X2, we are not in a position to, and do not, express an opinion on the results of its operations and its cash flows for the year then ended.

    In our opinion, the balance sheet gives a true and fair view of (or 'presents fairly in all material respects,') the financial position of the Company as at December 31, 19X2, in accordance with ..."

12. If the opening balances contain misstatements which could materially affect the current period's financial statements, the auditor would inform management and, after having obtained management's authorization, the predecessor auditor, if any. **If the effect of the misstatement is not properly accounted for and adequately presented and disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.**

13. **If the current period's accounting policies have not been consistently applied in relation to opening balances and if the change has not been**

properly accounted for and adequately presented and disclosed, the auditor should express a qualified opinion or an adverse opinion as appropriate.

14. If the entity's prior period auditor's report was modified, the auditor would consider the effect thereof on the current period's financial statements. For example, if there was a scope limitation, such as one due to the inability to determine opening inventory in the prior period, the auditor may not need to qualify or disclaim the current period's audit opinion. **However, if a modification regarding the prior period's financial statements remains relevant and material to the current period's financial statements, the auditor should modify the current auditor's report accordingly.**

INTERNATIONAL STANDARD ON AUDITING 520

ANALYTICAL PROCEDURES

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 520, "Analytical Procedures" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 520. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 520.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the application of analytical procedures during an audit.

2. **The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit.** Analytical procedures may also be applied as substantive procedures.

3. "Analytical procedures" means evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Nature and Purpose of Analytical Procedures

4. Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

    - Comparable information for prior periods.
    - Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
    - Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

5. Analytical procedures also include consideration of relationships:

    - Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
    - Between financial information and relevant non-financial information, such as payroll costs to number of employees.

6. Various methods may be used in performing the above audit procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions or segments) and individual elements of financial information. The auditor's choice of audit procedures, methods and level of application is a matter of professional judgment.

7. Analytical procedures are used for the following purposes:

   (a) As risk assessment procedures to obtain an understanding of the entity and its environment (paragraphs 8-9).

   (b) As substantive procedures when their use can be more effective or efficient than tests of details in reducing the risk of material misstatement at the assertion level to an acceptably low level (paragraphs 10-19).

   (c) As an overall review of the financial statements at the end of the audit (paragraph 13).

Analytical Procedures as Risk Assessment Procedures

8. **The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment.** Application of analytical procedures may indicate aspects of the entity of which the auditor was unaware and will assist in assessing the risks of material misstatement in order to determine the nature, timing and extent of further audit procedures.

9. Analytical procedures applied as risk assessment procedures use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold. Paragraph 10 of ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" contains additional guidance on applying analytical procedures as risk assessment procedures.

Analytical Procedures as Substantive Procedures

10. The auditor designs and performs substantive procedures to be responsive to the related assessment of the risk of material misstatement at the assertion level. The auditor's substantive procedures at the assertion level may be derived from tests of details, from substantive analytical procedures, or from a combination of both. The decision about which audit procedures to use to achieve a particular audit objective is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures in reducing the assessed risk of material misstatement at the assertion level to an acceptably low level.

11. The auditor will ordinarily inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures and the results of any such procedures performed by the entity. It may be efficient to use analytical data prepared by the entity, provided the auditor is satisfied that such data is properly prepared.

12. When designing and performing analytical procedures as substantive procedures, the auditor will need to consider a number of factors such as the following:

    - The suitability of using substantive analytical procedures given the assertions (paragraphs 12a and 12b).
    - The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed (paragraphs 12c and 12d).
    - Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance (paragraph 12e).
    - The amount of any difference of recorded amounts from expected values that is acceptable (paragraph 12f).

Suitability of Using Substantive Analytical Procedures Given the Assertions

12a. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of substantive analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and occurrence of transactions captured in the information produced by the entity's information system. However, reliance on the results of substantive analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

12b. In determining the suitability of substantive analytical procedures given the assertions, the auditor considers the following:

    (a) *The assessment of the risk of material misstatement.* The auditor considers the understanding of the entity and its internal control, the materiality and likelihood of misstatement of the items involved, and the nature of the assertion in determining whether substantive analytical procedures are suitable. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than substantive analytical procedures for assertions related to receivables. As another example, when inventory balances are material, the auditor ordinarily does not rely only on substantive analytical procedures when performing audit procedures on the existence assertion. ISA 330, "The Auditor's Procedures in Response to Assessed Risks" indicates that, when the approach to significant risks consists only of substantive procedures, the audit procedures appropriate to address such significant risks consist of tests of details

only, or a combination of tests of details and substantive analytical procedures.

(b) *Any tests of details directed toward the same assertion.* Substantive analytical procedures may also be considered appropriate when tests of details are performed on the same assertion. For example, when auditing the collectibility of accounts receivable, the auditor may apply substantive analytical procedures to an aging of customers' accounts in addition to tests of details on subsequent cash receipts.

The Reliability of the Data

12c. The reliability of data is influenced by its source and by its nature and is dependent on the circumstances under which it is obtained. In determining whether data is reliable for purposes of designing substantive analytical procedures, the auditor considers the following:

(a) *Source of the information available.* For example, information is ordinarily more reliable when it is obtained from independent sources outside the entity.

(b) *Comparability of the information available.* For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products.

(c) *Nature and relevance of the information available.* For example, whether budgets have been established as results to be expected rather than as goals to be achieved.

(d) *Controls over the preparation of the information.* For example, controls over the preparation, review and maintenance of budgets.

12d. The auditor considers testing the controls, if any, over the entity's preparation of information used by the auditor in applying substantive analytical procedures. When such controls are effective, the auditor has greater confidence in the reliability of the information and, therefore, in the results of substantive analytical procedures. The controls over non-financial information can often be tested in conjunction with other tests of controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing in the current or prior period. In determining the audit procedures to apply to the information upon which the expectation for substantive analytical procedures is based, the auditor considers the guidance in paragraph 11 of ISA 500, "Audit Evidence."

Whether the Expectation is Sufficiently Precise

12e. In assessing whether the expectation can be developed sufficiently precise to identify a material misstatement at the desired level of assurance, the auditor considers factors such as the following:

- *The accuracy with which the expected results of substantive analytical procedures can be predicted*. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
- *The degree to which information can be disaggregated.* For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- *The availability of the information*, *both financial and non-financial.* For example, the auditor considers whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor also considers the reliability of the information as discussed in paragraphs 12c and 12d above.

Amount of Difference of Recorded Amounts from Expected Values that is Acceptable

12f. In designing and performing substantive analytical procedures, the auditor considers the amount of difference from expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and the consistency with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount. The auditor increases the desired level of assurance as the risk of material misstatement increases by reducing the amount of difference from the expectation that can be accepted without further investigation. Paragraphs 17 and 18 below discuss the auditor's response when the amount of difference between the expected value and the reported value exceeds the amount that can be accepted without further investigation.

12g. When the auditor performs substantive procedures at an interim date and plans to perform substantive analytical procedures with respect to the intervening period, the auditor considers how the matters discussed in paragraphs 12a-12f affect the ability to obtain sufficient appropriate audit evidence for the remaining period. This includes considering whether the period end balances of the particular classes of transactions or account balances are reasonably

predictable with respect to amount, relative significance, and composition. See ISA 330, paragraphs 56-61, for additional guidance.

Analytical Procedures in the Overall Review at the End of the Audit

13. **The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.** The conclusions drawn from the results of such audit procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, they may also identify a previously unrecognized risk of material misstatement. In such circumstances, the auditor may need to re-evaluate 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.

14.-16. Paragraphs 14-16 were deleted when the *Audit Risk Standards*[1] became effective.

Investigating Unusual Items

17. **When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative audit evidence.**

18. The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:

    (a) Corroboration of management's responses, for example, by comparing them with the auditor's understanding of the entity and other audit evidence obtained during the course of the audit; and

    (b) Consideration of the need to apply other audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.

[1] The *Audit Risk Standards* comprise ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence." The *Audit Risk Standards* gave rise to conforming amendments to this and other ISAs.

Public Sector Perspective

1. *The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be appropriate in the audit of governments or other non-business public sector entities; for example, in many such public sector entities there is often little direct relationship between revenues and expenditures. In addition, because expenditure on the acquisition of assets is frequently non-capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. In addition, in the public sector, industry data or statistics for comparative purposes may not be available. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired. Where appropriate, reference has to be made to available private sector industry data and statistics. In certain instances, it may also be appropriate for the auditor to generate an in-house database of reference information.*

INTERNATIONAL STANDARD ON AUDITING 530

AUDIT SAMPLING AND OTHER MEANS OF TESTING

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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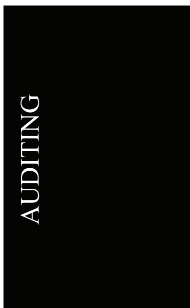

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 530. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 530.

International Standard on Auditing (ISA) 530, "Audit Sampling and Other Means of Testing" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the use of audit sampling and other means of selecting items for testing when designing audit procedures to gather audit evidence.

2. **When designing audit procedures, the auditor should determine appropriate means for selecting items for testing so as to gather sufficient appropriate audit evidence to meet the objectives of the audit procedures.**

Definitions

3. "Audit sampling" (sampling) involves the application of audit procedures to less than 100% of items within a class of transactions or account balance such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can use either a statistical or a non-statistical approach.

4. For purposes of this ISA, "error" means either control deviations, when performing tests of controls, or misstatements, when performing tests of details. Similarly, total error is used to mean either the rate of deviation or total misstatement.

5. "Anomalous error" means an error that arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of errors in the population.

6. "Population" means the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. For example, all of the items in a class of transactions or account balance constitute a population. A population may be divided into strata, or sub-populations, with each stratum being examined separately. The term population is used to include the term stratum.

7. "Sampling risk" arises from the possibility that the auditor's conclusion, based on a sample may be different from the conclusion reached if the entire population were subjected to the same audit procedure. There are two types of sampling risk:

   (a) The risk the auditor will conclude, in the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material error does not exist when in fact it does. This type of risk affects audit effectiveness and is more likely to lead to an inappropriate audit opinion; and

   (b) The risk the auditor will conclude, in the case of a test of controls, that controls are less effective than they actually are, or in the case of a test

of details, that a material error exists when in fact it does not. This type of risk affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

The mathematical complements of these risks are termed confidence levels.

8. "Non-sampling risk" arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, ordinarily the auditor finds it necessary to rely on audit evidence that is persuasive rather than conclusive, the auditor might use inappropriate audit procedures, or the auditor might misinterpret audit evidence and fail to recognize an error.

9. "Sampling unit" means the individual items constituting a population, for example checks listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances, or a monetary unit.

10. "Statistical sampling" means any approach to sampling that has the following characteristics:

    (a) Random selection of a sample; and

    (b) Use of probability theory to evaluate sample results, including measurement of sampling risk.

    A sampling approach that does not have characteristics (a) and (b) is considered non-statistical sampling.

11. "Stratification" is the process of dividing a population into subpopulations, each of which is a group of sampling units which have similar characteristics (often monetary value).

12. "Tolerable error" means the maximum error in a population that the auditor is willing to accept.

Audit Evidence

13. In accordance with ISA 500, "Audit Evidence" audit evidence is obtained by performing risk assessment procedures, tests of controls and substantive procedures. The type of audit procedure to be performed is important to an understanding of the application of audit sampling in gathering audit evidence.

Risk Assessment Procedures

13a. In accordance with ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," the auditor performs risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control. Ordinarily, risk assessment procedures do not involve the use of audit sampling. However, the auditor often plans and performs tests of controls concurrently with obtaining an

understanding of the design of controls and determining whether they have been implemented. In such cases, the following discussion of tests of controls is relevant.

Tests of Control

14. In accordance with ISA 330, "The Auditor's Procedures in Response to Assessed Risks" tests of controls are performed when the auditor's risk assessment includes an expectation of the operating effectiveness of controls.

15. Based on the auditor's understanding of internal control, the auditor identifies the characteristics or attributes that indicate performance of a control, as well as possible deviation conditions which indicate departures from adequate performance. The presence or absence of attributes can then be tested by the auditor.

16. Audit sampling for tests of controls is generally appropriate when application of the control leaves audit evidence of performance (for example, initials of the credit manager on a sales invoice indicating credit approval, or evidence of authorization of data input to a microcomputer based data processing system).

Substantive Procedures

17. Substantive procedures are concerned with amounts and are of two types: tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures. The purpose of substantive procedures is to obtain audit evidence to detect material misstatements at the assertion level. In the context of substantive procedures, audit sampling and other means of selecting items for testing, as discussed in this ISA, relate only to tests of details. When performing tests of details, audit sampling and other means of selecting items for testing and gathering audit evidence may be used to verify one or more assertions about a financial statement amount (for example, the existence of accounts receivable), or to make an independent estimate of some amount (for example, the value of obsolete inventories).

Risk Considerations in Obtaining Audit Evidence

18. **In obtaining audit evidence, the auditor should use professional judgment to assess the risk of material misstatement (which includes inherent and control risk) and design further audit procedures to ensure this risk is reduced to an acceptably low level.**

19. Paragraph 19 was deleted when the *Audit Risk Standards*[1] became effective.

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[1] The *Audit Risk Standards* comprise ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence." The *Audit Risk Standards* gave rise to conforming amendments to this and other ISAs.

20. Sampling risk and non-sampling risk can affect the components of the risk of material misstatement. For example, when performing tests of controls, the auditor may find no errors in a sample and conclude that controls are operating effectively, when the rate of error in the population is, in fact, unacceptably high (sampling risk). Or there may be errors in the sample which the auditor fails to recognize (non-sampling risk). With respect to substantive procedures, the auditor may use a variety of methods to reduce detection risk to an acceptable level. Depending on their nature, these methods will be subject to sampling and/or non-sampling risks. For example, the auditor may choose an inappropriate substantive analytical procedure (non-sampling risk) or may find only minor misstatements in a test of details when, in fact, the population misstatement is greater than the tolerable amount (sampling risk). For both tests of controls and substantive tests of details, sampling risk can be reduced by increasing sample size, while non-sampling risk can be reduced by proper engagement planning supervision and review.

Audit Procedures for Obtaining Audit Evidence

21. Audit procedures for obtaining audit evidence include inspection, observation, inquiry and confirmation, recalculation, reperformance and analytical procedures. The choice of appropriate audit procedures is a matter of professional judgment in the circumstances. Application of these audit procedures will often involve the selection of items for testing from a population. Paragraphs 19-38 of ISA 500 contain additional discussion on audit procedures for obtaining audit evidence.

Selecting Items for Testing to Gather Audit Evidence

22. **When designing audit procedures, the auditor should determine appropriate means of selecting items for testing.** The means available to the auditor are:

    (a) Selecting all items (100% examination);

    (b) Selecting specific items; and

    (c) Audit sampling.

23. The decision as to which approach to use will depend on the circumstances, and the application of any one or combination of the above means may be appropriate in particular circumstances. While the decision as to which means, or combination of means, to use is made on the basis of the risk of material misstatement related to the assertion being tested and audit efficiency, the auditor needs to be satisfied that methods used are effective in providing sufficient appropriate audit evidence to meet the objectives of the audit procedure.

Selecting All Items

24. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details. For example, 100% examination may be appropriate when the population constitutes a small number of large value items, when there is a significant risk and other means do not provide sufficient appropriate audit evidence, or when the repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective, for example, through the use of computer-assisted audit techniques (CAATs).

Selecting Specific Items

25. The auditor may decide to select specific items from a population based on such factors as the auditor's understanding of the entity, the assessed risk of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

    - *High value or key items*. The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example items that are suspicious, unusual, particularly risk-prone or that have a history of error.
    - *All items over a certain amount*. The auditor may decide to examine items whose values exceed a certain amount so as to verify a large proportion of the total amount of class of transactions or account balance.
    - *Items to obtain information*. The auditor may examine items to obtain information about matters such as the nature of the entity, the nature of transactions, and internal control.
    - *Items to test control activities*. The auditor may use judgment to select and examine specific items to determine whether or not a particular control activity is being performed.

26. While selective examination of specific items from a class of transactions or account balance will often be an efficient means of gathering audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population. The auditor considers the need to obtain sufficient appropriate audit evidence regarding the remainder of the population when that remainder is material.

Audit Sampling

27. The auditor may decide to apply audit sampling to a class of transactions or account balance. Audit sampling can be applied using either non-statistical

or statistical sampling methods. Audit sampling is discussed in detail in paragraphs 31-56.

Statistical versus Non-Statistical Sampling Approaches

28. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment regarding the most efficient manner to obtain sufficient appropriate audit evidence in the particular circumstances. For example, in the case of tests of controls the auditor's analysis of the nature and cause of errors will often be more important than the statistical analysis of the mere presence or absence (that is, the count) of errors. In such a situation, non-statistical sampling may be most appropriate.

29. When applying statistical sampling, the sample size can be determined using either probability theory or professional judgment. Moreover, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches. Sample size is a function of factors such as those identified in Appendices 1 and 2. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 1 and 2 will be similar regardless of whether a statistical or non-statistical approach is chosen.

30. Often, while the approach adopted does not meet the definition of statistical sampling, elements of a statistical approach are used, for example the use of random selection using computer generated random numbers. However, only when the approach adopted has the characteristics of statistical sampling are statistical measurements of sampling risk valid.

Design of the Sample

31. **When designing an audit sample, the auditor should consider the objectives of the audit procedure and the attributes of the population from which the sample will be drawn.**

32. The auditor first considers the specific objectives to be achieved and the combination of audit procedures which is likely to best achieve those objectives. Consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes an error and what population to use for sampling.

33. The auditor considers what conditions constitute an error by reference to the objectives of the audit procedure. A clear understanding of what constitutes an error is important to ensure that all, and only, those conditions that are relevant to the objectives of the audit procedure are included in the projection of errors. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client are not considered an error. Also, a misposting between customer accounts does not affect the total accounts

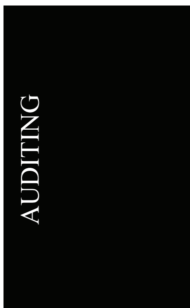
receivable balance. Therefore, it is not appropriate to consider this an error in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the likelihood of fraud or the adequacy of the allowance for doubtful accounts.

34. When performing tests of controls, the auditor generally makes an assessment of the rate of error the auditor expects to find in the population to be tested. This assessment is based on the auditor's understanding of the design of the relevant controls and whether they have been implemented or the examination of a small number of items from the population. Similarly, for tests of details, the auditor generally makes an assessment of the expected amount of error in the population. These assessments are useful for designing an audit sample and in determining sample size. For example, if the expected rate of error is unacceptably high, tests of controls will normally not be performed. However, when performing tests of details, if the expected amount of error is high, 100% examination or the use of a large sample size may be appropriate.

Population

35. It is important for the auditor to ensure that the population is:

    (a) *Appropriate* to the objective of the audit procedure, which will include consideration of the direction of testing. For example, if the auditor's objective is to test for overstatement of accounts payable, the population could be defined as the accounts payable listing. On the other hand, when testing for understatement of accounts payable, the population is not the accounts payable listing but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports or other populations that provide audit evidence of understatement of accounts payable; and



    (b) *Complete*. For example, if the auditor intends to select payment vouchers from a file, conclusions cannot be drawn about all vouchers for the period unless the auditor is satisfied that all vouchers have in fact been filed. Similarly, if the auditor intends to use the sample to draw conclusions about whether a control activity operated effectively during the financial reporting period, the population needs to include all relevant items from throughout the entire period. A different approach may be to stratify the population and use sampling only to draw conclusions about the control activity during, say, the first 10 months of a year, and to use alternative audit procedures or a separate sample regarding the remaining two months. ISA 330 contains additional guidance on performing audit procedures at an interim period.

35a. The auditor is required to obtain audit evidence about the accuracy and completeness of information produced by the entity's information system

when that information is used in performing audit procedures. When performing audit sampling, the auditor performs audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate. ISA 500 paragraph 11, contains additional guidance on the audit procedures to perform regarding the accuracy and completeness of such information.

Stratification

36. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without a proportional increase in sampling risk. Sub-populations need to be carefully defined such that any sampling unit can only belong to one stratum.

37. When performing tests of details, a class of transaction or account balance or is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items which may contain the greatest potential monetary error in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of error, for example, when testing the valuation of accounts receivable, balances may be stratified by age.

38. The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

Value Weighted Selection

39. It will often be efficient in performing tests of details, particularly when testing for overstatements, to identify the sampling unit as the individual monetary units (for example, dollars) that make up a class of transactions or account balance. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor then examines the particular items, for example, individual balances, that contain those monetary units. This approach to defining the sampling unit ensures that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes. This approach is ordinarily

used in conjunction with the systematic method of sample selection (described in Appendix 3) and is most efficient when selecting items using CAATs.

Sample Size

40. **In determining the sample size, the auditor should consider whether sampling risk is reduced to an acceptably low level.** Sample size is affected by the level of sampling risk that the auditor is willing to accept. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

41. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment objectively applied to the circumstances. Appendices 1 and 2 indicate the influences that various factors typically have on the determination of sample size, and hence the level of sampling risk.

Selecting the Sample

42. **The auditor should select items for the sample with the expectation that all sampling units in the population have a chance of selection.** Statistical sampling requires that sample items are selected at random so that each sampling unit has a known chance of being selected. The sampling units might be physical items (such as invoices) or monetary units. With non-statistical sampling, an auditor uses professional judgment to select the items for a sample. Because the purpose of sampling is to draw conclusions about the entire population, the auditor endeavors to select a representative sample by choosing sample items which have characteristics typical of the population, and the sample needs to be selected so that bias is avoided.

43. The principal methods of selecting samples are the use of random number tables or CAATs, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 3.

Performing the Audit Procedure

44. **The auditor should perform audit procedures appropriate to the particular audit objective on each item selected.**

45. If a selected item is not appropriate for the application of the audit procedure, the audit procedure is ordinarily performed on a replacement item. For example, a voided check may be selected when testing for evidence of payment authorization. If the auditor is satisfied that the check had been properly voided such that it does not constitute an error, an appropriately chosen replacement is examined.

46. Sometimes however, the auditor is unable to apply the designed audit procedures to a selected item because, for instance, documentation relating to that item has been lost. If suitable alternative audit procedures cannot be

performed on that item, the auditor ordinarily considers that item to be in error. An example of a suitable alternative audit procedure might be the examination of subsequent receipts when no reply has been received in response to a positive confirmation request.

Nature and Cause of Errors

47. **The auditor should consider the sample results, the nature and cause of any errors identified, and their possible effect on the particular audit objective and on other areas of the audit.**

48. When performing tests of controls, the auditor is primarily concerned with obtaining audit evidence that controls operated effectively throughout the period of reliance. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. The concept of effectiveness of the operation of controls recognizes that some errors in the way controls are applied by the entity may occur. However, when such errors are identified, the auditor makes specific inquiries to understand these matters and also needs to consider matters such as:

    (a) The direct effect of identified errors on the financial statements; and

    (b) The effectiveness of internal control and their effect on the audit approach when, for example, the errors result from management override of a control.

    In these cases, the auditor determines whether the tests of controls performed provide an appropriate basis for use as audit evidence, whether additional tests of controls are necessary, or whether the potential risks of misstatement need to be addressed using substantive procedures.

49. In analyzing the errors discovered, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures in that stratum. In addition, such errors may be intentional, and may indicate the possibility of fraud.

50. Sometimes, the auditor may be able to establish that an error arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of similar errors in the population (an anomalous error). To be considered an anomalous error, the auditor has to have a high degree of certainty that such error is not representative of the population. The auditor obtains this certainty by performing additional audit procedures. The additional audit procedures depend on the situation, but are adequate to provide the auditor with sufficient appropriate audit evidence that the error does not affect the remaining part of the population. One example is

an error caused by a computer breakdown that is known to have occurred on only one day during the period. In that case, the auditor assesses the effect of the breakdown, for example by examining specific transactions processed on that day, and considers the effect of the cause of the breakdown on audit procedures and conclusions. Another example is an error that is found to be caused by use of an incorrect formula in calculating all inventory values at one particular branch. To establish that this is an anomalous error, the auditor needs to ensure the correct formula has been used at other branches.

Projecting Errors

51. **For tests of details, the auditor should project monetary errors found in the sample to the population, and should consider the effect of the projected error on the particular audit objective and on other areas of the audit.** The auditor projects the total error for the population to obtain a broad view of the scale of errors, and to compare this to the tolerable error. For tests of details, tolerable error is the tolerable misstatement, and will be an amount less than or equal to the auditor's materiality used for the individual class of transactions or account balances being audited.

52. When an error has been established as an anomalous error, it may be excluded when projecting sample errors to the population. The effect of any such error, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous errors. If a class of transactions or account balance has been divided into strata, the error is projected for each stratum separately. Projected errors plus anomalous errors for each stratum are then combined when considering the possible effect of errors on the total class of transactions or account balance.

53. For tests of controls, no explicit projection of errors is necessary since the sample error rate is also the projected rate of error for the population as a whole.

Evaluating the Sample Results

54. **The auditor should evaluate the sample results to determine whether the assessment of the relevant characteristic of the population is confirmed or needs to be revised.** In the case of tests of controls, an unexpectedly high sample error rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. In the case of tests of details, an unexpectedly high error amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

55. If the total amount of projected error plus anomalous error is less than but close to that which the auditor deems tolerable, the auditor considers the

persuasiveness of the sample results in the light of other audit procedures, and may consider it appropriate to obtain additional audit evidence. The total of projected error plus anomalous error is the auditor's best estimate of error in the population. However, sampling results are affected by sampling risk. Thus when the best estimate of error is close to the tolerable error, the auditor recognizes the risk that a different sample would result in a different best estimate that could exceed the tolerable error. Considering the results of other audit procedures helps the auditor to assess this risk, while the risk is reduced if additional audit evidence is obtained.

56. If the evaluation of sample results indicates that the assessment of the relevant characteristic of the population needs to be revised, the auditor may:

    (a) Request management to investigate identified errors and the potential for further errors, and to make any necessary adjustments; and/or

    (b) Modify the nature, timing and extent of further audit procedures. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures; and/or

    (c) Consider the effect on the audit report.

Effective Date

57. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.

Appendix 1

Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor considers when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE
An increase in the extent to which the risk of material misstatement is reduced by the operating effectiveness of controls	Increase
An increase in the rate of deviation from the prescribed control activity that the auditor is willing to accept	Decrease
An increase in the rate of deviation from the prescribed control activity that the auditor expects to find in the population	Increase
An increase in the auditor's required confidence level (or conversely, a decrease in the risk that the auditor will conclude that the risk of material misstatement is lower than the actual risk of material misstatement in the population)	Increase
An increase in the number of sampling units in the population	Negligible effect

1. *The extent to which the risk of material misstatement is reduced by the operating effectiveness of controls.* The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the more the auditor relies on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased).

2. *The rate of deviation from the prescribed control activity the auditor is willing to accept (tolerable error).* The lower the rate of deviation that the auditor is willing to accept, the larger the sample size needs to be.

3. *The rate of deviation from the prescribed control activity the auditor expects to find in the population (expected error).* The higher the rate of deviation that the auditor expects, the larger the sample size needs to be so as to be in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected error rate include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected error rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement, and therefore in such circumstances tests of controls would ordinarily be omitted.

4. *The auditor's required confidence level.* The greater the degree of confidence that the auditor requires that the results of the sample are in fact indicative of the actual incidence of error in the population, the larger the sample size needs to be.

5. *The number of sampling units in the population.* For large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence.

Appendix 2

Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor considers when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE
An increase in the auditor's assessment of the risk of material misstatement	Increase
An increase in the use of other substantive procedures directed at the same assertion	Decrease
An increase in the auditor's required confidence level (or conversely, a decrease in the risk that the auditor will conclude that a material error does not exist, when in fact it does exist)	Increase
An increase in the total error that the auditor is willing to accept (tolerable error)	Decrease
An increase in the amount of error the auditor expects to find in the population	Increase
Stratification of the population when appropriate	Decrease
The number of sampling units in the population	Negligible Effect

1. Paragraph 1 was deleted when the *Audit Risk Standards*[2] became effective.

2. *The auditor's assessment of the risk of material misstatement.* The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.

3. *The use of other substantive procedures directed at the same assertion.* The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular class of transactions or account balance, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.

4. *The auditor's required confidence level.* The greater the degree of confidence that the auditor requires that the results of the sample are in fact indicative of the actual amount of error in the population, the larger the sample size needs to be.

5. *The total error the auditor is willing to accept (tolerable error).* The lower the total error that the auditor is willing to accept, the larger the sample size needs to be.

6. *The amount of error the auditor expects to find in the population (expected error).* The greater the amount of error the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of error in the population. Factors relevant to the auditor's consideration of the expected error amount include the extent to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.

7. *Stratification.* When there is a wide range (variability) in the monetary size of items in the population. It may be useful to group items of similar size into separate sub-populations or strata. This is referred to as stratification. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

[2] See footnote 1 of ISA 530.

8. *The number of sampling units in the population.* For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality.)

Appendix 3

Sample Selection Methods

The principal methods of selecting samples are as follows:

(a) Use of a computerized random number generator (through CAATs) or random number tables.

(b) Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

(c) Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

(d) Block selection involves selecting a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

INTERNATIONAL STANDARD ON AUDITING 540

AUDIT OF ACCOUNTING ESTIMATES

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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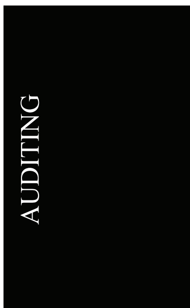
International Standard on Auditing (ISA) 540, "Audit of Accounting Estimates" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.



* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 540. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 540.

ISA 540 has been revised. In addition, matters of continuing relevance in ISA 545, "Auditing Fair Value Measurements and Disclosures" have been revised and incorporated in the revised ISA 540 to form one combined ISA dealing with the audit of accounting estimates, including fair value accounting estimates. The IAASB's clarity drafting conventions have been applied to the combined ISA. ISA 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures" can be found in Part II of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements*. It is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the audit of accounting estimates contained in financial statements. This ISA is not intended to be applicable to the examination of prospective financial information, though many of the audit procedures outlined herein may be suitable for that purpose.

2. **The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates.**

3. "Accounting estimate" means an approximation of the amount of an item in the absence of a precise means of measurement. Examples are:

   - Allowances to reduce inventory and accounts receivable to their estimated realizable value.
   - Provisions to allocate the cost of fixed assets over their estimated useful lives.
   - Accrued revenue.
   - Deferred tax.
   - Provision for a loss from a lawsuit.
   - Losses on construction contracts in progress.
   - Provision to meet warranty claims.

4. Management is responsible for making accounting estimates included in financial statements. These estimates are often made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur and involve the use of judgment. As a result, the risk of material misstatement is greater when accounting estimates are involved and in some cases the auditor may determine that the risk of material misstatement related to an accounting estimate is a significant risk that requires special audit consideration. See paragraphs 108-114 of ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement."

The Nature of Accounting Estimates

5. The determination of an accounting estimate may be simple or complex depending upon the nature of the item. For example, accruing a charge for rent may be a simple calculation, whereas estimating a provision for slow-moving or surplus inventory may involve considerable analyses of current data and a forecast of future sales. In complex estimates, there may be a high degree of special knowledge and judgment required.

6. Accounting estimates may be determined as part of the routine information system relevant to financial reporting operating on a continuing basis, or may

be nonroutine, operating only at period end. In many cases, accounting estimates are made by using a formula based on experience, such as the use of standard rates for depreciating each category of fixed assets or a standard percentage of sales revenue for computing a warranty provision. In such cases, the formula needs to be reviewed regularly by management, for example, by reassessing the remaining useful lives of assets or by comparing actual results with the estimate and adjusting the formula when necessary.

7. The uncertainty associated with an item, or the lack of objective data may make it incapable of reasonable estimation, in which case the auditor needs to consider whether the auditor's report needs modification to comply with ISA 701, "Modifications to the Independent Auditor's Report."

Audit Procedures Responsive to the Risk of Material Misstatement of the Entity's Accounting Estimates

8. **The auditor should design and perform further audit procedures to obtain sufficient appropriate audit evidence as to whether the entity's accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed.** The audit evidence available to detect a material misstatement in an accounting estimate will often be more difficult to obtain and less persuasive than audit evidence available to detect a material misstatement in other items in the financial statements. The auditor's understanding of the entity and its environment, including its internal control, assists the auditor in identifying and assessing the risks of material misstatement of the entity's accounting estimates.

9. An understanding of the procedures and methods, including relevant control activities, used by management in making the accounting estimates is important for the auditor to identify and assess risks of material misstatement in order to design the nature, timing and extent of the further audit procedures.

10. **The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:**

    (a) **Review and test the process used by management to develop the estimate;**

    (b) **Use an independent estimate for comparison with that prepared by management; or**

    (c) **Review of subsequent events which provide audit evidence of the reasonableness of the estimate made.**

Reviewing and Testing the Process Used by Management

11. The steps ordinarily involved in reviewing and testing of the process used by management are:

AUDITING

(a) Evaluation of the data and consideration of assumptions on which the estimate is based;

(b) Testing of the calculations involved in the estimate;

(c) Comparison, when possible, of estimates made for prior periods with actual results of those periods; and

(d) Consideration of management's approval procedures.

Evaluation of Data and Consideration of Assumptions

12. The auditor would evaluate whether the data on which the estimate is based is accurate, complete and relevant. When information produced by the entity is used, it will need to be consistent with the data processed through the information system relevant to financial reporting. For example, in substantiating a warranty provision, the auditor would obtain audit evidence that the data relating to products still within the warranty period at period end agree with the sales information within the information system relevant to financial reporting. ISA 500, "Audit Evidence" paragraph 11 provides additional guidance on the requirement to obtain audit evidence about the accuracy and completeness of information produced by the entity when it is used in performing audit procedures.

13. The auditor may also seek audit evidence from sources outside the entity. For example, when examining a provision for inventory obsolescence calculated by reference to anticipated future sales, the auditor may, in addition to examining internal data such as past levels of sales, orders on hand and marketing trends, seek audit evidence from industry-produced sales projections and market analyses. Similarly, when examining management's estimates of the financial implications of litigation and claims, the auditor would seek direct communication with the entity's lawyers.

14. The auditor would evaluate whether the data collected is appropriately analyzed and projected to form a reasonable basis for determining the accounting estimate. Examples are the analysis of the age of accounts receivable and the projection of the number of months of supply on hand of an item of inventory based on past and forecast usage.

15. The auditor would evaluate whether the entity has an appropriate base for the principal assumptions used in the accounting estimate. In some cases, the assumptions will be based on industry or government statistics, such as future inflation rates, interest rates, employment rates and anticipated market growth. In other cases, the assumptions will be specific to the entity and will be based on internally generated data.

16. In evaluating the assumptions on which the estimate is based, the auditor would consider, among other things, whether they are:

- Reasonable in light of actual results in prior periods;
- Consistent with those used for other accounting estimates; and
- Consistent with management's plans which appear appropriate.

The auditor would need to pay particular attention to assumptions which are sensitive to variation, subjective or susceptible to material misstatement.

17. In the case of complex estimating processes involving specialized techniques, it may be necessary for the auditor to use the work of an expert, for example, engineers for estimating quantities in stock piles of mineral ores. Guidance on how to use the work of an expert is provided in ISA 620, "Using the Work of an Expert."

18. The auditor would review the continuing appropriateness of formulae used by management in the preparation of accounting estimates. Such a review would reflect the auditor's knowledge of the financial results of the entity in prior periods, practices used by other entities in the industry and the future plans of management as disclosed to the auditor.

Testing of Calculations

19. The auditor would perform audit procedures on the calculation procedures used by management. The nature, timing and extent of the auditor's procedures will depend on the assessed risk of material misstatement, which is impacted by such factors as the complexity involved in calculating the accounting estimate, the auditor's understanding and evaluation of the procedures and methods, including relevant control activities used by the entity in producing the estimate and the materiality of the estimate in the context of the financial statements.

Comparison of Previous Estimates with Actual Results

20. When possible, the auditor would compare accounting estimates made for prior periods with actual results of those periods to assist in:

    (a) Obtaining audit evidence about the general reliability of the entity's estimating procedures and methods, including relevant control activities;

    (b) Considering whether adjustments to estimating formulae may be required; and

    (c) Evaluating whether differences between actual results and previous estimates have been quantified and that, where necessary, appropriate adjustments or disclosures have been made.

Consideration of Management's Approval Procedures

21. Material accounting estimates are ordinarily reviewed and approved by management. The auditor would consider whether such review and approval is performed by the appropriate level of management and that it is evidenced in the documentation supporting the determination of the accounting estimate.

Use of an Independent Estimate

22. The auditor may make or obtain an independent estimate and compare it with the accounting estimate prepared by management. When using an independent estimate the auditor would ordinarily evaluate the data, consider the assumptions and perform audit procedures on the calculation procedures used in its development. It may also be appropriate to compare accounting estimates made for prior periods with actual results of those periods.

Review of Subsequent Events

23. Transactions and events which occur after period end, but prior to completion of the audit, may provide audit evidence regarding an accounting estimate made by management. The auditor's review of such transactions and events may reduce, or even remove, the need for the auditor to review and perform audit procedures on the process used by management to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.

Evaluation of Results of Audit Procedures

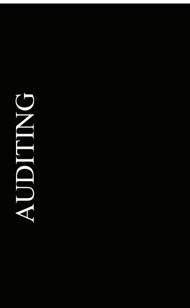
24. **The auditor should make a final assessment of the reasonableness of the entity's accounting estimates based on the auditor's understanding of the entity and its environment and whether the estimates are consistent with other audit evidence obtained during the audit.**

25. The auditor would consider whether there are any significant subsequent transactions or events which affect the data and the assumptions used in determining the accounting estimates.

26. Because of the uncertainties inherent in accounting estimates, evaluating differences can be more difficult than in other areas of the audit. When there is a difference between the auditor's estimate of the amount best supported by the available audit evidence and the estimated amount included in the financial statements, the auditor would determine whether such a difference requires adjustment. If the difference is reasonable, for example, because the amount in the financial statements falls within a range of acceptable results, it may not require adjustment. However, if the auditor believes the difference is unreasonable, management would be requested to revise the estimate. If management refuses to revise the estimate, the difference would be considered

a misstatement and would be considered with all other misstatements in assessing whether the effect on the financial statements is material.

27. The auditor would also consider whether individual differences which have been accepted as reasonable are biased in one direction, so that, on a cumulative basis, they may have a material effect on the financial statements. In such circumstances, the auditor would evaluate the accounting estimates taken as a whole.



INTERNATIONAL STANDARD ON AUDITING 545

AUDITING FAIR VALUE MEASUREMENTS AND DISCLOSURES

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 545. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 545.

Matters of continuing relevance in ISA 545 have been revised and incorporated in ISA 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures." ISA 540 (Revised and Redrafted), which reflects the IAASB's clarity drafting conventions, can be found in Part II of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements*. It is effective for audits of financial statements for periods beginning on or after December 15, 2009.

International Standard on Auditing (ISA) 545, "Auditing Fair Value Measurements and Disclosures" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, this ISA addresses audit considerations relating to the measurement, presentation and disclosure of material assets, liabilities and specific components of equity presented or disclosed at fair value in financial statements. Fair value measurements of assets, liabilities and components of equity may arise from both the initial recording of transactions and later changes in value. Changes in fair value measurements that occur over time may be treated in different ways under different financial reporting frameworks. For example, some financial reporting frameworks may require that such changes be reflected directly in equity, while others may require them to be reflected in income.

2. While this ISA provides guidance on auditing fair value measurements and disclosures, audit evidence obtained from other audit procedures also may provide audit evidence relevant to the measurement and disclosure of fair values. For example, inspection procedures to verify existence of an asset measured at fair value also may provide relevant audit evidence about its valuation (such as the physical condition of an investment property).

2a. ISA 500, "Audit Evidence," paragraph 16 requires the auditor to use assertions in sufficient detail to form a basis for the assessment of risks of material misstatements and the design and performance of further audit procedures in response to the assessed risks. Fair value measurements and disclosures are not in themselves assertions, but may be relevant to specific assertions, depending on the applicable financial reporting framework.

3. **The auditor should obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's applicable financial reporting framework.** Paragraph 22 of ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" requires the auditor to obtain an understanding of the entity's applicable financial reporting framework.

4. Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, management needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation and ensure that the presentation and disclosure of the fair value measurements are in accordance with the entity's applicable financial reporting framework.

5. Many measurements based on estimates, including fair value measurements, are inherently imprecise. In the case of fair value measurements, particularly those that do not involve contractual cash flows or for which market

information is not available when making the estimate, fair value estimates often involve uncertainty in both the amount and timing of future cash flows. Fair value measurements also may be based on assumptions about future conditions, transactions or events whose outcome is uncertain and will therefore be subject to change over time. The auditor's consideration of such assumptions is based on information available to the auditor at the time of the audit and the auditor is not responsible for predicting future conditions, transactions or events which, had they been known at the time of the audit, may have had a significant effect on management's actions or management's assumptions underlying the fair value measurements and disclosures. Assumptions used in fair value measurements are similar in nature to those required when developing other accounting estimates. ISA 540, "Audit of Accounting Estimates" provides guidance on auditing accounting estimates. This ISA, however, addresses considerations similar to those in ISA 540 as well as others in the specific context of fair value measurements and disclosures in accordance with an applicable financial reporting framework.

6. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist. While this ISA provides guidance on auditing fair value measurements and disclosures, it does not address specific types of assets or liabilities, transactions, or industry-specific practices. The Appendix to this ISA discusses fair value measurements and disclosures under different financial reporting frameworks and the prevalence of fair value measurements, including the fact that different definitions of "fair value" may exist under such frameworks. For example, International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement" defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."

7. In most financial reporting frameworks, underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, in this case, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. An entity, however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management's plan to dispose of an

asset on an accelerated basis to meet specific business objectives may be relevant to the determination of the fair value of that asset.

8. The measurement of fair value may be relatively simple for certain assets or liabilities, for example, assets that are bought and sold in active and open markets that provide readily available and reliable information on the prices at which actual exchanges occur. The measurement of fair value for other assets or liabilities may be more complex. A specific asset may not have an active market or may possess characteristics that make it necessary for management to estimate its fair value (for example, an investment property or a complex derivative financial instrument). The estimation of fair value may be achieved through the use of a valuation model (for example, a model premised on projections and discounting of future cash flows) or through the assistance of an expert, such as an independent valuer.

9. The uncertainty associated with an item, or the lack of objective data may make it incapable of reasonable estimation, in which case, the auditor considers whether the auditor's report needs modification to comply with ISA 701, "Modifications to the Independent Auditor's Report."

Understanding the Entity's Process for Determining Fair Value Measurements and Disclosures and Relevant Control Activities, and Assessing Risk

10. **As part of the understanding of the entity and its environment, including its internal control, the auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant control activities sufficient to identify and assess the risks of material misstatement at the assertion level and to design and perform further audit procedures.**

11. Management is responsible for establishing an accounting and financial reporting process for determining fair value measurements. In some cases, the measurement of fair value and therefore the process set up by management to determine fair value may be simple and reliable. For example, management may be able to refer to published price quotations to determine fair value for marketable securities held by the entity. Some fair value measurements, however, are inherently more complex than others and involve uncertainty about the occurrence of future events or their outcome, and therefore assumptions that may involve the use of judgment need to be made as part of the measurement process. The auditor's understanding of the measurement process, including its complexity, helps identify and assess the risks of material misstatement in order to determine the nature, timing and extent of the further audit procedures.

12. When obtaining an understanding of the entity's process for determining fair value measurements and disclosures, the auditor considers, for example:

- The relevant control activities over the process used to determine fair value measurements, including, for example, controls over data and the segregation of duties between those committing the entity to the underlying transactions and those responsible for undertaking the valuations.
- The expertise and experience of those persons determining the fair value measurements.
- The role that information technology has in the process.
- The types of accounts or transactions requiring fair value measurements or disclosures (for example, whether the accounts arise from the recording of routine and recurring transactions or whether they arise from non-routine or unusual transactions).
- The extent to which the entity's process relies on a service organization to provide fair value measurements or the data that supports the measurement. When an entity uses a service organization, the auditor complies with the requirements of ISA 402, "Audit Considerations Relating to Entities Using Service Organizations."
- The extent to which the entity uses the work of experts in determining fair value measurements and disclosures (see paragraphs 29-32 of this ISA).
- The significant management assumptions used in determining fair value.
- The documentation supporting management's assumptions.
- The methods used to develop and apply management assumptions and to monitor changes in those assumptions.
- The integrity of change controls and security procedures for valuation models and relevant information systems, including approval processes.
- The controls over the consistency, timeliness and reliability of the data used in valuation models.

13. ISA 315 requires the auditor to obtain an understanding of the components of internal control. In particular, the auditor obtains a sufficient understanding of control activities related to the determination of the entity's fair value measurements and disclosures in order to identify and assess the risks of material misstatement and to design the nature, timing and extent of the further audit procedures.

14. **After obtaining an understanding of the entity's process for determining fair value measurements and disclosures, the auditor should identify and assess the risks of material misstatement at the assertion level related to the fair value measurements and disclosures in the financial statements to determine the nature, timing and extent of the further audit procedures.**

15. The degree to which a fair value measurement is susceptible to misstatement is an inherent risk. Consequently, the nature, timing and extent of the further audit procedures will depend upon the susceptibility to misstatement of a fair value measurement and whether the process for determining fair value measurements is relatively simple or complex.

15a. Where the auditor has determined that the risk of material misstatement related to a fair value measurement or disclosure is a significant risk that requires special audit considerations, the auditor follows the requirements of ISA 315.

16. ISA 315 discusses the inherent limitations of internal controls. As fair value determinations often involve subjective judgments by management, this may affect the nature of control activities that are capable of being implemented. The susceptibility to misstatement of fair value measurements also may increase as the accounting and financial reporting requirements for fair value measurements become more complex. The auditor considers the inherent limitations of controls in such circumstances in assessing the risk of material misstatement.

Evaluating the Appropriateness of Fair Value Measurements and Disclosures

17. **The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework.**

18. The auditor's understanding of the requirements of the applicable financial reporting framework and knowledge of the business and industry, together with the results of other audit procedures, are used to assess whether the accounting for assets or liabilities requiring fair value measurements is appropriate, and whether the disclosures about the fair value measurements and significant uncertainties related thereto are appropriate under the entity's applicable financial reporting framework.

19. The evaluation of the appropriateness of the entity's fair value measurements under its applicable financial reporting framework and the evaluation of audit evidence depends, in part, on the auditor's knowledge of the nature of the business. This is particularly true where the asset or liability or the valuation method is highly complex. For example, derivative financial instruments may be highly complex, with a risk that differing interpretations of how to determine fair values will result in different conclusions. The measurement of the fair value of some items, for example "in-process research and development" or intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations if such considerations are appropriate under the entity's applicable financial reporting framework. Also, the auditor's knowledge of the business, together with the results of other audit procedures, may help identify

assets for which management needs to recognize an impairment by using a fair value measurement pursuant to the entity's applicable financial reporting framework.

20. Where the method for measuring fair value is specified by the applicable financial reporting framework, for example, the requirement that the fair value of a marketable security be measured using quoted market prices as opposed to using a valuation model, the auditor considers whether the measurement of fair value is consistent with that method.

21. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. When management has determined that it has overcome the presumption that fair value can be reliably determined, the auditor obtains sufficient appropriate audit evidence to support such determination, and whether the item is properly accounted for under the applicable financial reporting framework.

22. **The auditor should obtain audit evidence about management's intent to carry out specific courses of action, and consider its ability to do so, where relevant to the fair value measurements and disclosures under the entity's applicable financial reporting framework.**

23. In some financial reporting frameworks, management's intentions with respect to an asset or liability are criteria for determining measurement, presentation, and disclosure requirements, and how changes in fair values are reported within financial statements. In such financial reporting frameworks, management's intent is important in determining the appropriateness of the entity's use of fair value. Management often documents plans and intentions relevant to specific assets or liabilities and the applicable financial reporting framework may require it to do so. While the extent of audit evidence to be obtained about management's intent is a matter of professional judgment, the auditor's procedures ordinarily include inquiries of management, with appropriate corroboration of responses, for example, by:

    - Considering management's past history of carrying out its stated intentions with respect to assets or liabilities.
    - Reviewing written plans and other documentation, including, where applicable, budgets, minutes, etc.
    - Considering management's stated reasons for choosing a particular course of action.

- Considering management's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its contractual commitments.

The auditor also considers management's ability to pursue a specific course of action if ability is relevant to the use, or exemption from the use, of fair value measurement under the entity's applicable financial reporting framework.

24. **Where alternative methods for measuring fair value are available under the entity's applicable financial reporting framework, or where the method of measurement is not prescribed, the auditor should evaluate whether the method of measurement is appropriate in the circumstances under the entity's applicable financial reporting framework.**

25. Evaluating whether the method of measurement of fair value is appropriate in the circumstances requires the use of professional judgment. When management selects one particular valuation method from alternative methods available under the entity's applicable financial reporting framework, the auditor obtains an understanding of management's rationale for its selection by discussing with management its reasons for selecting the valuation method. The auditor considers whether:

    (a) Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method;

    (b) The valuation method is appropriate in the circumstances given the nature of the asset or liability being valued and the entity's applicable financial reporting framework; and

    (c) The valuation method is appropriate in relation to the business, industry and environment in which the entity operates.

26. Management may have determined that different valuation methods result in a range of significantly different fair value measurements. In such cases, the auditor evaluates how the entity has investigated the reasons for these differences in establishing its fair value measurements.

27. **The auditor should evaluate whether the entity's method for its fair value measurements is applied consistently.**

28. Once management has selected a specific valuation method, the auditor evaluates whether the entity has consistently applied that basis in its fair value measurement, and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity, or changes in the requirements of the entity's applicable financial reporting framework. If management has changed the valuation method, the auditor considers whether management can adequately demonstrate that the valuation method to which it has changed provides a more appropriate basis of

measurement, or whether the change is supported by a change in the requirements of the entity's applicable financial reporting framework or a change in circumstances. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.

Using the Work of an Expert

29. **The auditor should determine the need to use the work of an expert.** The auditor may have the necessary skill and knowledge to plan and perform audit procedures related to fair values or may decide to use the work of an expert. In making such a determination, the auditor considers the matters discussed in paragraph 7 of ISA 620, "Using the Work of an Expert."

30. If the use of such an expert is planned, the auditor obtains sufficient appropriate audit evidence that such work is adequate for the purposes of the audit, and complies with the requirements of ISA 620.

31. When planning to use the work of an expert, the auditor considers whether the expert's understanding of the definition of fair value and the method that the expert will use to determine fair value are consistent with that of management and the requirements of the applicable financial reporting framework. For example, the method used by an expert for estimating the fair value of real estate or a complex derivative, or the actuarial methodologies developed for making fair value estimates of insurance obligations, reinsurance receivables and similar items, may not be consistent with the measurement principles of the applicable financial reporting framework. Accordingly, the auditor considers such matters, often by discussing, providing or reviewing instructions given to the expert or when reading the report of the expert.

32. In accordance with ISA 620, the auditor assesses the appropriateness of the expert's work as audit evidence. While the reasonableness of assumptions and the appropriateness of the methods used and their application are the responsibility of the expert, the auditor obtains an understanding of the significant assumptions and methods used, and considers whether they are appropriate, complete and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures. The auditor often considers these matters by discussing them with the expert. Paragraphs 39-49 discuss the auditor's evaluation of significant assumptions used by management, including assumptions relied upon by management based on the work of an expert.

Audit Procedures Responsive to the Risk of Material Misstatement of the Entity's Fair Value Measurements and Disclosures

33. **The auditor should design and perform further audit procedures in response to assessed risks of material misstatement of assertions relating**

to the entity's fair value measurements and disclosures. ISA 330, "The Auditor's Procedures in Response to Assessed Risks" discusses the auditor's responsibility to design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risk of material misstatement at the assertion level. Such further audit procedures include tests of control and substantive procedures, as appropriate. Paragraphs 34-55 below provide additional specific guidance on substantive procedures that may be relevant in the context of the entity's fair value measurements and disclosures.

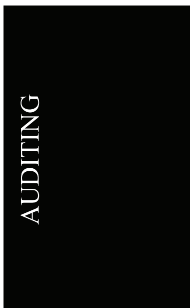
34. Because of the wide range of possible fair value measurements, from relatively simple to complex, the auditor's procedures can vary significantly in nature, timing and extent. For example, substantive procedures relating to the fair value measurements may involve (a) testing management's significant assumptions, the valuation model, and the underlying data (see paragraphs 39-49), (b) developing independent fair value estimates to corroborate the appropriateness of the fair value measurement (see paragraph 52), or (c) considering the effect of subsequent events on the fair value measurement and disclosures (see paragraphs 53-55).

35. The existence of published price quotations in an active market ordinarily is the best audit evidence of fair value. Some fair value measurements, however, are inherently more complex than others. This complexity arises either because of the nature of the item being measured at fair value or because of the valuation method required by the applicable financial reporting framework or selected by management. For example, in the absence of quoted prices in an active market, some financial reporting frameworks permit an estimate of fair value based on an alternative basis such as a discounted cash flow analysis or a comparative transaction model. Complex fair value measurements normally are characterized by greater uncertainty regarding the reliability of the measurement process. This greater uncertainty may be a result of the following:

- Length of the forecast period.
- The number of significant and complex assumptions associated with the process.
- A higher degree of subjectivity associated with the assumptions and factors used in the process.
- A higher degree of uncertainty associated with the future occurrence or outcome of events underlying the assumptions used.
- Lack of objective data when highly subjective factors are used.

36. The auditor's understanding of the measurement process, including its complexity, helps guide the auditor's determination of the nature, timing and extent of audit procedures to be performed. The following are examples of considerations in the development of audit procedures:

- Using a price quotation to obtain audit evidence about valuation may require an understanding of the circumstances in which the quotation was developed. For example, where quoted securities are held for investment purposes, valuation at the listed market price may require adjustment under the entity's applicable financial reporting framework if the holding is significantly large in size or is subject to restrictions in marketability.
- When using audit evidence provided by a third party, the auditor considers its reliability. For example, when information is obtained through the use of external confirmations, the auditor considers the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity in order to be satisfied with the reliability of the evidence. The extent of such audit procedures will vary according to the assessed risk of material misstatement associated with the fair value measurements. The auditor complies with ISA 505, "External Confirmations" in this regard.
- Audit evidence supporting fair value measurements, for example, a valuation by an independent valuer, may be obtained at a date that does not coincide with the date at which the entity is required to measure and report that information in its financial statements. In such cases, the auditor obtains audit evidence that management has taken into account the effect of events, transactions and changes in circumstances occurring between the date of fair value measurement and the reporting date.
- Collateral often is assigned for certain types of investments in debt instruments that either are required to be measured at fair value or are evaluated for possible impairment. If the collateral is an important factor in measuring the fair value of the investment or evaluating its carrying amount, the auditor obtains sufficient appropriate audit evidence regarding the existence, value, rights and access to or transferability of such collateral, including consideration whether all appropriate liens have been filed, and considers whether appropriate disclosures about the collateral have been made under the entity's applicable financial reporting framework.
- In some situations, additional audit procedures, such as the inspection of an asset by the auditor, may be necessary to obtain sufficient appropriate audit evidence about the appropriateness of a fair value measurement. For example, inspection of an investment property may be necessary to obtain information about the current physical condition of the asset relevant to its fair value, or inspection of a security may reveal a restriction on its marketability that may affect its value.



Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data

37. The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of further audit procedures. A reliable process for determining fair value is one that results in reasonably consistent measurement and, where relevant, presentation and disclosure of fair value when used in similar circumstances. When obtaining audit evidence about the entity's fair value measurements and disclosures, the auditor evaluates whether:

    (a) The assumptions used by management are reasonable;

    (b) The fair value measurement was determined using an appropriate model, if applicable; and

    (c) Management used relevant information that was reasonably available at the time.

38. Estimation techniques and assumptions and the auditor's consideration and comparison of fair value measurements determined in prior periods, if any, to results obtained in the current period may provide audit evidence of the reliability of management's processes. However, the auditor also considers whether such variances result from changes in economic circumstances.

39. **Where the auditor determines there is a significant risk related to fair values, or where otherwise applicable, the auditor should evaluate whether the significant assumptions used by management in measuring fair values, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements.**

40. It is necessary for management to make assumptions, including assumptions relied upon by management based upon the work of an expert, to develop fair value measurements. For these purposes, management's assumptions also include those assumptions developed under the guidance of those charged with governance. Assumptions are integral components of more complex valuation methods, for example valuation methods that employ a combination of estimates of expected future cash flows together with estimates of the values of assets or liabilities in the future, discounted to the present. Auditors pay particular attention to the significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable. To provide a reasonable basis for the fair value measurements and disclosures, assumptions need to be relevant, reliable, neutral, understandable and complete. Paragraph 36 of the "International Framework for Assurance Engagements" describes these characteristics in more detail.

41. Specific assumptions will vary with the characteristics of the asset or liability being valued and the valuation method used (for example, replacement cost, market or an income-based approach). For example, where discounted cash flows (an income-based approach) are used as the valuation method, there will be assumptions about the level of cash flows, the period of time used in the analysis, and the discount rate.

42. Assumptions ordinarily are supported by differing types of audit evidence from internal and external sources that provide objective support for the assumptions used. The auditor assesses the source and reliability of audit evidence supporting management's assumptions, including consideration of the assumptions in light of historical information and an evaluation of whether they are based on plans that are within the entity's capacity.

43. Audit procedures dealing with management's assumptions are performed in the context of the audit of the entity's financial statements. The objective of the audit procedures is therefore not intended to obtain sufficient appropriate audit evidence to provide an opinion on the assumptions themselves. Rather, the auditor performs audit procedures to consider whether the assumptions provide a reasonable basis in measuring fair values in the context of an audit of the financial statements taken as a whole.

44. Identifying those assumptions that appear to be significant to the fair value measurement requires the exercise of judgment by management. The auditor focuses attention on significant assumptions. Generally, significant assumptions cover matters that materially affect the fair value measurement and may include those that are:

    (a) Sensitive to variation or uncertainty in amount or nature. For example, assumptions about short-term interest rates may be less susceptible to significant variation compared to assumptions about long-term interest rates; and

    (b) Susceptible to misapplication or bias.

45. The auditor considers the sensitivity of the valuation to changes in significant assumptions, including market conditions that may affect the value. Where applicable, the auditor encourages management to use such techniques as sensitivity analysis to help identify particularly sensitive assumptions. In the absence of such management analysis, the auditor considers whether to employ such techniques. The auditor also considers whether the uncertainty associated with a fair value measurement, or the lack of objective data may make it incapable of reasonable estimation under the entity's applicable financial reporting framework (see paragraph 9).

46. The consideration of whether the assumptions provide a reasonable basis for the fair value measurements relates to the whole set of assumptions as well as to each assumption individually. Assumptions are frequently interdependent,

and therefore, need to be internally consistent. A particular assumption that may appear reasonable when taken in isolation may not be reasonable when used in conjunction with other assumptions. The auditor considers whether management has identified the significant assumptions and factors influencing the measurement of fair value.

47. The assumptions on which the fair value measurements are based (for example, the discount rate used in calculating the present value of future cash flows) ordinarily will reflect what management expects will be the outcome of specific objectives and strategies. To be reasonable, such assumptions, individually and taken as a whole, also need to be realistic and consistent with:

(a) The general economic environment and the entity's economic circumstances;

(b) The plans of the entity;

(c) Assumptions made in prior periods, if appropriate;

(d) Past experience of, or previous conditions experienced by, the entity to the extent currently applicable;

(e) Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures; and

(f) If applicable, the risk associated with cash flows, including the potential variability of the cash flows and the related effect on the discounted rate.

Where assumptions are reflective of management's intent and ability to carry out specific courses of action, the auditor considers whether they are consistent with the entity's plans and past experience (see paragraphs 22 and 23).

48. If management relies on historical financial information in the development of assumptions, the auditor considers the extent to which such reliance is justified. However, historical information might not be representative of future conditions or events, for example, if management intends to engage in new activities or circumstances change.

49. For items valued by the entity using a valuation model, the auditor is not expected to substitute his or her judgment for that of the entity's management. Rather, the auditor reviews the model, and evaluates whether the model is appropriate and the assumptions used are reasonable. For example, it may be inappropriate to use a discounted cash flow method in valuing an equity investment in a start-up enterprise if there are no current revenues on which to base the forecast of future earnings or cash flows.

50. **The auditor should perform audit procedures on the data used to develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions.**

51. The auditor evaluates whether the data on which the fair value measurements are based, including the data used in the work of an expert, are accurate, complete and relevant; and whether the fair value measurements have been properly determined using such data and management's assumptions. The auditor's procedures also may include, for example, audit procedures such as verifying the source of the data, mathematical recalculation and reviewing of information for internal consistency, including whether such information is consistent with management's intent to carry out specific courses of action discussed in paragraphs 22 and 23.

Developing Independent Fair Value Estimates for Corroborative Purposes

52. The auditor may make an independent estimate of fair value (for example, by using an auditor-developed model) to corroborate the entity's fair value measurement. When developing an independent estimate using management's assumptions, the auditor evaluates those assumptions as discussed in paragraphs 39-49. Instead of using management's assumptions the auditor may develop separate assumptions to make a comparison with management's fair value measurements. In that situation, the auditor nevertheless understands management's assumptions. The auditor uses that understanding to determine that the auditor's model considers the significant variables and to evaluate any significant difference from management's estimate. The auditor also performs audit procedures on the data used to develop the fair value measurements and disclosures as discussed in paragraphs 50 and 51. The auditor considers the guidance contained in ISA 520, "Analytical Procedures" when performing these procedures during an audit.

Subsequent Events

53. **The auditor should consider the effect of subsequent events on the fair value measurements and disclosures in the financial statements.**

54. Transactions and events that occur after period-end but prior to completion of the audit, may provide appropriate audit evidence regarding the fair value measurements made by management. For example, a sale of investment property shortly after the period-end may provide audit evidence relating to the fair value measurement.

55. In the period after a financial statement period-end, however, circumstances may change from those existing at the period-end. Fair value information after the period-end may reflect events occurring after the period-end and not the circumstances existing at the balance sheet date. For example, the prices of actively traded marketable securities that change after the period-end ordinarily

do not constitute appropriate audit evidence of the values of the securities that existed at the period-end. The auditor complies with ISA 560, "Subsequent Events" when evaluating audit evidence relating to such events.

Disclosures about Fair Values

56. **The auditor should evaluate whether the disclosures about fair values made by the entity are in accordance with its financial reporting framework.**

57. Disclosure of fair value information is an important aspect of financial statements in many financial reporting frameworks. Often, fair value disclosure is required because of the relevance to users in the evaluation of an entity's performance and financial position. In addition to the fair value information required by the applicable financial reporting framework, some entities disclose voluntary additional fair value information in the notes to the financial statements.

58. When auditing fair value measurements and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, the auditor ordinarily performs essentially the same types of audit procedures as those employed in auditing a fair value measurement recognized in the financial statements. The auditor obtains sufficient appropriate audit evidence that the valuation principles are appropriate under the entity's applicable financial reporting framework, are being consistently applied, and the method of estimation and significant assumptions used are properly disclosed in accordance with the entity's applicable financial reporting framework. The auditor also considers whether voluntary information may be inappropriate in the context of the financial statements. For example, management may disclose a current sales value for an asset without mentioning that significant restrictions under contractual arrangements preclude the sale in the immediate future.

59. The auditor evaluates whether the entity has made appropriate disclosures about fair value information as called for by its financial reporting framework. If an item contains a high degree of measurement uncertainty, the auditor assesses whether the disclosures are sufficient to inform users of such uncertainty. For example, the auditor might evaluate whether disclosures about a range of amounts, and the assumptions used in determining the range, within which the fair value is reasonably believed to lie is appropriate under the entity's applicable financial reporting framework, when management considers a single amount presentation not appropriate. Where applicable, the auditor also considers whether the entity has complied with the accounting and disclosure requirements relating to changes in the valuation method used to determine fair value measurements.

60. When disclosure of fair value information under the applicable financial reporting framework is omitted because it is not practicable to determine fair value with sufficient reliability, the auditor evaluates the adequacy of disclosures required in these circumstances. If the entity has not appropriately disclosed fair value information required by the applicable financial reporting framework, the auditor evaluates whether the financial statements are materially misstated by the departure from the applicable financial reporting framework.

Evaluating the Results of Audit Procedures

61. **In making a final assessment of whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework, the auditor should evaluate the sufficiency and appropriateness of the audit evidence obtained as well as the consistency of that evidence with other audit evidence obtained and evaluated during the audit.**

62. When assessing whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework, the auditor evaluates the consistency of the information and audit evidence obtained during the audit of fair value measurements with other audit evidence obtained during the audit, in the context of the financial statements taken as a whole. For example, the auditor considers whether there is or should be a relationship or correlation between the interest rates used to discount estimated future cash flows in determining the fair value of an investment property and interest rates on borrowings currently being incurred by the entity to acquire investment property.

Management Representations

63. **The auditor should obtain written representations from management regarding the reasonableness of significant assumptions, including whether they appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity where relevant to the fair value measurements or disclosures.**

64. ISA 580, "Management Representations" discusses the use of management representations as audit evidence. Depending on the nature, materiality and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about the following:

- The appropriateness of the measurement methods, including related assumptions, used by management in determining fair values within the applicable financial reporting framework, and the consistency in application of the methods.

- The basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework.
- The completeness and appropriateness of disclosures related to fair values under the entity's applicable financial reporting framework.
- Whether subsequent events require adjustment to the fair value measurements and disclosures included in the financial statements.

Communication with Those Charged with Governance

65. ISA 260, "Communication of Audit Matters with Those Charged with Governance" requires auditors to communicate audit matters of governance interest with those charged with governance. Because of the uncertainties often involved with some fair value measurements, the potential effect on the financial statements of any significant risks may be of governance interest. For example, the auditor considers communicating the nature of significant assumptions used in fair value measurements, the degree of subjectivity involved in the development of the assumptions, and the relative materiality of the items being measured at fair value to the financial statements as a whole. The auditor considers the guidance contained in ISA 260 when determining the nature and form of communication.

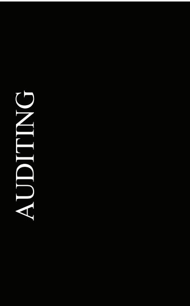
Effective Date

66. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.

Public Sector Perspective

1. *Many governments are moving to accrual accounting and are adopting fair value as the basis of valuation for many classes of the assets and liabilities that they hold, or for disclosures of items in the financial statements. The broad principles of this ISA are therefore applicable to the consideration of the audit of fair value measurements and disclosures included in the financial statements of public sector entities.*
2. *Paragraph 3 of the ISA states that when fair value measurements and disclosures are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence that such measurements and disclosures are in accordance with the entity's applicable financial reporting framework. The International Public Sector Accounting Standards accounting framework include a number of standards that require or allow the recognition or disclosure of fair values.*
3. *As noted in paragraph 8 of the ISA, determining the fair value of certain assets or liabilities may be complex where there is no active market. This can be a*

particular issue in the public sector, where entities have significant holdings of specialized assets. Furthermore many assets held by public sector entities do not generate cash flows. In these circumstances a fair value or similar current value may be estimated by reference to other valuation methods including, but not limited to, depreciated replacement cost and indexed price method.



Appendix

Fair Value Measurements and Disclosures Under Different Financial Reporting Frameworks

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.

2. Different definitions of fair value may exist among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement" defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as "entity-specific value," "value in use," or similar terms, but may still fall within the concept of fair value in this ISA.

3. Different financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management's intent to carry out certain courses of action with respect to the specific asset or liability.

4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:

   - Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information;
   - Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met;

- Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows;
- Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework); or
- Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.

5. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable.

6. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value, such as adjustments for estimated closing costs on sale, adjustments related to the property's condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications.

Prevalence of Fair Value Measurements

7. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the determination of, financial statements in a number of ways, including the measurement at fair value of the following:

- Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument, routinely or periodically "marked-to-market."
- Specific components of equity, for example when accounting for the recognition, measurement and presentation of certain financial

instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.

- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.
- Specific assets or liabilities adjusted to fair value on a one-time basis. Some financial reporting frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity's or unit's group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.
- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity's applicable financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.
- Transactions involving the exchange of assets between independent parties without monetary consideration. For example, a non-monetary exchange of plant facilities in different lines of business.
- Information disclosed in notes to financial statements or presented as supplementary information, but not recognized in the financial statements.

INTERNATIONAL STANDARD ON AUDITING 550

RELATED PARTIES

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 550, "Related Parties" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

AUDITING

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 550. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 550.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibilities and audit procedures regarding related parties and transactions with such parties regardless of whether International Accounting Standard (IAS) 24, "Related Party Disclosures," or similar requirement, is part of the applicable financial reporting framework.

2. **The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the effect of related party transactions that are material to the financial statements.** However, an audit cannot be expected to detect all related party transactions.

3. As indicated in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," in certain circumstances there are limitations that may affect the persuasiveness of audit evidence available to draw conclusions on particular assertions. Because of the degree of uncertainty associated with the assertions regarding the completeness of related parties, the audit procedures identified in this ISA will provide sufficient appropriate audit evidence regarding those assertions in the absence of any circumstance identified by the auditor that:

   (a) Increases the risk of material misstatement beyond that which would ordinarily be expected; or

   (b) Indicates that a material misstatement regarding related parties has occurred.

   Where there is any indication that such circumstances exist, the auditor should perform modified, extended or additional audit procedures as are appropriate in the circumstances.

4. Definitions regarding related parties are given in IAS 24 and are adopted for the purposes of this ISA.[1]

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[1] Definitions of related party and related party transactions from IAS 24, "Related Party Disclosures" are as follows:

Related party—A party is related to an entity if:

(a) Directly, or indirectly through one or more intermediaries, the party:

   (i) Controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);

   (ii) Has an interest in the entity that gives it significant influence over the entity; or

   (iii) Has joint control over the entity;

(b) The party is an associate (as defined in IAS 28, "Investments in Associates") of the entity;

5. Management is responsible for the identification and disclosure of related parties and transactions with such parties. This responsibility requires management to implement adequate internal control to ensure that transactions with related parties are appropriately identified in the information system and disclosed in the financial statements.

6. The auditor needs to have a sufficient understanding of the entity and its environment to enable identification of the events, transactions and practices that may result in a risk of material misstatement regarding related parties and transactions with such parties. While the existence of related parties and transactions between such parties are considered ordinary features of business, the auditor needs to be aware of them because:

   (a) The applicable financial reporting framework may require disclosure in the financial statements of certain related party relationships and transactions, such as those required by IAS 24;

   (b) The existence of related parties or related party transactions may affect the financial statements. For example, the entity's tax liability and expense may be affected by the tax laws in various jurisdictions which require special consideration when related parties exist;

   (c) The source of audit evidence affects the auditor's assessment of its reliability. Generally a greater degree of reliance may be placed on audit evidence that is obtained from or created by unrelated third parties; and

   (d) A related party transaction may be motivated by other than ordinary business considerations, for example, profit sharing or even fraud.

Existence and Disclosure of Related Parties

7. **The auditor should review information provided by those charged with governance and management identifying the names of all known related**

(c) The party is a joint venture in which the entity is a venturer (see IAS 31, "Interest in Joint Ventures");

(d) The party is a member of the key management personnel of the entity or its parent;

(e) The party is a close member of the family of any individual referred to in (a) or (d);

(f) The party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

(g) The party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

Related party transactions—A transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

parties and should perform the following audit procedures in respect of the completeness of this information:

(a) **Review prior year working papers for names of known related parties;**

(b) **Review the entity's procedures for identification of related parties;**

(c) **Inquire as to the affiliation of those charged with governance and officers with other entities;**

(d) **Review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register;**

(e) **Review minutes of the meetings of shareholders and those charged with governance and other relevant statutory records such as the register of directors' interests;**

(f) **Inquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties; and**

(g) **Review the entity's income tax returns and other information supplied to regulatory agencies.**

If, in the auditor's judgment, there is a lower risk of significant related parties remaining undetected, these procedures may be modified as appropriate.

8. **Where the applicable financial reporting framework requires disclosure of related party relationships, the auditor should be satisfied that the disclosure is adequate.**

Transactions with Related Parties

9. **The auditor should review information provided by those charged with governance and management identifying related party transactions and should be alert for other material related party transactions.**

10. **When obtaining an understanding of the entity's internal control, the auditor should consider the adequacy of control activities over the authorization and recording of related party transactions.**

11. During the course of the audit, the auditor needs to be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties. Examples include the following:

    - Transactions which have abnormal terms of trade, such as unusual prices, interest rates, guarantees, and repayment terms.

- Transactions which lack an apparent logical business reason for their occurrence.
- Transactions in which substance differs from form.
- Transactions processed in an unusual manner.
- High volume or significant transactions with certain customers or suppliers as compared with others.
- Unrecorded transactions such as the receipt or provision of management services at no charge.

12. During the course of the audit, the auditor carries out audit procedures which may identify the existence of transactions with related parties. Examples include the following:
    - Performing detailed tests of transactions and balances.
    - Reviewing minutes of meetings of shareholders and those charged with governance.
    - Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
    - Reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationship and other related party transactions.
    - Reviewing investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity.

Examining Identified Related Party Transactions

13. **In examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed.**
14. Given the nature of related party relationships, audit evidence of a related party transaction may be limited, for example, regarding the existence of inventory held by a related party on consignment or an instruction from a parent company to a subsidiary to record a royalty expense. Because of the limited availability of appropriate audit evidence about such transactions, the auditor considers performing audit procedures such as:
    - Confirming the terms and amount of the transaction with the related party.
    - Inspecting information in possession of the related party.
    - Confirming or discussing information with persons associated with the transaction, such as banks, lawyers, guarantors and agents.

Management Representations

15. **The auditor should obtain a written representation from management concerning:**

    (a) **The completeness of information provided regarding the identification of related parties; and**

    (b) **The adequacy of related party disclosures in the financial statements.**

Audit Conclusions and Reporting

16. **If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor should modify the auditor's report appropriately.**

Public Sector Perspective

1. *In applying the audit principles in this ISA, auditors have to make reference to legislative requirements which are applicable to public sector entities and employees in respect of related party transactions. Such legislation may prohibit entities and employees from entering into transactions with related parties. There may also be a requirement for public sector employees to declare their interests in entities with which they transact on a professional or commercial basis. Where such legislative requirements exist, the audit procedures would need to be expanded to detect instances of noncompliance with these requirements.*

2. *While International Public Sector Guideline 1, "Financial Reporting by Government Business Enterprise" indicates that all International Accounting Standards (IASs) apply to business enterprises in the public sector, IAS 24, "Related Party Disclosures" does not require that transactions between state controlled enterprises be disclosed. Definitions of related parties included in IAS 24 and this ISA do not address all circumstances relevant to public sector entities. For example, the status, for purposes of application of this ISA, of the relationship between ministers and departments of state, and departments of state and statutory authorities or government agencies is not discussed.*

INTERNATIONAL STANDARD ON AUDITING 560

SUBSEQUENT EVENTS

(Effective for audits of financial statements for periods beginning on or after December 31, 2006)*

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International Standard on Auditing (ISA) 560, "Subsequent Events" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

AUDITING

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 560. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 560.

ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" also gave rise to conforming amendments to ISA 560. These amendments are effective for auditors' reports dated on or after December 31, 2006 and have been incorporated in the text of ISA 560.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibility regarding subsequent events. In this ISA, the term "subsequent events" is used to refer to both events occurring between the date of the financial statements and the date of the auditor's report, and facts discovered after the date of the auditor's report.

2. **The auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.**

3. International Accounting Standard (IAS) 10, "Events After the Balance Sheet Date," deals with the treatment in financial statements of events, both favorable and unfavorable, that occur between the date of the financial statements (referred to as the "balance sheet date" in the IAS) and the date when the financial statements are authorized for issue and identifies two types of events:

   (a) Those that provide evidence of conditions that existed at the date of the financial statements; and

   (b) Those that are indicative of conditions that arose after the date of the financial statements.

Definitions

4. The following terms have the meanings attributed below:

   (a) "Date of the financial statements" is the date of the end of the latest period covered by the financial statements, which is normally the date of the most recent balance sheet in the financial statements subject to audit.

   (b) "Date of approval of the financial statements" is the date on which those with the recognized authority assert that they have prepared the entity's complete set of financial statements, including the related notes, and that they have taken responsibility for them. In some jurisdictions, the law or regulation identifies the individuals or bodies (for example, the directors) that are responsible for concluding that a complete set of financial statements has been prepared, and specifies the necessary approval process. In other jurisdictions, the approval process is not prescribed in law or regulation and the entity follows its own procedures in preparing and finalizing its financial statements in view of its management and governance structures. In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of the ISAs is the earlier date on which those with the recognized authority determine that a complete set of financial statements has been prepared.

(c) "Date of the auditor's report" is the date selected by the auditor to date the report on the financial statements. The auditor's report is not dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements.[1] Sufficient appropriate audit evidence includes evidence that the entity's complete set of financial statements has been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

(d) "Date the financial statements are issued" is the date that the auditor's report and audited financial statements are made available to third parties, which may be, in many circumstances, the date that they are filed with a regulatory authority.

Events Occurring Up to the Date of the Auditor's Report

5. **The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.** These procedures are in addition to procedures which may be applied to specific transactions occurring after the date of the financial statements to obtain audit evidence as to account balances as at the date of the financial statements, for example, the testing of inventory cutoff and payments to creditors. The auditor is not, however, expected to conduct a continuing review of all matters to which previously applied audit procedures have provided satisfactory conclusions.

6. The audit procedures to identify events that may require adjustment of, or disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report. Such audit procedures take into account the auditor's risk assessment and ordinarily include the following:

   - Reviewing procedures management has established to ensure that subsequent events are identified.
   - Reading minutes of the meetings of shareholders, those charged with governance, including established committees such as relevant executive committees and the audit committee, held after the date of the financial statements and inquiring about matters discussed at meetings for which minutes are not yet available.
   - Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.

[1] In rare circumstances, law or regulation also identifies the point in the financial statement reporting process at which the audit is expected to be complete.

- Inquiring, or extending previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims.
- Inquiring of management as to whether any subsequent events have occurred which might affect the financial statements. Examples of inquiries of management on specific matters are:
  - The current status of items that were accounted for on the basis of preliminary or inconclusive data.
  - Whether new commitments, borrowings or guarantees have been entered into.
  - Whether sales or acquisitions of assets have occurred or are planned.
  - Whether the issue of new shares or debentures or an agreement to merge or liquidate has been made or is planned.
  - Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
  - Whether there have been any developments regarding risk areas and contingencies.
  - Whether any unusual accounting adjustments have been made or are contemplated.
  - Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.

7. When a component, such as a division, branch or subsidiary, is audited by another auditor, the auditor would consider the other auditor's procedures regarding events after the date of the financial statements and the need to inform the other auditor of the planned date of the auditor's report.

8. **When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are properly accounted for and adequately disclosed in the financial statements.**

Facts Discovered After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued

9. The auditor does not have any responsibility to perform audit procedures or make any inquiry regarding the financial statements after the date of the auditor's report. During the period from the date of the auditor's report to the

date the financial statements are issued, the responsibility to inform the auditor of facts which may affect the financial statements rests with management.

10. **When, after the date of the auditor's report but before the date the financial statements are issued, the auditor becomes aware of a fact which may materially affect the financial statements, the auditor should consider whether the financial statements need amendment, should discuss the matter with management, and should take the action appropriate in the circumstances.**

11. When management amends the financial statements, the auditor would carry out the audit procedures necessary in the circumstances and would provide management with a new report on the amended financial statements. The new auditor's report would be dated not earlier than the date of approval of the amended financial statements and, accordingly, the audit procedures referred to in paragraph 5 would be extended to the date of the new auditor's report.

12. **When management does not amend the financial statements in circumstances where the auditor believes they need to be amended and the auditor's report has not been released to the entity, the auditor should express a qualified opinion or an adverse opinion, as described in ISA 701, "Modifications to the Independent Auditor's Report."**

13. When the auditor's report has been released to the entity, the auditor would notify those charged with governance of the entity not to issue the financial statements and the auditor's report thereon to third parties. If the financial statements are subsequently released, the auditor needs to take action to prevent reliance on the auditor's report. The action taken will depend on the auditor's legal rights and obligations and the recommendations of the auditor's lawyer.

Facts Discovered After the Financial Statements have been Issued

14. After the financial statements have been issued, the auditor has no obligation to make any inquiry regarding such financial statements.

15. **When, after the financial statements have been issued, the auditor becomes aware of a fact which existed at the date of the auditor's report and which, if known at that date, may have caused the auditor to modify the auditor's report, the auditor should consider whether the financial statements need revision, should discuss the matter with management, and should take the action appropriate in the circumstances.**

16. When management revises the financial statements, the auditor would carry out the audit procedures necessary in the circumstances, would review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation, and would issue a new report on the revised financial statements.

17. **The new auditor's report should include an emphasis of a matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor.** The new auditor's report would be dated not earlier than the date of approval of the revised financial statements and, accordingly, the audit procedures referred to in paragraph 5 would ordinarily be extended to the date of the new auditor's report. Local regulations of some countries permit the auditor to restrict the audit procedures regarding the revised financial statements to the effects of the subsequent event that necessitated the revision. In such cases, the new auditor's report would contain a statement to that effect.

18. When management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation and does not revise the financial statements in circumstances where the auditor believes they need to be revised, the auditor would notify those charged with governance of the entity that action will be taken by the auditor to prevent future reliance on the auditor's report. The action taken will depend on the auditor's legal rights and obligations and the recommendations of the auditor's lawyers.

19. It may not be necessary to revise the financial statements and issue a new auditor's report when issue of the financial statements for the following period is imminent, provided appropriate disclosures are to be made in such statements.

Offering of Securities to the Public

20. **In cases involving the offering of securities to the public, the auditor should consider any legal and related requirements applicable to the auditor in all jurisdictions in which the securities are being offered.** For example, the auditor may be required to carry out additional audit procedures to the date of the final offering document. These procedures would ordinarily include carrying out the audit procedures referred to in paragraphs 5 and 6 up to a date at or near the effective date of the final offering document and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.

Effective Date

21. This ISA is effective for auditors' reports dated on or after December 31, 2006.

INTERNATIONAL STANDARD ON AUDITING 570

GOING CONCERN

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 570, "Going Concern" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

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* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 570. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 570.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibility in the audit of financial statements with respect to the going concern assumption used in the preparation of the financial statements, including considering management's assessment of the entity's ability to continue as a going concern.

2. **When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements.**

Management's Responsibility

3. The going concern assumption is a fundamental principle in the preparation of financial statements. Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

4. Some financial reporting frameworks contain an explicit requirement[1] for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. For example, International Accounting Standard (IAS) 1, "Presentation of Financial Statements" requires management to make an assessment of an enterprise's ability to continue as a going concern.[2]

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[1] The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may be set out in accounting standards, legislation or regulation.

[2] International Accounting Standard (IAS) 1, "Presentation of Financial Statements," paragraphs 23 and 24 state: "When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties shall be disclosed. When financial statements are not prepared on a going concern basis, that fact shall be disclosed, together with the basis on which the financial statements are prepared and the reasons why the entity is not regarded as a going concern.

In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate may be reached without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability,

5. In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle in the preparation of the financial statements, management has a responsibility to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit responsibility to do so.

6. When there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis.

7. Management's assessment of the going concern assumption involves making a judgment, at a particular point in time, about the future outcome of events or conditions which are inherently uncertain. The following factors are relevant:

   - In general terms, the degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future a judgment is being made about the outcome of an event or condition. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
   - Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events can contradict a judgment which was reasonable at the time it was made.
   - The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors all affect the judgment regarding the outcome of events or conditions.

8. Examples of events or conditions, which may give rise to business risks, that individually or collectively may cast significant doubt about the going concern assumption are set out below. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty[3] exists.

   Financial

   - Net liability or net current liability position.

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debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate."

3 The phrase "material uncertainty" is used in IAS 1 in discussing the uncertainties related to events or conditions which may cast significant doubt on the enterprise's ability to continue as a going concern that should be disclosed in the financial statements. In other financial reporting frameworks, and elsewhere in the ISA's, the phrase "significant uncertainties" is used in similar circumstances.

- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by debtors and other creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Loss of key management without replacement.
- Loss of a major market, franchise, license, or principal supplier.
- Labor difficulties or shortages of important supplies.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.
- Changes in legislation or government policy expected to adversely affect the entity.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Auditor's Responsibility

9. The auditor's responsibility is to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements. The auditor considers the appropriateness of management's use of the going concern assumption even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

10. The auditor cannot predict future events or conditions that may cause an entity to cease to continue as a going concern. Accordingly, the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Planning the Audit and Performing Risk Assessment Procedures

11. **In obtaining an understanding of the entity, the auditor should consider whether there are events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern.**

12. **The auditor should remain alert for audit evidence of events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern in performing audit procedures throughout the audit. If such events or conditions are identified, the auditor should, in addition to performing the procedures in paragraph 26, consider whether they affect the auditor's assessment of the risks of material misstatement.**

13. The auditor considers events and conditions relating to the going concern assumption when performing risk assessment procedures, because this allows for more timely discussions with management, review of management's plans and resolution of any identified going concern issues.

14. In some cases, management may have already made a preliminary assessment when the auditor is performing risk assessment procedures. If so, the auditor reviews that assessment to determine whether management has identified events or conditions, such as those discussed in paragraph 8, and management's plans to address them.

15. If management has not yet made a preliminary assessment, the auditor discusses with management the basis for their intended use of the going concern assumption, and inquires of management whether events or conditions, such as those discussed in paragraph 8, exist. The auditor may request management to begin making its assessment, particularly when the

auditor has already identified events or conditions relating to the going concern assumption.

16. The auditor considers the effect of identified events or conditions when assessing the risks of material misstatement and, therefore, their existence may affect the nature, timing and extent of the auditor's further procedures in response to the assessed risks.

Evaluating Management's Assessment

17. **The auditor should evaluate management's assessment of the entity's ability to continue as a going concern.**

18. **The auditor should consider the same period as that used by management in making its assessment under the applicable financial reporting framework. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the balance sheet date, the auditor should ask management to extend its assessment period to twelve months from the balance sheet date.**

19. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of the going concern assumption. As noted in paragraph 7, most financial reporting frameworks requiring an explicit management assessment specify the period for which management is required to take into account all available information.[4]

20. In evaluating management's assessment, the auditor considers the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future action. The auditor considers whether the assessment has taken into account all relevant information of which the auditor is aware as a result of the audit procedures.

21. As noted in paragraph 6, when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In such circumstances, the auditor's conclusion about the appropriateness of this assessment normally is also made without the need for performing detailed procedures. When events or conditions have been identified which may cast significant doubt about the entity's ability to continue as a going concern, however, the auditor performs additional audit procedures, as described in paragraph 26.

Period Beyond Management's Assessment

22. **The auditor should inquire of management as to its knowledge of events or conditions and related business risks beyond the period of assessment**

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[4] For example, IAS 1 defines this as a period that should be at least, but is not limited to, twelve months from the balance sheet date.

used by management that may cast significant doubt on the entity's ability to continue as a going concern.

23. The auditor is alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management's use of the going concern assumption in preparing the financial statements. The auditor may become aware of such known events or conditions during the planning and performance of the audit, including subsequent events procedures.

24. Since the degree of uncertainty associated with the outcome of an event or condition increases as the event or condition is further into the future, in considering such events or conditions, the indications of going concern issues will need to be significant before the auditor considers taking further action. The auditor may need to ask management to determine the potential significance of the event or condition on their going concern assessment.

25. The auditor does not have a responsibility to design audit procedures other than inquiry of management to test for indications of events or conditions which cast significant doubt on the entity's ability to continue as a going concern beyond the period assessed by management which, as discussed in paragraph 18, would be at least twelve months from the balance sheet date.

Further Audit Procedures when Events or Conditions are Identified

26. **When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:**

    (a) **Review management's plans for future actions based on its going concern assessment;**

    (b) **Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary, including considering the effect of any plans of management and other mitigating factors**; **and**

    (c) **Seek written representations from management regarding its plans for future action.**

27. Events or conditions which may cast significant doubt on the entity's ability to continue as a going concern may be identified in performing risk assessment procedures or in the course of performing further audit procedures. The process of considering events or conditions continues as the audit progresses. When the auditor believes such events or conditions may cast significant doubt

on the entity's ability to continue as a going concern, certain audit procedures may take on added significance. The auditor inquires of management as to its plans for future action, including its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital. The auditor also considers whether any additional facts or information are available since the date on which management made its assessment. The auditor obtains sufficient appropriate audit evidence that management's plans are feasible and that the outcome of these plans will improve the situation.

28. Audit procedures that are relevant in this regard may include the following:

- Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- Analyzing and discussing the entity's latest available interim financial statements.
- Reviewing the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Considering the entity's plans to deal with unfilled customer orders.
- Reviewing events after period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

29. When analysis of cash flow is a significant factor in considering the future outcome of events or conditions the auditor considers:

(a) The reliability of the entity's information system for generating such information; and

(b) Whether there is adequate support for the assumptions underlying the forecast.

In addition the auditor compares:

(a) The prospective financial information for recent prior periods with historical results; and

(b) The prospective financial information for the current period with results achieved to date.

Audit Conclusions and Reporting

30. **Based on the audit evidence obtained, the auditor should determine if, in the auditor's judgment, a material uncertainty exists related to events or conditions that alone or in aggregate, may cast significant doubt on the entity's ability to continue as a going concern.**

31. A material uncertainty exists when the magnitude of its potential impact is such that, in the auditor's judgment, clear disclosure of the nature and implications of the uncertainty is necessary for the presentation of the financial statements not to be misleading.

Going Concern Assumption Appropriate but a Material Uncertainty Exists

32. If the use of the going concern assumption is appropriate but a material uncertainty exists, the auditor considers whether the financial statements:

    (a) Adequately describe the principal events or conditions that give rise to the significant doubt on the entity's ability to continue in operation and management's plans to deal with these events or conditions; and

    (b) State clearly that there is a material uncertainty related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

33. **If adequate disclosure is made in the financial statements, the auditor should express an unqualified opinion but modify the auditor's report by adding an emphasis of matter paragraph that highlights the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern and draws attention to the note in the financial statements that discloses the matters set out in paragraph 32**. In evaluating the adequacy of the financial statement disclosure, the auditor considers whether the information explicitly draws the reader's attention to the possibility that the entity may be unable to continue realizing its assets and discharging its liabilities in the normal course of business. The following is an example of such a paragraph when the auditor is satisfied as to the adequacy of the note disclosure:

    "Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by ZZZ. These conditions, along with other matters as set forth in Note X,

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> indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern."

In extreme cases, such as situations involving multiple material uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

34. **If adequate disclosure is not made in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate (ISA 701, "Modifications to the Independent Auditor's Report"). The report should include specific reference to the fact that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.** The following is an example of the relevant paragraphs when a qualified opinion is to be expressed:

> "The Company's financing arrangements expire and amounts outstanding are payable on March 19, 20X1. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty which may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.
>
> In our opinion, except for the omission of the information included in the preceding paragraph, the financial statements give a true and fair view of (present fairly, in all material respects) the financial position of the Company at December 31, 20X0 and of its financial performance and its cash flows for the year then ended in accordance with …"

The following is an example of the relevant paragraphs when an adverse opinion is to be expressed:

> "The Company's financing arrangements expired and the amount outstanding was payable on December 31, 20X0. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty which may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.
>
> In our opinion, because of the omission of the information mentioned in the preceding paragraph, the financial statements do not give a true and fair view of (or do not present fairly) the financial position of the

Company as at December 31, 20X0, and of its financial performance and its cash flows for the year then ended in accordance with… (and do not comply with…) …"

Going Concern Assumption Inappropriate

35. **If, in the auditor's judgment, the entity will not be able to continue as a going concern, the auditor should express an adverse opinion if the financial statements have been prepared on a going concern basis.** If, on the basis of the additional audit procedures carried out and the information obtained, including the effect of management's plans, the auditor's judgment is that the entity will not be able to continue as a going concern, the auditor concludes, regardless of whether or not disclosure has been made, that the going concern assumption used in the preparation of the financial statements is inappropriate and expresses an adverse opinion.

36. When the entity's management has concluded that the going concern assumption used in the preparation of the financial statements is not appropriate, the financial statements need to be prepared on an alternative authoritative basis. If on the basis of the additional audit procedures carried out and the information obtained the auditor determines the alternative basis is appropriate, the auditor can issue an unqualified opinion if there is adequate disclosure but may require an emphasis of matter in the auditor's report to draw the user's attention to that basis.

Management Unwilling to Make or Extend Its Assessment

37. **If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor should consider the need to modify the auditor's report as a result of the limitation on the scope of the auditor's work.** In certain circumstances, such as those described in paragraphs 15, 18 and 24, the auditor may believe that it is necessary to ask management to make or extend its assessment. If management is unwilling to do so, it is not the auditor's responsibility to rectify the lack of analysis by management, and a modified report may be appropriate because it may not be possible for the auditor to obtain sufficient appropriate evidence regarding the use of the going concern assumption in the preparation of the financial statements.

38. In some circumstances, the lack of analysis by management may not preclude the auditor from being satisfied about the entity's ability to continue as a going concern. For example, the auditor's other procedures may be sufficient to assess the appropriateness of management's use of the going concern assumption in the preparation of the financial statements because the entity has a history of profitable operations and a ready access to financial resources. In other circumstances, however, the auditor may not be able to confirm or dispel, in the absence of management's assessment, whether or not events or

conditions exist which indicate there may be a significant doubt on the entity's ability to continue as a going concern, or the existence of plans management has put in place to address them or other mitigating factors. In these circumstances, the auditor modifies the auditor's report as discussed in ISA 701, "Modifications to the Independent Auditor's Report."

Significant Delay in the Signature or Approval of Financial Statements

39. When there is significant delay in the signature or approval of the financial statements by management after the balance sheet date, the auditor considers the reasons for the delay. When the delay could be related to events or conditions relating to the going concern assessment, the auditor considers the need to perform additional audit procedures, as described in paragraph 26, as well as the effect on the auditor's conclusion regarding the existence of a material uncertainty, as described in paragraph 30.

Effective Date

40. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.

Public Sector Perspective

1. The appropriateness of the use of the going concern assumption in the preparation of the financial statements is generally not in question when auditing either a central government or those public sector entities having funding arrangements backed by a central government. However, where such arrangements do not exist, or where central government funding of the entity may be withdrawn and the existence of the entity may be at risk, this ISA will provide useful guidance. As governments corporatize and privatize government entities, going concern issues will become increasingly relevant to the public sector.

INTERNATIONAL STANDARD ON AUDITING 580

MANAGEMENT REPRESENTATIONS

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 580, "Management Representations" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

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* ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500 , "Audit Evidence" gave rise to conforming amendments to ISA 580. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 580.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations and the action to be taken if management refuses to provide appropriate representations.

2. **The auditor should obtain appropriate representations from management.**

Acknowledgment by Management of Its Responsibility for the Financial Statements

3. **The auditor should obtain audit evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the applicable financial reporting framework, and has approved the financial statements.** The auditor can obtain audit evidence of management's acknowledgment of such responsibility and approval from relevant minutes of meetings of those charged with governance or by obtaining a written representation from management or a signed copy of the financial statements.

Representations by Management as Audit Evidence

4. **The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.** The possibility of misunderstandings between the auditor and management is reduced when oral representations are confirmed by management in writing. Matters which might be included in a letter from management or in a confirmatory letter to management are contained in the example of a management representation letter in the Appendix to this ISA.

5. Written representations requested from management may be limited to matters that are considered either individually or collectively material to the financial statements. Regarding certain items it may be necessary to inform management of the auditor's understanding of materiality.

5a. **The auditor should obtain written representation from management that:**

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

   (b) **It believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.**

6. During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific inquiries. When such representations relate to matters which are material to the financial statements, the auditor will need to:

   (a) Seek corroborative audit evidence from sources inside or outside the entity;

   (b) Evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and

   (c) Consider whether the individuals making the representations can be expected to be well informed on the particular matters.

7. Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the cost of an asset is not a substitute for the audit evidence of such cost that an auditor would ordinarily expect to obtain. If the auditor is unable to obtain sufficient appropriate audit evidence regarding a matter which has, or may have, a material effect on the financial statements and such audit evidence is expected to be available, this will constitute a limitation in the scope of the audit, even if a representation from management has been received on the matter.

8. In certain instances, audit evidence other than that obtained by performing inquiry may not be reasonably expected to be available; therefore the auditor obtains a written representation by management. For example, the auditor may not be able to obtain other audit evidence to corroborate management's intention to hold a specific investment for long-term appreciation.

9. **If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.**

Documentation of Representations by Management

10. The auditor would ordinarily include in audit working papers evidence of management's representations in the form of a summary of oral discussions with management or written representations from management.

11. A written representation is ordinarily more reliable audit evidence than an oral representation and can take the form of:

    (a) A representation letter from management;

    (b) A letter from the auditor outlining the auditor's understanding of management's representations, duly acknowledged and confirmed by management; or

(c) Relevant minutes of meetings of the board of directors or similar body or a signed copy of the financial statements.

Basic Elements of a Management Representation Letter

12. When requesting a management representation letter, the auditor would request that it be addressed to the auditor, contain specified information and be appropriately dated and signed.

13. A management representation letter would ordinarily be dated the same date as the auditor's report. However, in certain circumstances, a separate representation letter regarding specific transactions or other events may also be obtained during the course of the audit or at a date after the date of the auditor's report, for example, on the date of a public offering.

14. A management representation letter would ordinarily be signed by the members of management who have primary responsibility for the entity and its financial aspects (ordinarily the senior executive officer and the senior financial officer) based on the best of their knowledge and belief. In certain circumstances, the auditor may wish to obtain representation letters from other members of management. For example, the auditor may wish to obtain a written representation about the completeness of all minutes of the meetings of shareholders, the board of directors and important committees from the individual responsible for keeping such minutes.

Action if Management Refuses to Provide Representations

15. **If management refuses to provide a representation that the auditor considers necessary, this constitutes a scope limitation and the auditor should express a qualified opinion or a disclaimer of opinion.** In such circumstances, the auditor would evaluate any reliance placed on other representations made by management during the course of the audit and consider if the other implications of the refusal may have any additional effect on the auditor's report.

Appendix

Example of a Management Representation Letter

The following letter is not intended to be a standard letter. Representations by management will vary from one entity to another and from one period to the next.

Although seeking representations from management on a variety of matters may serve to focus management's attention on those matters, and thus cause management to specifically address those matters in more detail than would otherwise be the case, the auditor needs to be cognizant of the limitations of management representations as audit evidence as set out in this ISA.

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 19X1 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of (present fairly, in all material respects) the financial position of ABC Company as of December 31, 19X1 and of the results of its operations and its cash flows for the year then ended in accordance with (indicate applicable financial reporting framework).

We acknowledge our responsibility for the fair presentation of the financial statements in accordance with (indicate applicable financial reporting framework).[1]

We confirm, to the best of our knowledge and belief, the following representations:

Include here representations relevant to the entity. Such representations may include the following:

- There have been no irregularities involving management or employees who have a significant role in internal control or that could have a material effect on the financial statements.
- We have made available to you all books of account and supporting documentation and all minutes of meetings of shareholders and the board of directors (namely those held on March 15, 19X1 and September 30, 19X1, respectively).
- We confirm the completeness of the information provided regarding the identification of related parties.

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[1] If required, add "On behalf of the board of directors (or similar body)."

- The financial statements are free of material misstatements, including omissions.
- The Company has complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of noncompliance. There has been no noncompliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of noncompliance.
- The following have been properly recorded and, when appropriate, adequately disclosed in the financial statements:
  - The identity of, and balances and transactions with, related parties.
  - Losses arising from sale and purchase commitments.
  - Agreements and options to buy back assets previously sold.
  - Assets pledged as collateral.
- We have no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements.
- We have no plans to abandon lines of product or other plans or intentions that will result in any excess or obsolete inventory, and no inventory is stated at an amount in excess of net realizable value.
- The Company has satisfactory title to all assets and there are no liens or encumbrances on the company's assets, except for those that are disclosed in Note X to the financial statements.
- We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent, and have disclosed in Note X to the financial statements all guarantees that we have given to third parties.
- Other than . . . described in Note X to the financial statements, there have been no events subsequent to period end which require adjustment of or disclosure in the financial statements or Notes thereto.
- The . . . claim by XYZ Company has been settled for the total sum of XXX which has been properly accrued in the financial statements. No other claims in connection with litigation have been or are expected to be received.
- There are no formal or informal compensating balance arrangements with any of our cash and investment accounts. Except as disclosed in Note X to the financial statements, we have no other line of credit arrangements.

- We have properly recorded or disclosed in the financial statements the capital stock repurchase options and agreements, and capital stock reserved for options, warrants, conversions and other requirements.

(Senior Executive Officer)

(Senior Financial Officer)

INTERNATIONAL STANDARD ON AUDITING 600

USING THE WORK OF ANOTHER AUDITOR

(This Standard is effective)*

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International Standard on Auditing (ISA) 600, "Using the Work of Another Auditor" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 600 has been revised. The IAASB's clarity drafting conventions have been applied to the revised ISA. ISA 600 (Revised and Redrafted), "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)" can be found in Part II of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements*. It is effective for audits of group financial statements for periods beginning on or after December 15, 2009.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance when an auditor, reporting on the financial statements of an entity, uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity. This ISA does not deal with those instances where two or more auditors are appointed as joint auditors nor does it deal with the auditor's relationship with a predecessor auditor. Further, when the principal auditor concludes that the financial statements of a component are immaterial, the standards in this ISA do not apply. When, however, several components, immaterial in themselves, are together material, the procedures outlined in this ISA would need to be considered.

2. **When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.**

3. "Principal auditor" means the auditor with responsibility for reporting on the financial statements of an entity when those financial statements include financial information of one or more components audited by another auditor.

4. "Other auditor" means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial statements audited by the principal auditor. Other auditors include affiliated firms, whether using the same name or not, and correspondents, as well as unrelated auditors.

5. "Component" means a division, branch, subsidiary, joint venture, associated company or other entity whose financial information is included in financial statements audited by the principal auditor.

Acceptance as Principal Auditor

6. **The auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor.** For this purpose the principal auditor would consider:

   (a) The materiality of the portion of the financial statements which the principal auditor audits;

   (b) The principal auditor's degree of knowledge regarding the business of the components;

   (c) The risk of material misstatements in the financial statements of the components audited by the other auditor; and

   (d) The performance of additional procedures as set out in this ISA regarding the components audited by the other auditor resulting in the principal auditor having significant participation in such audit.

The Principal Auditor's Procedures

7. **When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of the specific assignment.** Some of the sources of information for this consideration could be common membership of a professional organization, common membership of, or affiliation, with another firm or reference to the professional organization to which the other auditor belongs. These sources can be supplemented when appropriate by inquiries with other auditors, bankers, etc. and by discussions with the other auditor.

8. **The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment.**

9. The principal auditor would advise the other auditor of:

   (a) The independence requirements regarding both the entity and the component and obtain written representation as to compliance with them;

   (b) The use that is to be made of the other auditor's work and report and make sufficient arrangements for the coordination of their efforts at the initial planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of intercompany transactions that may require disclosure and the timetable for completion of the audit; and

   (c) The accounting, auditing and reporting requirements and obtain written representation as to compliance with them.

10. The principal auditor might also, for example, discuss with the other auditor the audit procedures applied, review a written summary of the other auditor's procedures (which may be in the form of a questionnaire or checklist) or review working papers of the other auditor. The principal auditor may wish to perform these procedures during a visit to the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of previous audit work of the other auditor.

11. The principal auditor may conclude that it is not necessary to apply procedures such as those described in paragraph 10 because sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of the other auditor's practice. For example, when they are affiliated firms the principal auditor and the other auditor may have a continuing, formal relationship providing for procedures

that give that audit evidence such as periodic inter-firm review, tests of operating policies and procedures and review of working papers of selected audits.

12. **The principal auditor should consider the significant findings of the other auditor.**

13. The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the component and may also decide that supplementary tests of the records or the financial information of the component are necessary. Such tests may, depending on the circumstances, be performed by the principal auditor or the other auditor.

14. The principal auditor would document in the audit working papers the components whose financial information was audited by other auditors, their significance to the financial statements of the entity as a whole, the names of the other auditors and any conclusions reached that individual components are immaterial. The principal auditor would also document the procedures performed and the conclusions reached. For example, working papers of the other auditor that have been reviewed would be identified and the results of discussions with the other auditor would be recorded. However, the principal auditor need not document the reasons for limiting the procedures in the circumstances described in paragraph 11, provided those reasons are summarized elsewhere in documentation maintained by the principal auditor's firm.

Cooperation Between Auditors

15. **The other auditor, knowing the context in which the principal auditor will use the other auditor's work, should cooperate with the principal auditor.** For example, the other auditor would bring to the principal auditor's attention any aspect of the other auditor's work that cannot be carried out as requested. Similarly, subject to legal and professional considerations, the other auditor will need to be advised of any matters that come to the attention of the principal auditor which may have an important bearing on the other auditor's work.

Reporting Considerations

16. **When the principal auditor concludes that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation in the scope of the audit.**

17. If the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor would consider whether the subject of the modification is of such a nature and significance, in relation to the financial statements of the entity on which the principal auditor is reporting, that a modification of the principal auditor's report is required.

Division of Responsibility

18. While compliance with the guidance in the preceding paragraphs is considered desirable, the local regulations of some countries permit a principal auditor to base the audit opinion on the financial statements taken as a whole solely upon the report of another auditor regarding the audit of one or more components. **When the principal auditor does so, the principal auditor's report should state this fact clearly and should indicate the magnitude of the portion of the financial statements audited by the other auditor.** When the principal auditor makes such a reference in the auditor's report, audit procedures are ordinarily limited to those described in paragraphs 7 and 9.

Public Sector Perspective

1. The basic principles in this ISA apply to the audit of financial statements in the public sector, however, supplementary guidance on additional considerations when using the work of other auditors in the public sector is needed. For example, the principal auditor in the public sector has to ensure that, where legislation has prescribed compliance with a particular set of auditing standards, the other auditor has complied with those standards. In respect to public sector entities, the Public Sector Committee[1] has supplemented the guidance included in this ISA in its Study 4, "Using the Work of Other Auditors—A Public Sector Perspective."

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

INTERNATIONAL STANDARD ON AUDITING 610

CONSIDERING THE WORK OF INTERNAL AUDIT

(Effective for audits of financial statements for periods
beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 610, "Considering the Work of Internal Audit" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

AUDITING

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 610. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 610.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance to external auditors in considering the work of internal auditing. This ISA does not deal with instances when personnel from internal auditing assist the external auditor in carrying out external audit procedures. The audit procedures noted in this ISA need only be applied to internal auditing activities which are relevant to the audit of the financial statements.

2. **The external auditor should consider the activities of internal auditing and their effect, if any, on external audit procedures.**

3. "Internal auditing" means an appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things, monitoring internal control.

4. While the external auditor has sole responsibility for the audit opinion expressed and for determining the nature, timing and extent of external audit procedures, certain parts of internal auditing work may be useful to the external auditor.

Scope and Objectives of Internal Auditing

5. The scope and objectives of internal auditing vary widely and depend on the size and structure of the entity and the requirements of its management. Ordinarily, internal auditing activities include one or more of the following:

   - Monitoring of internal control. The establishment of adequate internal control is a responsibility of management which demands proper attention on a continuous basis. Internal auditing is ordinarily assigned specific responsibility by management for reviewing controls, monitoring their operation and recommending improvements thereto.

   - Examination of financial and operating information. This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.

   - Review of the economy, efficiency and effectiveness of operations including non-financial controls of an entity.

   - Review of compliance with laws, regulations and other external requirements and with management policies and directives and other internal requirements.

Relationship Between Internal Auditing and the External Auditor

6. The role of internal auditing is determined by management, and its objectives differ from those of the external auditor who is appointed to report

independently on the financial statements. The internal audit function's objectives vary according to management's requirements. The external auditor's primary concern is whether the financial statements are free of material misstatements.

7. Nevertheless some of the means of achieving their respective objectives are often similar and thus certain aspects of internal auditing may be useful in determining the nature, timing and extent of external audit procedures.

8. Internal auditing is part of the entity. Irrespective of the degree of autonomy and objectivity of internal auditing, it cannot achieve the same degree of independence as required of the external auditor when expressing an opinion on the financial statements. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by any use made of internal auditing. All judgments relating to the audit of the financial statements are those of the external auditor.

Understanding and Preliminary Assessment of Internal Auditing

9. **The external auditor should obtain a sufficient understanding of internal audit activities to identify and assess the risks of material misstatement of the financial statements and to design and perform further audit procedures.**

10. Effective internal auditing will often allow a modification in the nature and timing, and a reduction in the extent of audit procedures performed by the external auditor but cannot eliminate them entirely. In some cases, however, having considered the activities of internal auditing, the external auditor may decide that internal auditing will have no effect on external audit procedures.

11. **The external auditor should perform an assessment of the internal audit function when internal auditing is relevant to the external auditor's risk assessment.**

12. The external auditor's assessment of the internal audit function will influence the external auditor's judgment about the use which may be made of internal auditing in making risk assessments and thereby modifying the nature, timing and extent of further external audit procedures.

13. When obtaining an understanding and performing an assessment of the internal audit function, the important criteria are the following:

    (a) *Organizational status:* Specific status of internal auditing in the entity and the effect this has on its ability to be objective. In the ideal situation, internal auditing will report to the highest level of management and be free of any other operating responsibility. Any constraints or restrictions placed on internal auditing by management would need to be carefully considered. In particular, the internal

auditors will need to be free to communicate fully with the external auditor.

(b) *Scope of function:* The nature and extent of internal auditing assignments performed. The external auditor would also need to consider whether management acts on internal audit recommendations and how this is evidenced.

(c) *Technical competence:* Whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors. The external auditor may, for example, review the policies for hiring and training the internal auditing staff and their experience and professional qualifications.

(d) *Due professional care:* Whether internal auditing is properly planned, supervised, reviewed and documented. The existence of adequate audit manuals, work programs and working papers would be considered.

Timing of Liaison and Coordination

14. When planning to use the work of internal auditing, the external auditor will need to consider internal auditing's tentative plan for the period and discuss it at as early a stage as possible. Where the work of internal auditing is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to agree in advance the timing of such work, the extent of audit coverage, materiality levels and proposed methods of sample selection, documentation of the work performed and review and reporting procedures.

15. Liaison with internal auditing is more effective when meetings are held at appropriate intervals during the period. The external auditor would need to be advised of and have access to relevant internal auditing reports and be kept informed of any significant matter that comes to the internal auditor's attention which may affect the work of the external auditor. Similarly, the external auditor would ordinarily inform the internal auditor of any significant matters which may affect internal auditing.

Evaluating the Work of Internal Auditing

16. **When the external auditor intends to use specific work of internal auditing, the external auditor should evaluate and perform audit procedures on that work to confirm its adequacy for the external auditor's purposes.**

17. The evaluation of specific work of internal auditing involves consideration of the adequacy of the scope of work and related programs and whether the

assessment of the internal auditing remains appropriate. This evaluation may include consideration of whether:

(a) The work is performed by persons having adequate technical training and proficiency as internal auditors and the work of assistants is properly supervised, reviewed and documented;

(b) Sufficient appropriate audit evidence is obtained to be able to draw reasonable conclusions;

(c) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and

(d) Any exceptions or unusual matters disclosed by internal auditing are properly resolved.

18. The nature, timing and extent of the audit procedures performed on the specific work of internal auditing will depend on the external auditor's judgment as to the risk of material misstatement of the area concerned, the assessment of internal auditing and the evaluation of the specific work by internal auditing. Such audit procedures may include examination of items already examined by internal auditing, examination of other similar items and observation of internal auditing procedures.

19. The external auditor would record conclusions regarding the specific internal auditing work that has been evaluated and the audit procedures performed on the internal auditor's work.

Public Sector Perspective

1. The basic principles in this ISA apply to the audit of financial statements in the public sector. Supplementary guidance on additional considerations, when considering the work of internal auditing in the public sector is provided in the Public Sector Committee's[1] *Study 4, "Using the Work of Other Auditors—A Public Sector Perspective."*

AUDITING

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

INTERNATIONAL STANDARD ON AUDITING 620

USING THE WORK OF AN EXPERT

(Effective for audits of financial statements for periods beginning on or after June 15, 2005)*

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International Standard on Auditing (ISA) 620, "Using the Work of an Expert" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 620. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 620.

ISQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements," and ISA 220, "Quality Control for Audits of Historical Financial Information" gave rise to conforming amendments to ISA 620. The conforming amendments are effective for audits of financial statements for periods beginning on or after June 15, 2005 and have been incorporated in the text of this ISA.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on using the work of an expert as audit evidence.

2. **When using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit.**

3. "Expert" means a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

4. The auditor's education and experience enable the auditor to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation, such as an actuary or engineer.

5. An expert may be:

   (a) Contracted by the entity;

   (b) Contracted by the auditor;

   (c) Employed by the entity; or

   (d) Employed by the auditor.

   When the auditor uses the work of an expert employed by the audit firm, the auditor will be able to rely on the firm's systems for recruitment and training that determine that expert's capabilities and competence, as explained in ISA 220, "Quality Control for Audits of Historical Financial Information" instead of needing to evaluate them for each audit engagement.

Determining the Need to Use the Work of an Expert

6. In obtaining an understanding of the entity and performing further procedures in response to assessed risks, the auditor may need to obtain, in conjunction with the entity or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. Examples include the following:

   - Valuations of certain types of assets, for example, land and buildings, plant and machinery, works of art, and precious stones.
   - Determination of quantities or physical condition of assets, for example, minerals stored in stockpiles, underground mineral and petroleum reserves, and the remaining useful life of plant and machinery.
   - Determination of amounts using specialized techniques or methods, for example, an actuarial valuation.

- The measurement of work completed and to be completed on contracts in progress.
- Legal opinions concerning interpretations of agreements, statutes and regulations.

7. When determining the need to use the work of an expert, the auditor would consider:

    (a) The engagement team's knowledge and previous experience of the matter being considered;

    (b) The risk of material misstatement based on the nature, complexity, and materiality of the matter being considered; and

    (c) The quantity and quality of other audit evidence expected to be obtained.

Competence and Objectivity of the Expert

8. **When planning to use the work of an expert, the auditor should evaluate the professional competence of the expert.** This will involve considering the expert's:

    (a) Professional certification or licensing by, or membership in, an appropriate professional body; and

    (b) Experience and reputation in the field in which the auditor is seeking audit evidence.

9. **The auditor should evaluate the objectivity of the expert.**

10. The risk that an expert's objectivity will be impaired increases when the expert is:

    (a) Employed by the entity; or

    (b) Related in some other manner to the entity, for example, by being financially dependent upon or having an investment in the entity.

    If the auditor is concerned regarding the competence or objectivity of the expert, the auditor needs to discuss any reservations with management and consider whether sufficient appropriate audit evidence can be obtained concerning the work of an expert. The auditor may need to undertake additional audit procedures or seek audit evidence from another expert (after taking into account the factors in paragraph 7).

Scope of the Expert's Work

11. **The auditor should obtain sufficient appropriate audit evidence that the scope of the expert's work is adequate for the purposes of the audit.** Audit evidence may be obtained through a review of the terms of reference which are

often set out in written instructions from the entity to the expert. Such instructions to the expert may cover matters such as the following:

- The objectives and scope of the expert's work.
- A general outline as to the specific matters the auditor expects the expert's report to cover.
- The intended use by the auditor of the expert's work, including the possible communication to third parties of the expert's identity and extent of involvement.
- The extent of the expert's access to appropriate records and files.
- Clarification of the expert's relationship with the entity, if any.
- Confidentiality of the entity's information.
- Information regarding the assumptions and methods intended to be used by the expert and their consistency with those used in prior periods.

In the event that these matters are not clearly set out in written instructions to the expert, the auditor may need to communicate with the expert directly to obtain audit evidence in this regard. In obtaining an understanding of the entity, the auditor also considers whether to include the expert during the engagement team's discussion of the susceptibility of the entity's financial statements to material misstatement.

Evaluating the Work of the Expert

12. **The auditor should evaluate the appropriateness of the expert's work as audit evidence regarding the assertion being considered.** This will involve evaluation of whether the substance of the expert's findings is properly reflected in the financial statements or supports the assertions, and consideration of:

    - Source data used;
    - Assumptions and methods used and their consistency with prior periods; and
    - Results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of other audit procedures.

13. When considering whether the expert has used source data which is appropriate in the circumstances, the auditor would consider the following procedures:

    (a) Making inquiries regarding any procedures undertaken by the expert to establish whether the source data is relevant and reliable.

    (b) Reviewing or testing the data used by the expert.

14. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor will need to obtain an understanding of the assumptions and methods used and to consider whether they are appropriate and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures.

15. **If the results of the expert's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, the auditor should resolve the matter.** This may involve discussions with the entity and the expert, applying additional audit procedures, including possibly engaging another expert, or modifying the auditor's report.

Reference to an Expert in the Auditor's Report

16. **When issuing an unmodified auditor's report, the auditor should not refer to the work of an expert.** Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended.

17. If, as a result of the work of an expert, the auditor decides to issue a modified auditor's report, in some circumstances it may be appropriate, in explaining the nature of the modification, to refer to or describe the work of the expert (including the identity of the expert and the extent of the expert's involvement). In these circumstances, the auditor would obtain the permission of the expert before making such a reference. If permission is refused and the auditor believes a reference is necessary, the auditor may need to seek legal advice.

INTERNATIONAL STANDARD ON AUDITING 700

THE INDEPENDENT AUDITOR'S REPORT ON A COMPLETE SET OF GENERAL PURPOSE FINANCIAL STATEMENTS[1]

(Effective for auditors' reports dated on or after December 31, 2006)*

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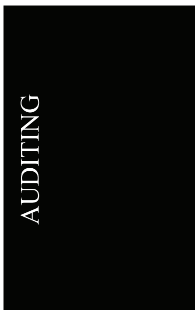
International Standard on Auditing (ISA) 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.



1 This ISA is applicable for auditors' reports on financial statements described in paragraph 1 of the ISA. ISA 701, "Modifications to the Independent Auditor's Report" establishes standards and provides guidance to be applied when the independent auditor's report should be modified.

* ISA 700 gave rise to conforming amendments to ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," ISA 210, "Terms of Audit Engagements," ISA 560, "Subsequent Events," ISA 701, "Modifications to the Independent Auditor's Report," and ISA 800, "The Independent Auditor's Report on Special Purpose Audit Engagements." The conforming amendments to ISAs 200, 210, 560 and 800 have been incorporated in the text of those Standards.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the independent auditor's report issued as a result of an audit of a complete set of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation. It also provides guidance on the matters the auditor considers in forming an opinion on those financial statements. As described in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," "general purpose financial statements" are financial statements prepared in accordance with a financial reporting framework that is designed to meet the common information needs of a wide range of users.[2]

2. This ISA addresses circumstances when the auditor is able to express an unqualified opinion and no modification to the auditor's report is necessary. ISA 701, "Modifications to the Independent Auditor's Report" establishes standards and provides guidance on the modifications to this report for an emphasis of matter, a qualified opinion, a disclaimer of opinion, or an adverse opinion.

3. ISA 800, "The Independent Auditor's Report on Special Purpose Audit Engagements" establishes standards and provides guidance on the form and content of the auditor's report issued as a result of an audit of:

   (a) A complete set of financial statements prepared in accordance with an other comprehensive basis of accounting;

   (b) A component of a complete set of general purpose or special purpose financial statements, such as a single financial statement, specified accounts, elements of accounts, or items in a financial statement;

   (c) Compliance with contractual agreements; and

   (d) Summarized financial statements.

The Auditor's Report on Financial Statements

4. **The auditor's report should contain a clear expression of the auditor's opinion on the financial statements.**

5. As stated 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

[2] Implementation of the final sentence of paragraph 3 and paragraphs 37-48 of ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" (amended as a result of ISA 700) has been deferred until such time as proposed ISA 800 (Revised and Redrafted), "Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" becomes effective. The remainder of ISA 200 (amended as a result of ISA 700) is effective for audits of financial statements for periods beginning on or after December 15, 2005.

prepared, in all material respects, in accordance with the applicable financial reporting framework.

6. Unless required by law or regulation to use different wording, the auditor's opinion on a complete set[3] of general purpose financial statements prepared in accordance with a financial reporting framework that is designed to achieve fair presentation (for purposes of this ISA referred to as "financial statements") states whether the financial statements "give a true and fair view" or "are presented fairly, in all material respects," in accordance with the applicable financial reporting framework. These phrases "give a true and fair view" and "are presented fairly, in all material respects," are equivalent. Which of these phrases is used in any particular jurisdiction is determined by the law or regulations governing the audit of financial statements in that jurisdiction, or by established practice in that jurisdiction.

7. In some jurisdictions, law or regulation governing the audit of financial statements may prescribe wording for the auditor's opinion that is different from the phrases described in paragraph 6. Although the auditor may be obliged to use the prescribed wording, the auditor's responsibilities as described in this ISA for forming the opinion remain the same.

8. When wording prescribed by law or regulation differs significantly from the phrases in paragraph 6, the auditor carefully considers whether there may be a risk that users might misunderstand the assurance obtained in an audit of financial statements. For example, the wording might convey to readers that the auditor is attesting to the accuracy of the financial statement amounts rather than expressing an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects. In such circumstances, the auditor considers whether the risk of misunderstanding can be mitigated through appropriate explanation in the auditor's report (see ISA 701).

Applicable Financial Reporting Framework

9. The auditor's judgment regarding whether the financial statements give a true and fair view or are presented fairly, in all material respects, is made in the context of the applicable financial reporting framework. As discussed in ISA 210, "Terms of Audit Engagements," without an acceptable financial reporting framework, the auditor does not have suitable criteria for evaluating the entity's financial statements.[4] ISA 200 describes the auditor's responsibility to

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[3] As explained in paragraph 35 of ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," the financial reporting framework determines what constitutes a complete set of financial statements. A complete set of financial statements under International Financial Reporting Standards (IFRSs) comprises a balance sheet, an income statement, a statement of changes in equity, a cash flow statement and a summary of significant accounting policies and other explanatory notes.

[4] Implementation of ISA 210, "Terms of Audit Engagements" (amended as a result of ISA 700) has been deferred until such time as ISA 800 (Revised and Redrafted), "Special Considerations—Audits of

determine whether the financial reporting framework adopted by management in preparing the financial statements is acceptable.[5]

10. In the case of financial statements that are within the scope of this ISA, application of a financial reporting framework determined to be acceptable for general purpose financial statements will, except in the extremely rare circumstances discussed in paragraph 15, result in financial statements that achieve fair presentation. Although the financial reporting framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework. Thus, the financial reporting framework provides a context for the auditor's evaluation of the fair presentation of the financial statements, including whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures.

Forming an Opinion on the Financial Statements

11. **The auditor should evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements.**

12. When forming an opinion on the financial statements, the auditor evaluates whether, based on the audit evidence obtained, there is reasonable assurance about whether the financial statements taken as a whole are free from material misstatement. This involves concluding whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risks of material misstatement of the financial statements[6] and evaluating the effects of uncorrected misstatements identified.[7]

13. Forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework involves evaluating whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures. This evaluation includes considering whether, in the context of the applicable financial reporting framework:

Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" becomes effective.

5 See footnote 2.

6 See ISA 330, "The Auditor's Procedures in Response to Assessed Risks."

7 See ISA 320, "Audit Materiality."

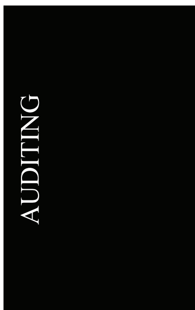
(a) The accounting policies selected and applied are consistent with the financial reporting framework and are appropriate in the circumstances;

(b) The accounting estimates made by management are reasonable in the circumstances;

(c) The information presented in the financial statements, including accounting policies, is relevant, reliable, comparable and understandable; and

(d) The financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements, for example, in the case of financial statements prepared in accordance with International Financial Reporting Standards (IFRSs), the entity's financial position, financial performance and cash flows.

14. Forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework also involves evaluating the fair presentation of the financial statements. The auditor considers whether the financial statements, after any adjustments made by management as a result of the audit process, are consistent with the auditor's understanding of the entity and its environment. The auditor considers the overall presentation, structure and content of the financial statements. The auditor also considers whether the financial statements, including the note disclosures, faithfully represent the underlying transactions and events in a manner that gives a true and fair view of or presents fairly, in all material respects, the information conveyed in the financial statements in the context of the financial reporting framework. Analytical procedures performed at or near the end of the audit help to corroborate conclusions formed during the audit and assist in arriving at the overall conclusion as to the fair presentation of the financial statements.



Extremely Rare Circumstances when Applying the Financial Reporting Framework Results in Misleading Financial Statements

15. As discussed in ISA 210, the auditor considers the acceptability of the financial reporting framework when considering accepting the engagement.[8] Application of a financial reporting framework determined to be acceptable for general purpose financial statements will ordinarily result in financial statements that achieve fair presentation. In extremely rare circumstances, however, application of a specific requirement in a framework that has been determined to be acceptable for general purpose financial statements may result in financial statements that are misleading in the particular circumstances of the entity. Some financial reporting frameworks determined to be acceptable for general purpose

[8] See footnote 4.

financial statements acknowledge, implicitly or explicitly, that there are extremely rare circumstances when it is necessary for the financial statements to depart from a specific requirement in the framework in order to achieve the objective of fair presentation of the financial statements and provide guidance on the disclosures required. Other financial reporting frameworks may not provide any guidance on these circumstances even though they are acceptable frameworks for general purpose financial statements. If the auditor encounters circumstances that lead the auditor to conclude that compliance with a specific requirement results in financial statements that are misleading, the auditor considers the need to modify the auditor's report. The modifications, if any, that are appropriate to the auditor's report will depend on how management addresses the matter in the financial statements and how the financial reporting framework deals with these rare circumstances (see ISA 701).

Elements of the Auditor's Report in an Audit Conducted in Accordance with International Standards on Auditing[9]

16. Consistency in the auditor's report, when the audit has been conducted in accordance with the ISAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the reader's understanding and to identify unusual circumstances when they occur.

17. Paragraphs 18-60 set out the requirements relating to the following elements of the auditor's report when the audit has been conducted in accordance with the ISAs:

    (a) Title;

    (b) Addressee;

    (c) Introductory paragraph;

    (d) Management's responsibility for the financial statements;

    (e) Auditor's responsibility;

    (f) Auditor's opinion;

    (g) Other reporting responsibilities;

    (h) Auditor's signature;

    (i) Date of the auditor's report; and

    (j) Auditor's address.

9 Paragraphs 61-66 address the auditor's report when the audit has been conducted in accordance with both ISAs and auditing standards of a specific jurisdiction or country.

Title

18. **The auditor's report should have a title that clearly indicates that it is the report of an independent auditor.**

19. A title indicating the report is the report of an independent auditor, for example, "Independent Auditor's Report," affirms that the auditor has met all of the relevant ethical requirements regarding independence and, therefore, distinguishes the independent auditor's report from reports issued by others.

Addressee

20. **The auditor's report should be addressed as required by the circumstances of the engagement.**

21. National laws or regulations often specify to whom the auditor's report on general purpose financial statements should be addressed in that particular jurisdiction. Ordinarily, the auditor's report on general purpose financial statements is addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

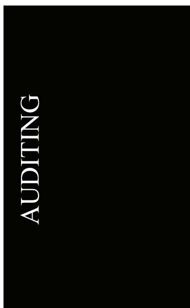
Introductory Paragraph

22. **The introductory paragraph in the auditor's report should identify the entity whose financial statements have been audited and should state that the financial statements have been audited. The introductory paragraph should also:**

    (a) **Identify the title of each of the financial statements that comprise the complete set of financial statements;**

    (b) **Refer to the summary of significant accounting policies and other explanatory notes; and**

    (c) **Specify the date and period covered by the financial statements.**



23. This requirement is ordinarily met by stating that the auditor has audited the accompanying financial statements of the entity, which comprise [state the titles of the complete set of financial statements required by the applicable financial reporting framework, specifying the date and period covered by those financial statements] and referring to the summary of significant accounting policies and other explanatory notes. In addition, when the auditor is aware that the financial statements will be included in a document that contains other information, such as an annual report, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the financial statements are presented. This helps readers to identify the financial statements to which the auditor's report relates.

24. The auditor's opinion covers the complete set of financial statements as defined by the applicable financial reporting framework. In the case of financial statements prepared in accordance with IFRSs, this includes: a balance sheet, an income statement, a statement of changes in equity, a cash flow statement, and a summary of significant accounting policies and other explanatory notes. In some jurisdictions additional information might also be considered to be an integral part of the financial statements.

25. In some circumstances, the entity may be required by law or regulation or standards, or may voluntarily choose, to present together with the financial statements supplementary information that is not required by the financial reporting framework. For example, supplementary information might be presented to enhance a user's understanding of the financial reporting framework or to provide further explanation of specific financial statement items. Such information is normally presented in either supplementary schedules or as additional notes. The auditor's opinion may or may not cover the supplementary information and it is therefore important for the auditor to be satisfied that any supplementary information that is not covered by the auditor's opinion is clearly differentiated, as discussed in paragraphs 67-71.

26. In some circumstances, the supplementary information cannot be clearly differentiated from the financial statements because of its nature and how it is presented. Such supplementary information is covered by the auditor's opinion. For example, the auditor's opinion covers notes or supplementary schedules that are cross-referenced from the financial statements. This would also be the case when the notes to the financial statements include an explanation of the extent to which the financial statements comply with another financial reporting framework.

27. Supplementary information that is presented as an integral part of the financial statements does not need to be specifically referred to in the introductory paragraph of the auditor's report when the reference to the notes in the description of the components of the financial statements in the introductory paragraph is sufficient.

Management's Responsibility for the Financial Statements

28. **The auditor's report should state that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework and that this responsibility includes:**

    (a) **Designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error;**

    (b) **Selecting and applying appropriate accounting policies; and**

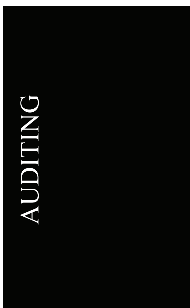
(c) **Making accounting estimates that are reasonable in the circumstances.**

29. Financial statements are the representations of management. Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework. For example, in the case of financial statements prepared in accordance with IFRSs, management is responsible for preparing financial statements that fairly present the financial position, financial performance and cash flows of the entity in accordance with IFRSs. To fulfill this responsibility, management designs and implements internal control[10] to prevent or to detect and correct misstatements, whether due to fraud or error, in order to ensure the reliability of the entity's financial reporting. The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

30. There may be circumstances when it is appropriate for the auditor to add to the description of management's responsibilities in paragraph 28 to reflect additional responsibilities that are relevant to the preparation and presentation of the financial statements in the context of the particular jurisdiction or the nature of the entity.

31. The term management has been used in this ISA to describe those responsible for the preparation and fair presentation of the financial statements. Other terms may be appropriate depending on the legal framework in the particular jurisdiction. For example, in some jurisdictions, the appropriate reference may be to those charged with governance (for example, the directors).

Auditor's Responsibility



32. **The auditor's report should state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.**

33. The auditor's report states that the auditor's responsibility is to express an opinion on the financial statements based on the audit in order to contrast it to management's responsibility for the preparation and fair presentation of the financial statements.

34. **The auditor's report should state that the audit was conducted in accordance with International Standards on Auditing. The auditor's report should also explain that those standards require that the auditor comply with ethical requirements and that the auditor plan and perform the audit**

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10 In some jurisdictions, law or regulation prescribing management's responsibilities may specifically refer to a responsibility for the adequacy of accounting books and records, or accounting system. As books, records and systems are an integral part of internal control (as defined in ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement"), no specific reference is made to them in paragraph 28 for the description of management's responsibilities.

to obtain reasonable assurance whether the financial statements are free from material misstatement.

35. The reference to the standards used conveys to the reader that the audit has been conducted in accordance with established standards.

36. ISA 200 specifies what is required in order to conduct an audit in accordance with the ISAs. Paragraph 14 in that ISA explains that the auditor cannot describe the audit as being conducted in accordance with the ISAs unless the auditor has complied fully with all of the ISAs relevant to the audit.

37. **The auditor's report should describe an audit by stating that:**

    (a) **An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements;**

    (b) **The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor should omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of internal control; and**

    (c) **An audit also includes evaluating the appropriateness of the accounting policies used, the reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements.**

38. **The auditor's report should state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.**

Auditor's Opinion

39. **An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.**

40. **When expressing an unqualified opinion, the opinion paragraph of the auditor's report should state the auditor's opinion that the financial statements give a true and fair view or present fairly, in all material**

respects, in accordance with the applicable financial reporting framework (unless the auditor is required by law or regulation to use different wording for the opinion, in which case the prescribed wording should be used).

41. **When International Financial Reporting Standards or International Public Sector Accounting Standards are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion should identify the jurisdiction or country of origin of the financial reporting framework.**

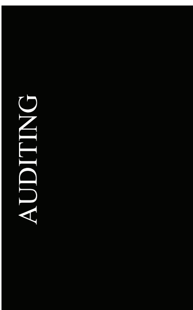
42. The auditor's opinion states that the financial statements give a true and fair view of or present fairly, in all material respects, the information that the financial statements are designed to convey (which is determined by the financial reporting framework). For example, in the case of financial statements prepared in accordance with IFRSs, the auditor expresses an opinion that the financial statements give a true and fair view of or are presented fairly, in all material respects, the financial position of the entity as at the end of the period and the entity's financial performance and cash flows for the period then ended.

43. To advise the reader of the context in which the auditor's opinion is expressed, the auditor's opinion identifies the applicable financial reporting framework on which the financial statements are based. When the applicable financial reporting framework is not IFRSs or International Public Sector Accounting Standards (IPSASs), the auditor's opinion also identifies the jurisdiction or country of origin of the applicable financial reporting framework. The auditor identifies the applicable financial reporting framework in such terms as:

- "… in accordance with International Financial Reporting Standards" or
- "… in accordance with accounting principles generally accepted in Country X …"

44. When the applicable financial reporting framework encompasses legal and regulatory requirements, the auditor identifies the applicable financial reporting framework in such terms as:

    "… in accordance with International Financial Reporting Standards and the requirements of Country X Corporations Act."



Other Matters

45. Standards, laws or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon. Such matters may be addressed in a separate paragraph following the auditor's opinion.

Other Reporting Responsibilities

46. In some jurisdictions, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibility to express an opinion on the financial statements. For example, the auditor may be asked to report certain matters if they come to the auditor's attention during the course of the audit of the financial statements. Alternatively, the auditor may be asked to perform and report on additional specified procedures, or to express an opinion on specific matters, such as the adequacy of accounting books and records. Auditing standards in the specific jurisdiction or country often provide guidance on the auditor's responsibilities with respect to specific additional reporting responsibilities in that jurisdiction or country.

47. In some cases, the relevant standards or laws may require or permit the auditor to report on these other responsibilities within the auditor's report on the financial statements. In other cases, the auditor may be required or permitted to report on them in a separate report.

48. **When the auditor addresses other reporting responsibilities within the auditor's report on the financial statements, these other reporting responsibilities should be addressed in a separate section in the auditor's report that follows the opinion paragraph.**

49. The auditor addresses these other reporting responsibilities in a separate section of the report in order to clearly distinguish them from the auditor's responsibilities for, and opinion on, the financial statements.

Auditor's Signature

50. **The auditor's report should be signed.**

51. The auditor's signature is either in the name of the audit firm, the personal name of the auditor or both, as appropriate for the particular jurisdiction. In addition to the auditor's signature, in certain jurisdictions, the auditor may be required to declare the auditor's professional accountancy designation or the fact that the auditor or firm, as appropriate, has been recognized by the appropriate licensing authority in that jurisdiction.

Date of the Auditor's Report

52. **The auditor should date the report on the financial statements no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. Sufficient appropriate audit evidence should include evidence that the entity's complete set of financial statements has been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.**

53. The date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in ISA 560, "Subsequent Events."

54. Since the auditor's opinion is provided on the financial statements and the financial statements are the responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until the auditor obtains evidence that a complete set of financial statements has been prepared and management has accepted responsibility for them.

55. In some jurisdictions, the law or regulation identifies the individuals or bodies (for example, the directors) that are responsible for concluding that a complete set of financial statements has been prepared, and specifies the necessary approval process. In such cases, the auditor obtains evidence of that approval before dating the report on the financial statements.[11] In other jurisdictions, however, the approval process is not prescribed in law or regulation. In such cases, the auditor takes into account the procedures the entity follows in preparing and finalizing its financial statements in view of its management and governance structures in order to identify the individuals or body with the authority to conclude that the entity's complete set of financial statements, including the related notes, has been prepared.

56. In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of the ISAs is the earlier date on which those with the recognized authority determine that a complete set of financial statements has been prepared.

Auditor's Address

57. **The report should name the location in the country or jurisdiction where the auditor practices.**

Auditor's Report

58. **The auditor's report should be in writing.**

59. A written report encompasses both reports issued in hard copy format and those using an electronic medium.

AUDITING

[11] In rare circumstances, law or regulation also identifies the point in the financial statement reporting process at which the audit is expected to be complete.

60. The following is an illustration of the auditor's report incorporating the elements set forth above for an audit of financial statements prepared in accordance with IFRSs expressing an unqualified opinion. In addition to the audit of the financial statements, the illustration assumes that the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements[12]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit

[12] The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading, "Report on Other Legal and Regulatory Requirements" is not applicable.

procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[13] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of *(or "present fairly, in all material respects,")* the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

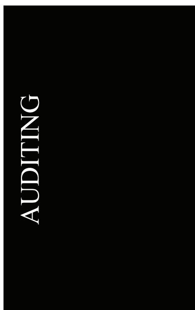
[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Auditor's Report for Audits Conducted in Accordance with Both ISAs and Auditing Standards of a Specific Jurisdiction or Country



61. The auditor may conduct the audit in accordance with both the ISAs and the auditing standards of a specific jurisdiction or country (for purposes of this ISA referred to as "national auditing standards").

62. **The auditor's report should refer to the audit having been conducted in accordance with the International Standards on Auditing only when the auditor has complied fully with all of the International Standards on Auditing relevant to the audit.**

[13] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances."

63. The auditor may refer to the audit having been conducted in accordance with both ISAs as well as national auditing standards when the auditor complies with each of the ISAs relevant to the audit and performs any additional audit procedures necessary to comply with the relevant standards of that jurisdiction or country. A reference to both the ISAs and national auditing standards is not appropriate if there is a conflict between the reporting requirements regarding the auditor's report in the ISAs and in the national auditing standards that affects the auditor's opinion or the need to include an emphasis of matter paragraph in the particular circumstances. For example, some national auditing standards prohibit the auditor from including an emphasis of matter paragraph to highlight a going concern problem, whereas ISA 701 requires the auditor to modify the auditor's report by adding an emphasis of matter paragraph in such circumstances. In case of such conflicts, the auditor's report refers only to the auditing standards (either ISAs or the relevant national auditing standards) in accordance with which the auditor has complied with the reporting requirements.

64. **When the auditor's report refers to both International Standards on Auditing and auditing standards of a specific jurisdiction or country, the auditor's report should identify the jurisdiction or country of origin of the auditing standards.**

65. **When the auditor prepares the auditor's report using the layout or wording specified by the law, regulation or auditing standards of the specific jurisdiction or country, the auditor's report should refer to the audit being conducted in accordance with both International Standards on Auditing and the auditing standards of the specific jurisdiction or country only if the auditor's report includes, at a minimum, each of the following elements:**

    (a) **A title;**

    (b) **An addressee, as required by the circumstances of the engagement;**

    (c) **An introductory paragraph that identifies the financial statements audited;**

    (d) **A description of management's responsibility for the preparation and fair presentation of the financial statements;**

    (e) **A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:**

        (i) **A reference to the International Standards on Auditing and the auditing standards of the specific jurisdiction or country, and**

        (ii) **A description of the work an auditor performs in an audit.**

    (f) **An opinion paragraph containing an expression of opinion on the financial statements[14] and a reference to the applicable financial**

[14] Circumstances when the auditor needs to modify the auditor's opinion are addressed in ISA 701, "Modifications to the Independent Auditor's Report." In some circumstances, the auditor may not be

reporting framework used to prepare the financial statements (including identifying the country of origin of the financial reporting framework when International Financial Reporting Standards or International Public Sector Accounting Standards are not used);

(g) **The auditor's signature;**

(h) **The date of the auditor's report; and**

(i) **The auditor's address.**

66. The auditor may be obliged by national law or regulation to use a layout or wording in the auditor's report that differs from that described in this ISA. When the differences only relate to the layout and wording of the auditor's report, the auditor will be considered to have complied with the reporting requirements of the ISAs provided that the auditor's report includes, at a minimum, each of the elements identified in paragraph 65 – even if using the layout and wording specified by national laws or regulations. Where specific requirements in a particular jurisdiction do not conflict with ISAs, the auditor adopts the layout and wording used in this ISA so that users can more readily recognize the auditor's report as a report on an audit conducted in accordance with ISAs.

Unaudited Supplementary Information Presented with Audited Financial Statements

67. **The auditor should be satisfied that any supplementary information presented together with the financial statements that is not covered by the auditor's opinion is clearly differentiated from the audited financial statements.**

68. As noted in paragraphs 25-26, the entity may be required to, or management may choose to, include supplementary information together with the financial statements. The auditor's opinion is considered to cover supplementary information that cannot be clearly differentiated from the financial statements because of its nature and how it is presented. In other circumstances, however, law or regulation may not require the supplementary information to be audited and management may not ask the auditor to include the supplementary information within the scope of the audit of the financial statements. When the supplementary information is not intended to be audited, the auditor considers whether that supplementary information is presented in a manner that could be construed as being covered by the auditor's opinion and, if so, asks management to change how the information is presented. The auditor considers, for example, where the unaudited information is presented in relation to the financial statements and any audited supplementary information, and whether it is clearly

able to express an opinion on the financial statements because the effect of a limitation on the scope of the audit is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence. In such circumstances, the auditor expresses a disclaimer of opinion.

labeled as "unaudited." The auditor asks management to remove any cross references from the financial statements to unaudited supplementary schedules or unaudited notes because the demarcation between the audited and unaudited information would not be sufficiently clear. Unaudited notes that are intermingled with the audited notes can also be misinterpreted as being audited. Therefore, the auditor asks the entity to place the unaudited information outside of the set of financial statements, or, if that is not possible in the circumstances, at a minimum, place the unaudited notes together at the end of the required notes to the financial statements and clearly label them as unaudited.

69. As noted in paragraph 23, when the auditor is aware that the financial statements will be included in a document that contains other information, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the audited financial statements are presented in the auditor's report. This helps readers differentiate the financial statements from other information not covered by the auditor's opinion.

70. **If the auditor concludes that the entity's presentation of any unaudited supplementary information does not differentiate it sufficiently from the audited financial statements, the auditor should explain in the auditor's report that that information has not been audited.**

71. The fact that supplementary information is unaudited does not relieve the auditor of the responsibility to read that information to identify material inconsistencies with the audited financial statements. The auditor's responsibilities with respect to unaudited supplementary information are consistent with those described in ISA 720, "Other Information in Documents Containing Audited Financial Statements."

Effective Date

72. This ISA is effective for auditors' reports dated on or after December 31, 2006.

Public Sector Perspective

1. *Some terms in this ISA such as "engagement partner" and "firm" should be read as referring to their public sector equivalents.*

2. *In the public sector, legislation governing the audit mandate may specify the layout of or words to be used in the auditor's report. When the auditor prepares the auditor's report using the layout or wording specified in such legislation, the auditor's report should refer to the audit being conducted in accordance with ISAs, and the legislation governing the audit mandate, only if the auditor's report includes, at a minimum, each of the elements specified in paragraph 65(a)-(j). As discussed in paragraph 66, where legislation governing the audit mandate does not conflict with ISAs, the auditor adopts the layout and wording used in this ISA so that users can more readily recognize the auditor's report as a report on an audit conducted in accordance with ISAs.*

3. *In addition, such legislation may specify the responsibilities of management and auditors in relation to the audit. The descriptions of such responsibilities included in the auditor's report will need to reflect the requirements of the legislation.*

INTERNATIONAL STANDARD ON AUDITING 701

MODIFICATIONS TO THE INDEPENDENT AUDITOR'S REPORT[1]

(Effective for auditors' reports dated on or after December 31, 2006)

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International Standard on Auditing (ISA) 701, "Modifications to the Independent Auditor's Report" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

1 This ISA establishes standards and provides guidance to be applied when the independent auditor's report should be modified. ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" establishes standards and provides guidance to be applied when the auditor is able to express an unqualified opinion and no modification to the auditor's report is necessary.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the circumstances when the independent auditor's report should be modified and the form and the content of the modifications to the auditor's report in those circumstances.

2. ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" establishes standards and provides guidance on the form and content of the independent auditor's report on a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation when the auditor is able to express an unqualified opinion and no modification to the auditor's report is necessary. ISA 800, "The Independent Auditor's Report on Special Purpose Audit Engagements" establishes standards and provides guidance on the form and content of the independent auditor's report in other audit engagements. This ISA describes how the auditor's report wording is modified in the following situations:

   Matters that Do Not Affect the Auditor's Opinion

   (a) Emphasis of matter

   Matters that Do Affect the Auditor's Opinion

   (a) Qualified opinion,

   (b) Disclaimer of opinion, or

   (c) Adverse opinion.

3. Uniformity in the form and content of each type of modified report will further the user's understanding of such reports. Accordingly, this ISA includes suggested wording of modifying phrases for use when issuing modified reports.

4. The illustrative reports in this ISA are based on the auditor's report on general purpose financial statements for a business enterprise. The principles relating to the circumstances when the auditor's report needs to be modified are, however, also applicable to reports on other engagements related to the audit of historical financial information, such as general purpose financial statements for entities of a different nature (for example, a not-for-profit organization) and the audit engagements described in ISA 800 the illustrative reports would be adapted as appropriate in the circumstances.

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Matters that Do Not Affect the Auditor's Opinion

5. In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter

paragraph does not affect the auditor's opinion. The paragraph would preferably be included after the paragraph containing the auditor's opinion but before the section on any other reporting responsibilities, if any. The emphasis of matter paragraph would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

6. **The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem.**

7. **The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than a going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements.** An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

8. An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor's report follows:

   > *Without qualifying our opinion we draw attention to Note X to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.*

   (An illustration of an emphasis of matter paragraph relating to going concern is set out in ISA 570, "Going Concern.")

9. The addition of a paragraph emphasizing a going concern problem or significant uncertainty is ordinarily adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

10. In addition to the use of an emphasis of matter paragraph for matters that affect the financial statements, the auditor may also modify the auditor's report by using an emphasis of matter paragraph, preferably after the paragraph containing the auditor's opinion but before the section on any other reporting responsibilities, if any, to report on matters other than those affecting the financial statements. For example, if an amendment to other information in a document containing audited financial statements is necessary and the entity refuses to make the amendment, the auditor would consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency.

Matters that Do Affect the Auditor's Opinion

11. An auditor may not be able to express an unqualified opinion when either of the following circumstances exist and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

    (a) There is a limitation on the scope of the auditor's work; or

    (b) There is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

    The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion. These circumstances are discussed more fully in paragraphs 16-21.

12. **A *qualified opinion* should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being 'except for' the effects of the matter to which the qualification relates.**

13. **A *disclaimer of opinion* should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.**

14. **An *adverse opinion* should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.**

15. **Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements.** Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion on the financial statements and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

Circumstances that may Result in Other than an Unqualified Opinion

Limitation on Scope

16. A limitation on the scope of the auditor's work may sometimes be imposed by the entity (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is

necessary). However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists, the auditor would ordinarily not accept such a limited engagement as an audit engagement, unless required by statute. Also, a statutory auditor would not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.

17. A scope limitation may be imposed by circumstances (for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories). It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.

18. **When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.**

19. Illustrations of these matters are set out below.

Limitation on Scope—Qualified Opinion

> "We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see paragraph 60 of ISA 700).
>
> Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – see paragraph 60 of ISA 700).
>
> Our responsibility is to express an opinion on these financial statements based on our audit. *Except as discussed in the following paragraph*, we conducted our audit in accordance with ... (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see paragraph 60 of ISA 700).
>
> *We did not observe the counting of the physical inventories as of December 31, 20X1, since that date was prior to the time we were initially engaged as auditors for the Company. Owing to the nature of the Company's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.*
>
> *In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities*, the financial statements give a true and fair view of ... (remaining words are the

same as illustrated in the opinion paragraph – paragraph 60 of ISA 700)."

Limitation on Scope—Disclaimer of Opinion

"We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – see paragraph 60 of ISA 700).

(Omit the sentence stating the responsibility of the auditor.)

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope limitation as follows:

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the Company.)

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements."

Disagreement with Management

20. The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. **If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.**

21. Illustrations of these matters are set out below.

Disagreement on Accounting Policies—Inappropriate Accounting Method—Qualified Opinion

"We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see paragraph 60 of ISA 700).

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – see paragraph 60 of ISA 700).

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Our responsibility is to … (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see paragraph 60 of ISA 700).

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Financial Reporting Standards. The provision for the year ended December 31, 20X1, should be xxx based on the straight-line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly, the fixed assets should be reduced by accumulated depreciation of xxx and the loss for the year and accumulated deficit should be increased by xxx and xxx, respectively.

In our opinion, *except for the effect on the financial statements of the matter referred to in the preceding paragraph*, the financial statements give a true and fair view of ... (remaining words are the same as illustrated in the opinion paragraph – see paragraph 60 of ISA 700)."

Disagreement on Accounting Policies—Inadequate Disclosure—Qualified Opinion

"We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see paragraph 60 of ISA 700).

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – see paragraph 60 of ISA 700).

Our responsibility is to … (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see paragraph 60 of ISA 700).

On January 15, 20X2, the Company issued debentures in the amount of xxx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 19X1. In our opinion, disclosure of this information is required by ...[2]

In our opinion, *except for the omission of the information included in the preceding paragraph*, the financial statements give a true and fair view of ... (remaining words are the same as illustrated in the opinion paragraph–see paragraph 60 of ISA 700)."

[2] Refer to relevant statutes or law.

Disagreement on Accounting Policies—Inadequate Disclosure—Adverse Opinion

"We have audited ... (remaining words are the same as illustrated in the introductory paragraph – see paragraph 60 of ISA 700).

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – see paragraph 60 of ISA 700).

Our responsibility is to … (remaining words are the same as illustrated in the auditor's responsibility paragraphs – see paragraph 60 of ISA 700).

(Paragraph(s) discussing the disagreement.)

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view of (or 'do not present fairly, in all material respects,') the financial position of ABC Company as of December 20, 19X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards."

Effective Date

22. This ISA is effective for auditors' reports dated on or after December 31, 2006.

INTERNATIONAL STANDARD ON AUDITING 710

COMPARATIVES

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 710, "Comparatives" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 710. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 710.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibilities regarding comparatives. It does not deal with situations when summarized financial statements are presented with the audited financial statements (for guidance see ISA 720, "Other Information in Documents Containing Audited Financial Statements," and ISA 800, "The Auditor's Report on Special Purpose Audit Engagements").

2. **The auditor should determine whether the comparatives comply in all material respects with the financial reporting framework applicable to the financial statements being audited.**

3. The existence of differences in financial reporting frameworks between countries results in comparative financial information being presented differently in each framework. Comparatives in financial statements, for example, may present amounts (such as financial position, results of operations, cash flows) and appropriate disclosures of an entity for more than one period, depending on the framework. The frameworks and methods of presentation are referred to in this ISA as follows:

   (a) *Corresponding figures* where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures" for the purpose of this ISA). These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures.

   (b) *Comparative financial statements* where amounts and other disclosures for the preceding period are included for comparison with the financial statements of the current period, but do not form part of the current period financial statements.

   (Refer to Appendix 1 to this ISA for discussion of these different reporting frameworks.)

4. Comparatives are presented in compliance with the applicable financial reporting framework. The essential audit reporting differences are that:

   (a) For corresponding figures, the auditor's report only refers to the financial statements of the current period; whereas

   (b) For comparative financial statements, the auditor's report refers to each period that financial statements are presented.

5. This ISA provides guidance on the auditor's responsibilities for comparatives and for reporting on them under the two frameworks in separate sections.

Corresponding Figures

The Auditor's Responsibilities

6. **The auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the applicable financial reporting framework.** The extent of audit procedures performed on the corresponding figures is significantly less than for the audit of the current period figures and is ordinarily limited to ensuring that the corresponding figures have been correctly reported and are appropriately classified. This involves the auditor evaluating whether:

   (a) Accounting policies used for the corresponding figures are consistent with those of the current period or whether appropriate adjustments and/or disclosures have been made; and

   (b) Corresponding figures agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and/or disclosures have been made.

7. When the financial statements of the prior period have been audited by another auditor, the incoming auditor evaluates whether the corresponding figures meet the conditions specified in paragraph 6 above and also follows the guidance in ISA 510, "Initial Engagements—Opening Balances."

8. When the financial statements of the prior period were not audited, the incoming auditor nonetheless assesses whether the corresponding figures meet the conditions specified in paragraph 6 above and also follows the guidance in ISA 510.

9. If the auditor becomes aware of a possible material misstatement in the corresponding figures when performing the current period audit, the auditor performs such additional audit procedures as are appropriate in the circumstances.

Reporting

10. **When the comparatives are presented as corresponding figures, the auditor should issue an auditor's report in which the comparatives are not specifically identified because the audit opinion is on the current period financial statements as a whole, including the corresponding figures.**

11. The auditor's report would make specific reference to the corresponding figures only in the circumstances described in paragraphs 12, 13, 15(b), and 16-19.

12. **When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification is:**

    (a) **Unresolved, and results in a modification of the auditor's report regarding the current period figures, the auditor's report should also be modified regarding the corresponding figures; or**

    (b) **Unresolved, but does not result in a modification of the auditor's report regarding the current period figures, the auditor's report should be modified regarding the corresponding figures.**

13. When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification is resolved and properly dealt with in the financial statements, the current report does not ordinarily refer to the previous modification. However, if the matter is material to the current period, the auditor may include an emphasis of matter paragraph dealing with the situation.

14. In performing the audit of the current period financial statements, the auditor, in certain unusual circumstances, may become aware of a material misstatement that affects the prior period financial statements on which an unmodified report has been previously issued.

15. **In such circumstances, the auditor should consider the guidance in ISA 560, "Subsequent Events" and:**

    (a) **If the prior period financial statements have been revised and reissued with a new auditor's report, the auditor should obtain sufficient appropriate audit evidence that the corresponding figures agree with the revised financial statements; or**

    (b) **If the prior period financial statements have not been revised and reissued, and the corresponding figures have not been properly restated and/or appropriate disclosures have not been made, the auditor should issue a modified report on the current period financial statements, modified with respect to the corresponding figures included therein.**

16. If, in the circumstances described in paragraph 14, the prior period financial statements have not been revised and an auditor's report has not been reissued, but the corresponding figures have been properly restated and/or appropriate disclosures have been made in the current period financial statements, the auditor may include an emphasis of matter paragraph describing the circumstances and referencing to the appropriate disclosures. In this regard, the auditor also considers the guidance in ISA 560.

Incoming Auditor—Additional Requirements

Prior Period Financial Statements Audited by Another Auditor

17. In some jurisdictions, the incoming auditor is permitted to refer to the predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period. **When the auditor decides to refer to another auditor, the incoming auditor's report should indicate:**

    (a) **That the financial statements of the prior period were audited by another auditor;**

    (b) **The type of report issued by the predecessor auditor and, if the report was modified, the reasons therefor; and**

    (c) **The date of that report.**

Prior Period Financial Statements Not Audited

18. **When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited.** Such a statement does not, however, relieve the auditor of the requirement to perform appropriate audit procedures regarding opening balances of the current period. Clear disclosure in the financial statements that the corresponding figures are unaudited is encouraged.

19. **In situations where the incoming auditor identifies that the corresponding figures are materially misstated, the auditor should request management to revise the corresponding figures or if management refuses to do so, appropriately modify the report.**

Comparative Financial Statements

The Auditor's Responsibilities

20. **The auditor should obtain sufficient appropriate audit evidence that the comparative financial statements meet the requirements of the applicable financial reporting framework.** This involves the auditor evaluating whether:

    (a) Accounting policies of the prior period are consistent with those of the current period or whether appropriate adjustments and/or disclosures have been made; and

    (b) Prior period figures presented agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and disclosures have been made.

21. When the financial statements of the prior period have been audited by another auditor, the incoming auditor evaluates whether the comparative financial statements meet the conditions in paragraph 20 above and also follows the guidance in ISA 510.

22. When the financial statements of the prior period were not audited, the incoming auditor nonetheless evaluates whether the comparative financial statements meet the conditions specified in paragraph 20 above and also follows the guidance in ISA 510.

23. If the auditor becomes aware of a possible material misstatement in the prior year figures when performing the current period audit, the auditor performs such additional audit procedures as are appropriate in the circumstances.

Reporting

24. **When the comparatives are presented as comparative financial statements, the auditor should issue a report in which the comparatives are specifically identified because the audit opinion is expressed individually on the financial statements of each period presented.** Since the auditor's report on comparative financial statements applies to the individual financial statements presented, the auditor may express a qualified or adverse opinion, disclaim an opinion, or include an emphasis of matter paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements.

25. **When reporting on the prior period financial statements in connection with the current year's audit, if the opinion on such prior period financial statements is different from the opinion previously expressed, the auditor should disclose the substantive reasons for the different opinion in an emphasis of matter paragraph.** This may arise when the auditor becomes aware of circumstances or events that materially affect the financial statements of a prior period during the course of the audit of the current period.

Incoming Auditor—Additional Requirements

Prior Period Financial Statements Audited by Another Auditor

26. **When the financial statements of the prior period were audited by another auditor:**

    (a) **The predecessor auditor may reissue the auditor's report on the prior period with the incoming auditor only reporting on the current period; or**

    (b) **The incoming auditor's report should state that the prior period was audited by another auditor and the incoming auditor's report should indicate:**

        (i) **That the financial statements of the prior period were audited by another auditor;**

        (ii) **The type of report issued by the predecessor auditor and if the report was modified, the reasons therefor; and**

(iii) **The date of that report.**

27. In performing the audit on the current period financial statements, the incoming auditor, in certain unusual circumstances, may become aware of a material misstatement that affects the prior period financial statements on which the predecessor auditor had previously reported without modification.

28. **In these circumstances, the incoming auditor should discuss the matter with management and, after having obtained management's authorization, contact the predecessor auditor and propose that the prior period financial statements be restated. If the predecessor agrees to reissue the auditor's report on the restated financial statements of the prior period, the auditor should follow the guidance in paragraph 26.**

29. If, in the circumstances discussed in paragraph 27, the predecessor does not agree with the proposed restatement or refuses to reissue the auditor's report on the prior period financial statements, the introductory paragraph of the auditor's report may indicate that the predecessor auditor reported on the financial statements of the prior period before restatement. In addition, if the incoming auditor is engaged to audit and applies sufficient audit procedures to be satisfied as to the appropriateness of the restatement adjustment, the auditor may also include the following paragraph in the report:

> *We also audited the adjustments described in Note X that were applied to restate the 19X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.*

Prior Period Financial Statements Not Audited

30. **When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the comparative financial statements are unaudited.** Such a statement does not, however, relieve the auditor of the requirement to carry out appropriate audit procedures regarding opening balances of the current period. Clear disclosure in the financial statements that the comparative financial statements are unaudited is encouraged.

31. **In situations where the incoming auditor identifies that the prior year unaudited figures are materially misstated, the auditor should request management to revise the prior year's figures or if management refuses to do so, appropriately modify the report.**

Effective Date

32. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.

Appendix 1

Discussion of Financial Reporting Frameworks for Comparatives

1. Comparatives covering one or more preceding periods provide the users of financial statements with information necessary to identify trends and changes affecting an entity over a period of time.

2. Under financial reporting frameworks (both implicit and explicit) prevailing in a number of countries, comparability and consistency are desirable qualities for financial information. Defined in broadest terms, comparability is the quality of having certain characteristics in common and comparison is normally a quantitative assessment of the common characteristics. Consistency is a quality of the relationship between two accounting numbers. Consistency (for example, consistency in the use of accounting principles from one period to another, the consistency of the length of the reporting period, etc.) is a prerequisite for true comparability.

3. There are two broad financial reporting frameworks for comparatives: the corresponding figures and the comparative financial statements.

4. Under the corresponding figures framework, the corresponding figures for the prior period(s) are an integral part of the current period financial statements and have to be read in conjunction with the amounts and other disclosures relating to the current period. The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

5. Under the comparative financial statements framework, the comparative financial statements for the prior period(s) are considered separate financial statements. Accordingly, the level of information included in those comparative financial statements (including all statement amounts, disclosures, footnotes and other explanatory statements to the extent that they continue to be of significance) approximates that of the financial statements of the current period.

Appendix 2

Example Auditors' Reports

Example A Corresponding Figures: Example report for the circumstances described in paragraph 12(a)

AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying[1] balance sheet of the ABC Company as of December 31, 19X1, and income statement, statement of change in equity and cash flow statement for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to applicable national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Accounting Standards (or refer to applicable national standards). This is the result of a decision taken by management at the start of the preceding financial year and caused us to qualify our audit opinion on the financial statements relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by xxx in 19X1 and xxx in 19X0, the fixed assets should be reduced by accumulated depreciation of xxx in 19X1 and xxx in 19X0, and the accumulated loss should be increased by xxx in 19X1 and xxx in 19X0.

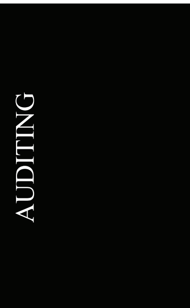
In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view of (or

[1] The reference can be by page numbers.

present fairly, in all material respects) the financial position of the Company as of December 31, 19X1, and of its financial performance and its cash flows for the year then ended in accordance with ...[2] (and comply with ...[3]).

AUDITOR

Date
Address



2 Indicate International Accounting Standards or applicable national standards.

3 Reference to applicable statutes or laws.

Example B Corresponding Figures: Example report for the circumstances described in paragraph 12(b)

AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying[4] balance sheet of the ABC Company as of December 31, 19X1, and income statement, statement of change in equity and cash flow statement for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to applicable national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Because we were appointed auditors of the Company during 19X0, we were not able to observe the counting of the physical inventories at the beginning of that (period) or satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories enter into the determination of the results of operations, we were unable to determine whether adjustments to the results of operations and opening retained earnings might be necessary for 19X0. Our auditor's report on the financial statements for the (period) ended (balance sheet date) 19X0 was modified accordingly.

In our opinion, except for the effect on the corresponding figures for 19X0 of the adjustments, if any, to the results of operations for the (period) ended 19X0, which we might have determined to be necessary had we been able to observe beginning inventory quantities as at ..., the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of December 31, 19X1, and of its financial performance and its cash flows for the year then ended in accordance with...[5] (and comply with ....[6]).

AUDITOR

Date
Address

---

4 The reference can be by page numbers.

5 Indicate International Accounting Standards or applicable national standards.

6 Reference to applicable statutes or laws.

Example C **Comparative Financial Statements: Example report for the circumstances described in paragraph 24**

AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying[7] balance sheets of the ABC Company as of December 31, 19X1 and 19X0, and income statement, statement of change in equity and cash flow statement for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with International Standards on Auditing (or refer to applicable national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Accounting Standards (or refer to applicable national standards). Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by xxx in 19X1 and xxx in 19X0, the fixed assets should be reduced by accumulated depreciation of xxx in 19X1 and xxx in 19X0, and the accumulated loss should be increased by xxx in 19X1 and xxx in 19X0.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of December 31, 19X1 and 19X0, and of its financial performance and its cash flows for the year then ended in accordance with...[8] (and comply with ....[9]).

AUDITOR

Date
Address

7 The reference can be by page numbers.

8 Indicate International Accounting Standards or applicable national standards.

9 Reference to applicable statutes or laws.

Example D Corresponding Figures: Example report for the circumstances described in paragraph 17

AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying[10] balance sheet of the ABC Company as of December 31, 19X1, and income statement, statement of change in equity and cash flow statement for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Company as of December 31, 19X0, were audited by another auditor whose report dated March 31, 19X1, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with International Standards on Auditing (or refer to applicable national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of December 31, 19X1, and of its financial performance and its cash flows for the year then ended in accordance with...[11] (and comply with ...[12]).

AUDITOR

Date
Address

---

[10] The reference can be by page numbers.

[11] Indicate International Accounting Standards or applicable national standards.

[12] Reference to applicable statutes or laws.

Example E Comparative Financial Statements: Example report for the circumstances described in paragraph 26(b)

AUDITOR'S REPORT

(APPROPRIATE ADDRESSEE)

We have audited the accompanying[13] balance sheet of the ABC Company as of December 31, 19X1, and income statement, statement of change in equity and cash flow statement for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Company as of December 31, 19X0, were audited by another auditor whose report dated March 31, 19X1, expressed a qualified opinion due to a disagreement as to the adequacy of the provision for doubtful receivables.

We conducted our audit in accordance with International Standards on Auditing (or refer to applicable national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The receivables referred to above are still outstanding at December 31, 19X1 and no provision for potential loss has been made in the financial statements. Accordingly, the provision for doubtful receivables at December 31, 19X1 and 19X0 should be increased by xxx, the net profit for 19X0 decreased by xxx and the retained earnings at December 31, 19X1 and 19X0 reduced by xxx.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the 19X1 financial statements referred to above give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of December 31, 19X1, and of its financial performance and its cash flows for the year then ended in accordance with...[14] (and comply with ...[15]).

AUDITOR

Date
Address

[13] The reference can be by page numbers.

[14] Indicate International Accounting Standards or applicable national standards.

[15] Reference to applicable statutes or laws.

INTERNATIONAL STANDARD ON AUDITING 720

OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 720, "Other Information in Documents Containing Audited Financial Statements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 720. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 720.

The IAASB's clarity drafting conventions have been applied to ISA 720. ISA 720 (Redrafted), "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements" can be found in Part II of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements*. It is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements. This ISA applies when an annual report is involved; however, it may also apply to other documents, such as those used in securities offerings.

2. **The auditor should read the other information to identify material inconsistencies with the audited financial statements.**

3. A "material inconsistency" exists when other information contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.

4. An entity ordinarily issues on an annual basis a document which includes its audited financial statements together with the auditor's report thereon. This document is frequently referred to as the "annual report." In issuing such a document, an entity may also include, either by law or custom, other financial and non-financial information. For the purpose of this ISA, such other financial and non-financial information is called "other information."

5. Examples of other information include a report by management or those charged with governance on operations, financial summaries or highlights, employment data, planned capital expenditures, financial ratios, names of officers and directors and selected quarterly data.

6. In certain circumstances, the auditor has a statutory or contractual obligation to report specifically on other information. In other circumstances, the auditor has no such obligation. However, the auditor needs to give consideration to such other information when issuing a report on the financial statements, as the credibility of the audited financial statements may be undermined by inconsistencies which may exist between the audited financial statements and other information.

7. Some jurisdictions require the auditor to apply specific procedures to certain of the other information, for example, required supplementary data and interim financial information. If such other information is omitted or contains deficiencies, the auditor may be required to refer to the matter in the auditor's report.

8. When there is an obligation to report specifically on other information, the auditor's responsibilities are determined by the nature of the engagement and by local legislation and professional standards. When such responsibilities involve the review of other information, the auditor will need to follow the guidance on review engagements in the appropriate ISAs.

Access to Other Information

9. In order that an auditor can consider other information included in the annual report, timely access to such information will be required. The auditor therefore needs to make appropriate arrangements with the entity to obtain such information prior to the date of the auditor's report. In certain circumstances, all the other information may not be available prior to such date. In these circumstances, the auditor would follow the guidance in paragraphs 20-23.

Consideration of Other Information

10. The objective and scope of an audit of financial statements are formulated on the premise that the auditor's responsibility is restricted to information identified in the auditor's report. Accordingly, the auditor has no specific responsibility to determine that other information is properly stated.

Material Inconsistencies

11. **If, on reading the other information, the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other information needs to be amended.**

12. **If an amendment is necessary in the audited financial statements and the entity refuses to make the amendment, the auditor should express a qualified or adverse opinion.**

13. **If an amendment is necessary in the other information and the entity refuses to make the amendment, the auditor should consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency or taking other actions.** The actions taken, such as not issuing the auditor's report or withdrawing from the engagement, will depend upon the particular circumstances and the nature and significance of the inconsistency. The auditor would also consider obtaining legal advice as to further action.

Material Misstatements of Fact

14. While reading the other information for the purpose of identifying material inconsistencies, the auditor may become aware of an apparent material misstatement of fact.

15. For the purpose of this ISA, a "material misstatement of fact" in other information exists when such information, not related to matters appearing in the audited financial statements, is incorrectly stated or presented.

16. **If the auditor becomes aware that the other information appears to include a material misstatement of fact, the auditor should discuss the matter with the entity's management.** When discussing the matter with the entity's management, the auditor may not be able to evaluate the validity of the

other information and management's responses to the auditor's inquiries, and would need to consider whether valid differences of judgment or opinion exist.

17. **When the auditor still considers that there is an apparent misstatement of fact, the auditor should request management to consult with a qualified third party, such as the entity's legal counsel and should consider the advice received.**

18. **If the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor should consider taking further appropriate action.** The actions taken could include such steps as notifying those charged with governance in writing of the auditor's concern regarding the other information and obtaining legal advice.

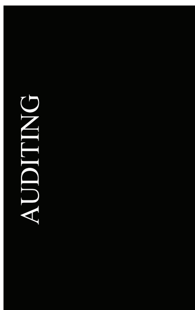
Availability of Other Information After the Date of the Auditor's Report

19. When all the other information is not available to the auditor prior to the date of the auditor's report, the auditor would read the other information at the earliest possible opportunity thereafter to identify material inconsistencies.

20. If, on reading the other information, the auditor identifies a material inconsistency or becomes aware of an apparent material misstatement of fact, the auditor would determine whether the audited financial statements or the other information need revision.

21. When revision of the audited financial statements is appropriate, the guidance in ISA 560, "Subsequent Events" would be followed.

22. When revision of the other information is necessary and the entity agrees to make the revision, the auditor would carry out the audit procedures necessary under the circumstances. The audit procedures may include reviewing the steps taken by management to ensure that individuals in receipt of the previously issued financial statements, the auditor's report thereon and the other information are informed of the revision.



23. **When revision of the other information is necessary but management refuses to make the revision, the auditor should consider taking further appropriate action.** The actions taken could include such steps as notifying those charged with governance in writing of the auditor's concern regarding the other information and obtaining legal advice.

Public Sector Perspective

1. *This ISA is applicable in the context of the audit of financial statements. In the public sector, the auditor may often have a statutory or contractual obligation to report specifically on other information. As paragraph 8 of this ISA indicates, the procedures stated in this ISA would not be adequate to satisfy legislative or other audit requirements related to, for example, the expression of an opinion on the reliability of performance indicators and other information contained in the annual report. It would be inappropriate to apply this ISA in circumstances where the auditor does have an obligation to express an opinion on such information. In the absence of specific auditing requirements in relation to "other information," the broad principles contained in this ISA are applicable.*

INTERNATIONAL STANDARD ON AUDITING 800

THE INDEPENDENT AUDITOR'S REPORT ON SPECIAL PURPOSE AUDIT ENGAGEMENTS

(Effective for auditors' reports dated on or after December 31, 2006)*

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International Standard on Auditing (ISA) 800, "The Auditor's Report on Special Purpose Audit Engagements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

AUDITING

* ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" gave rise to conforming amendments to ISA 800. These amendments are effective for auditor's reports dated on or after December 31, 2006 and have been incorporated in the text of ISA 800.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance in connection with special purpose audit engagements including:

   - A complete set of financial statements prepared in accordance with ~~a~~ an other comprehensive basis of accounting;
   - A component of a complete set of general purpose or special purpose financial statements, such as a single financial statement, specified accounts, elements of accounts, or items in a financial statement;
   - Compliance with contractual agreements; and
   - Summarized financial statements.

   This ISA does not apply to review, agreed-upon procedures or compilation engagements.

2. **The auditor should review and assess the conclusions drawn from the audit evidence obtained during the special purpose audit engagement as the basis for an expression of opinion. The report should contain a clear written expression of opinion.**

General Considerations

3. The nature, timing and extent of work to be performed in a special purpose audit engagement will vary with the circumstances. **Before undertaking a special purpose audit engagement, the auditor should ensure there is agreement with the client as to the exact nature of the engagement and the form and content of the report to be issued.**

4. In planning the audit work, the auditor will need a clear understanding of the purpose for which the information being reported on is to be used, and who is likely to use it. To avoid the possibility of the auditor's report being used for purposes for which it was not intended, the auditor may wish to indicate in the report the purpose for which the report is prepared and any restrictions on its distribution and use.

5. **The auditor's report on a special purpose audit engagement, except for a report on summarized financial statements, should include the following basic elements, ordinarily in the following layout:**

   (a) **Title;**[1]

[1] It may be appropriate to use the term "Independent Auditor" in the title to distinguish the auditor's report from reports that might be issued by others, such as officers of the entity, or from the reports of other auditors who may not have to abide by the same ethical requirements as the independent auditor.

(b) **Addressee;**

(c) **Opening or introductory paragraph, including:**

(i) **Identification of the financial information audited; and**

(ii) **A statement of the responsibility of the entity's management and the responsibility of the auditor;**

(d) **A scope paragraph (describing the nature of an audit), including:**

(i) **The reference to the ISAs applicable to special purpose audit engagements or relevant national standards or practices; and**

(ii) **A description of the work the auditor performed;**

(e) **Opinion paragraph containing an expression of opinion on the financial information;**

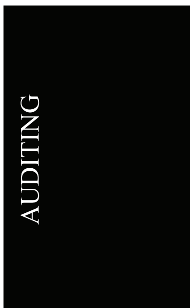
(f) **Date of the report;**

(g) **Auditor's address; and**

(h) **Auditor's signature.**

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding.

6. In the case of financial information to be supplied by an entity to government authorities, trustees, insurers and other entities there may be a prescribed format for the auditor's report. Such prescribed reports may not conform to the requirements of this ISA. For example, the prescribed report may require a certification of fact when an expression of opinion is appropriate, may require an opinion on matters outside the scope of the audit or may omit essential wording. **When requested to report in a prescribed format, the auditor should consider the substance and wording of the prescribed report and, when necessary, should make appropriate changes to conform to the requirements of this ISA, either by rewording the form or by attaching a separate report.**



7. When the information on which the auditor has been requested to report is based on the provisions of an agreement, the auditor needs to consider whether any significant interpretations of the agreement have been made by management in preparing the information. An interpretation is significant when adoption of another reasonable interpretation would have produced a material difference in the financial information.

8. **The auditor should consider whether any significant interpretations of an agreement on which the financial information is based are clearly disclosed in the financial information.** The auditor may wish to make reference in the auditor's report on the special purpose audit engagement to the note within the financial information that describes such interpretations.

Reports on Financial Statements Prepared in Accordance with an Other Comprehensive Basis of Accounting

9. A comprehensive basis of accounting comprises a set of criteria used in preparing financial statements which applies to all material items and which has substantial support. As discussed in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," financial statements that are not prepared to meet the common information needs of a wide range of users may be prepared to meet the financial information needs of specific users. The information needs of such users will determine the applicable financial reporting framework in such circumstances (which is referred to in this ISA as "an other comprehensive basis of accounting"). Financial statements prepared in accordance with such financial reporting frameworks may be the only financial statements prepared by an entity and, in such circumstances, are often used by users in addition to those for whom the financial reporting framework is designed. Despite the broad distribution of the financial statements in those circumstances, the financial statements are still considered to be designed to meet the financial information needs of specific users for purposes of the ISAs. In addition, although specific users may not be identified, financial statements that are prepared in accordance with a framework that is not designed to achieve fair presentation are also considered to be prepared in accordance with an other comprehensive basis of accounting. Examples of financial reporting frameworks that are designed to address the needs of specific users include the following:

   - The tax basis of accounting for a set of financial statements that accompany an entity's tax return.
   - The cash receipts and disbursements basis of accounting for cash flow information that a business enterprise may be requested to prepare by creditors.
   - The financial reporting provisions of a government regulatory agency for a set of financial statements prepared for regulatory purposes.

10. **The auditor's report on financial statements prepared in accordance with an other comprehensive basis of accounting should include a statement that indicates the basis of accounting used or should refer to the note to the financial statements giving that information. The opinion should state whether the financial statements are prepared, in all material respects, in accordance with the identified basis of accounting.** The terms used to express the auditor's opinion are "give a true and fair view" or "present fairly, in all material respects," which are equivalent terms. Appendix 1 to this ISA gives examples of auditors' reports on financial statements prepared in accordance with an other comprehensive basis of accounting.

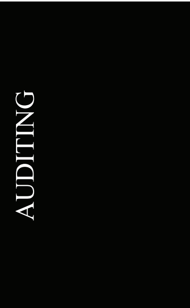
11. The auditor would consider whether the title of, or a note to, the financial statements makes it clear to the reader that such statements are not prepared in

accordance with International Financial Reporting Standards or generally accepted accounting principles promulgated by a recognized standards setting organization. For example, a tax basis financial statement might be entitled "Statement of Income and Expenses—Income Tax Basis." **If the financial statements prepared on an other comprehensive basis of accounting are not suitably titled or the basis of accounting is not adequately disclosed, the auditor should issue an appropriately modified report.**

Reports on a Component of Financial Statements

12. The auditor may be requested to express an opinion on one or more components of financial statements, for example, a single financial statement such as a balance sheet, accounts receivable, inventory, an employee's bonus calculation or a provision for income taxes. The component might be prepared to meet the financial information needs of specific users and have limited distribution, or may be intended to meet the information needs of a wide range of users and, therefore, prepared in accordance with the relevant requirements of an applicable financial reporting framework. This type of engagement may be undertaken as a separate engagement or in conjunction with an audit of the entity's financial statements (see Other Reporting Responsibilities in ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements"). However, this type of engagement does not result in a report on the financial statements taken as a whole and, accordingly, the auditor would express an opinion only as to whether the component audited is prepared, in all material respects, in accordance with the identified basis of accounting.

13. Many financial statement items are interrelated, for example, sales and receivables, and inventory and payables. Accordingly, when reporting on a component of financial statements, the auditor will sometimes be unable to consider the subject of the audit in isolation and will need to examine certain other financial information. **In determining the scope of the engagement, the auditor should consider those financial statement items that are interrelated and which could materially affect the information on which the audit opinion is to be expressed.**



14. **The auditor should consider the concept of materiality in relation to the component of financial statements being reported upon.** For example, a particular account balance provides a smaller base against which to measure materiality compared with the financial statements taken as a whole. Consequently, the auditor's examination will ordinarily be more extensive than if the same component were to be audited in connection with a report on the entire financial statements.

15. **The auditor's report on a component of financial statements should include a statement that indicates the applicable financial reporting framework in accordance with which the component is presented or refers to an agreement that specifies the basis of accounting used. The opinion should**

state whether the component is prepared, in all material respects, in accordance with the applicable financial reporting framework or identified basis of accounting. Appendix 2 to this ISA gives examples of auditors' reports on components of financial statements.

16. **When an adverse opinion or disclaimer of opinion on the entire financial statements has been expressed, the auditor should report on components of the financial statements only if those components are not so extensive as to constitute a major portion of the financial statements.** To do otherwise may overshadow the report on the entire financial statements.

Reports on Compliance with Contractual Agreements

17. The auditor may be requested to report on an entity's compliance with certain aspects of contractual agreements, such as bond indentures or loan agreements. Such agreements ordinarily require the entity to comply with a variety of covenants involving such matters as payments of interest, maintenance of predetermined financial ratios, restriction of dividend payments and the use of the proceeds of sales of property.

18. **Engagements to express an opinion as to an entity's compliance with contractual agreements should be undertaken only when the overall aspects of compliance relate to accounting and financial matters within the scope of the auditor's professional competence.** However, when there are particular matters forming part of the engagement that are outside the auditor's expertise, the auditor would consider using the work of an expert.

19. **The report should state whether, in the auditor's opinion, the entity has complied with the particular provisions of the agreement.** Appendix 3 to this ISA gives examples of auditors' reports on compliance given in a separate report and in a report accompanying financial statements.

Reports on Summarized Financial Statements

20. An entity may prepare financial statements summarizing its annual audited financial statements for the purpose of informing user groups interested in the highlights only of the entity's financial position and the results of its operations**. Unless the auditor has expressed an audit opinion on the financial statements from which the summarized financial statements were derived, the auditor should not report on summarized financial statements.**

21. Summarized financial statements are presented in considerably less detail than annual audited financial statements. Therefore, such financial statements need to clearly indicate the summarized nature of the information and caution the reader that, for a better understanding of an entity's financial position and the results of its operations, summarized financial statements are to be read in conjunction with the entity's most recent audited financial statements which include all disclosures required by the relevant financial reporting framework.

22. Summarized financial statements need to be appropriately titled to identify the audited financial statements from which they have been derived, for example, "Summarized Financial Information Prepared from the Audited Financial Statements for the Year Ended December 31, 19X1."

23. Summarized financial statements do not contain all the information required by the financial reporting framework used for the annual audited financial statements. Consequently, wording such as "true and fair" or "present fairly, in all material respects," is not used by the auditor when expressing an opinion on summarized financial statements.

24. **The auditor's report on summarized financial statements should include the following basic elements ordinarily in the following layout:**

    (a) **Title;**[2]

    (b) **Addressee;**

    (c) **An identification of the audited financial statements from which the summarized financial statements were derived;**

    (d) **A reference to the date of the audit report on the unabridged financial statements and the type of opinion given in that report;**

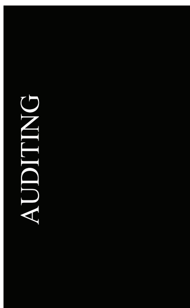
    (e) **An opinion as to whether the information in the summarized financial statements is consistent with the audited financial statements from which it was derived. When the auditor has issued a modified opinion on the unabridged financial statements yet is satisfied with the presentation of the summarized financial statements, the auditor's report should state that, although consistent with the unabridged financial statements, the summarized financial statements were derived from financial statements on which a modified auditor's report was issued;**

    (f) **A statement, or reference to the note within the summarized financial statements, which indicates that for a better understanding of an entity's financial performance and position and of the scope of the audit performed, the summarized financial statements should be read in conjunction with the unabridged financial statements and the auditor's report thereon;**

    (g) **Date of the report;**

    (h) **Auditor's address; and**

    (i) **Auditor's signature.**



2 See footnote 1.

Appendix 4 to this ISA gives examples of auditors' reports on summarized financial statements.

Effective Date

25. This ISA is effective for auditors' reports dated on or after December 31, 2006.

Public Sector Perspective

1. *Some of the engagements considered "special purpose audit engagements" in the private sector are not special purpose in the public sector. For example, reports on financial statements prepared in accordance with a comprehensive basis of accounting other than IASs or national standards are ordinarily the norm, not the exception in the public sector. This has to be noted and guidance provided to the auditor on his or her responsibility to assess whether the accounting policies will result in misleading information.*

2. *A factor that also has to be considered is that public sector auditors' reports are ordinarily public documents and therefore, it is not possible to restrict the report to specific users.*

Appendix 1

Examples of Reports on Financial Statements Prepared in Accordance with a Comprehensive Basis of Accounting Other than International Accounting Standards or National Standards

A Statement of Cash Receipts and Disbursements

AUDITOR'S REPORT TO .....

We have audited the accompanying statement of ABC Company's cash receipts and disbursements for the year ended December 31, 19X1.[3] This statement is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the accompanying statement based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Company's policy is to prepare the accompanying statement on the cash receipts and disbursements basis. On this basis revenue is recognized when received rather than when earned, and expenses are recognized when paid rather than when incurred.

In our opinion, the accompanying statement gives a true and fair view of (or presents fairly, in all material respects) the revenue collected and expenses paid by the Company during the year ended December 31, 19X1 in accordance with the cash receipts and disbursements basis as described in Note X.

AUDITOR

Date
Address

[3] Provide suitable identification, such as by reference to page numbers or by identifying the individual statement.

Financial Statements Prepared on the Entity's Income Tax Basis

AUDITOR'S REPORT TO .....

We have audited the accompanying income tax basis financial statements of ABC Company for the year ended December 31, 19X1.[4] These statements are the responsibility of ABC Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of December 31, 19X1 and its revenues and expenses for the year then ended, in accordance with the basis of accounting used for income tax purposes as described in Note X.

AUDITOR

Date
Address

---

4 See footnote 3.

Appendix 2

Example of Reports on Components of Financial Statements

Schedule of Accounts Receivable

AUDITOR'S REPORT TO .....

We have audited the accompanying schedule of accounts receivable of ABC Company for the year ended December 31, 19X1.[5] This schedule is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the schedule based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the schedule. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of accounts receivable gives a true and fair view of (or presents fairly, in all material respects) the accounts receivable of the Company as of December 31, 19X1 in accordance with ... [6]

AUDITOR

Date
Address

---

[5] See footnote 3.

[6] Indicate the relevant national standards or refer to International Accounting Standards, the terms of an agreement or any described basis of accounting.

Schedule of Profit Participation

AUDITOR'S REPORT TO .....

We have audited the accompanying schedule of DEF's profit participation for the year ended December 31, 19X1.[7] This schedule is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the schedule based on our audit.

We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the schedule. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of profit participation gives a true and fair view of (or presents fairly, in all material respects) DEF's participation in the profits of the Company for the year ended December 31, 19X1 in accordance with the provisions of the employment agreement between DEF and the Company dated June 1, 19X0.

AUDITOR

Date
Address

[7] See footnote 3.

Appendix 3

Examples of Reports on Compliance

Separate Report

AUDITOR'S REPORT TO .....

We have audited ABC Company's compliance with the accounting and financial reporting matters of sections XX to XX inclusive of the Indenture dated May 15, 19X1 with DEF Bank.

We conducted our audit in accordance with International Standards on Auditing applicable to compliance auditing (or refer to relevant national standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether ABC Company has complied with the relevant sections of the Indenture. An audit includes examining appropriate evidence on a test basis. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Company was, in all material respects, in compliance with the accounting and financial reporting matters of the sections of the Indenture referred to in the preceding paragraphs as of December 31, 19X1.

AUDITOR

Date
Address

Report Accompanying Financial Statements

AUDITOR'S REPORT TO .....

We have audited the accompanying balance sheet of the ABC Company as of December 31, 19X1, and the income statement and statement of changes in equity and cash flow statement for the year then ended (the reference can be by page numbers). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We have also audited ABC Company's compliance with the accounting and financial reporting matters of sections XX to XX inclusive of the Indenture dated May 15, 19X1 with DEF Bank.

We conducted our audits in accordance with International Standards on Auditing (or refer to relevant national standards or practices) applicable to the audit of financial statements and to compliance auditing. Those Standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and about whether ABC Company has complied with the relevant sections of the Indenture. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion:

(a) The financial statements give a true and fair view of (or present fairly, in all material respects) the financial position of the Company as of December 31, 19X1, and of its financial performance and its cash flows for the year then ended in accordance with ... (and comply with ...); and

(b) The Company was, in all material respects, in compliance with the accounting and financial reporting matters of the sections of the Indenture referred to in the preceding paragraphs as of December 31, 19X1.

AUDITOR

Date
Address

Appendix 4

Examples of Reports on Summarized Financial Statements

When an Unqualified Opinion was Expressed on the Annual Audited Financial Statements

AUDITOR'S REPORT TO .....

We have audited the financial statements of ABC Company for the year ended December 31, 19X0, from which the summarized financial statements[8] were derived, in accordance with International Standards on Auditing (or refer to relevant national standards or practices). In our report dated March 10, 19X1 we expressed an unqualified opinion on the financial statements from which the summarized financial statements were derived.

In our opinion, the accompanying summarized financial statements are consistent, in all material respects, with the financial statements from which they were derived.

For a better understanding of the Company's financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized financial statements were derived and our audit report thereon.

AUDITOR

Date
Address

[8] See footnote 3.

When a Qualified Opinion was Expressed on the Annual Audited Financial Statements

AUDITOR'S REPORT TO .....

We have audited the financial statements of ABC Company for the year ended December 31, 19X0, from which the summarized financial statements[9] were derived, in accordance with International Standards on Auditing (or refer to relevant national standards or practices). In our report dated March 10, 19X1 we expressed an opinion that the financial statements from which the summarized financial statements were derived gave a true and fair view of (or presented fairly, in all material respects) ... except that inventory had been overstated by ....

In our opinion, the accompanying summarized financial statements are consistent, in all material respects, with the financial statements from which they were derived and on which we expressed a qualified opinion.

For a better understanding of the Company's financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized financial statements were derived and our audit report thereon.

AUDITOR

Date
Address

[9] See footnote 3.

INTERNATIONAL AUDITING PRACTICE STATEMENT 1000

INTER-BANK CONFIRMATION PROCEDURES

(This Statement is effective)

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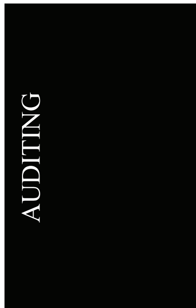
International Auditing Practice Statement (IAPS) 1000, "Inter-bank Confirmation Procedures" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of IAPSs.

This International Auditing Practice Statement was prepared and approved jointly by the International Auditing Practices Committee of the International Federation of Accountants and the Committee on Banking Regulations and Supervisory Practices of the Group of Ten major industrialized countries and Switzerland in November 1983 for publication in February 1984.

This Statement is published to provide practical assistance to external independent auditors and also internal auditors and inspectors on inter-bank confirmation procedures. This statement is not intended to have the authority of an International Standard on Auditing.



Introduction

1. The purpose of this International Auditing Practice Statement (IAPS) is to provide assistance on inter-bank confirmation procedures to the external independent auditor and also to bank management, such as internal auditors or inspectors. The guidance contained in this IAPS should contribute to the effectiveness of inter-bank confirmation procedures and to the efficiency of processing replies.

2. An important audit step in the examination of bank financial statements and related information is to request direct confirmation from other banks of both balances and other amounts which appear in the balance sheet and other information which may not be shown on the face of the balance sheet but which may be disclosed in the notes to the accounts. Off balance sheet items requiring confirmation include, such items as guarantees, forward purchase and sale commitments, repurchase options, and offset arrangements. This type of audit evidence is valuable because it comes directly from an independent source and, therefore, provides greater assurance of reliability than that obtained solely from the bank's own records.

3. The auditor, in seeking to obtain inter-bank confirmations, may encounter difficulties in relation to language, terminology, consistent interpretation and scope of matters covered by the reply. Frequently, these difficulties result from the use of different kinds of confirmation requests or misunderstandings about what they are intended to cover.

4. Audit procedures may differ from country to country, and consequently local practices will have relevance to the way in which inter-bank confirmation procedures are applied. While this IAPS does not purport to describe a comprehensive set of audit procedures, nevertheless, it does emphasize some important steps which should be followed in the use of a confirmation request.

The Need for Confirmation

5. An essential feature of management control over business relations, with individuals or groups of financial institutions, is the ability to obtain confirmation of transactions with those institutions and of the resulting positions. The requirement for bank confirmation arises from the need of the bank's management and its auditors to confirm the financial and business relationships between the following:

   - The bank and other banks within the same country.
   - The bank and other banks in different countries.
   - The bank and its non-bank customers.

While inter-bank relationships are similar in nature to those between the bank and a non-bank customer, there may be special significance in some inter-bank relationships, for example, in connection with certain types of "off balance sheet" transactions, such as contingencies, forward transactions, commitments and offset agreements.

Use of Confirmation Requests

6. The guidance set out in the following paragraphs is designed to assist banks and their auditors to obtain independent confirmation of financial and business relationships within other banks. However, there may be occasions on which the approach described within this IAPS may also be appropriate to confirmation procedures between the bank and its non-bank customers. The procedures described are not relevant to the routine inter-bank confirmation procedures which are carried out in respect to the day to day commercial transactions conducted between banks.

7. The auditor should decide from which bank or banks to request confirmation, have regard to such matters as size of balances, volume of activity, degree of reliance on internal controls, and materiality within the context of the financial statements. Tests of particular activities of the bank may be structured in different ways and confirmation requests may, therefore, be limited solely to inquiries about those activities. Requests for confirmation of individual transactions may either form part of the test of a bank's system of internal control or be a means of verifying balances appearing in a bank's financial statements at a particular date. Therefore, confirmation requests should be designed to meet the particular purpose for which they are required.

8. The auditor should determine which of the following approaches is the most appropriate in seeking confirmation of balances or other information from another bank:

   - Listing balances and other information, and requesting confirmation of their accuracy and completeness.
   - Requesting details of balances and other information, which can then be compared with the requesting bank's records.

   In determining which of the above approaches is the most appropriate, the auditor should weigh the quality of audit evidence he requires in the particular circumstances against the practicality of obtaining a reply from the confirming bank.

9. Difficulty may be encountered in obtaining a satisfactory response even where the requesting bank submits information for confirmation to the confirming bank. It is important that a response be sought for all

confirmation requests. It is not usual practice to request a response only if the information submitted is incorrect or incomplete.

Preparation and Dispatch of Requests and Receipt of Replies

10. The auditor should determine the appropriate location to which the confirmation request should be sent, for example a department, such as internal audit, inspection and other specialist department, which may be designated by the confirming bank as responsible for replying to confirmation requests. It may be appropriate, therefore, to direct confirmation requests to the head office of the bank (in which such departments are often located) rather than to the location where balances and other relevant information are held. In other situations, the appropriate location may be the local branch of the confirming bank.

11. Whenever possible, the confirmation request should be prepared in the language of the confirming bank or in the language normally used for business purposes.

12. Control over the content and dispatch of confirmation requests is the responsibility of the auditor. However, it will be necessary for the request to be authorized by the requesting bank. Replies should be returned directly to the auditor and to facilitate such a reply, a pre-addressed envelope should be enclosed with the request.

Content of Confirmation Requests

13. The form and content of a confirmation request letter will depend on the purpose for which it is required, on local practices and on the requesting bank's account procedures, for example, whether or not it makes extensive use of electronic data processing.

14. The confirmation request should be prepared in a clear and concise manner to ensure ready comprehension by the confirming bank.

15. Not all information for which confirmation is usually sought will be required at the same time. Accordingly, request letters may be sent at various times during the year dealing with particular aspects of the inter-bank relationship.

16. The most commonly requested information is in respect of balances due to or from the requesting bank on current, deposit, loan and other accounts. The request letter should provide the account description, number and the type of currency for the account. It may also be advisable to request information about nil balances on correspondent accounts, and correspondent accounts which were closed in the twelve months prior to the chosen confirmation date. The requesting bank may ask for confirmation not only of the balances on accounts but also, where it may be helpful, other

information, such as the maturity and interest terms, unused facilities, lines of credit/standby facilities, any offset or other rights or encumbrances, and details of any collateral given or received.

17. An important part of banking business relates to the control of those transactions commonly designated as "off balance sheet." Accordingly, the requesting bank and its auditors are likely to request confirmation of contingent liabilities, such as those arising on guarantees, comfort letters and letters of undertaking, bills, own acceptances, and endorsements. Confirmation may be sought both of the contingent liabilities of the requesting bank to the confirming bank and of the confirming bank to the requesting bank. The details supplied or requested should describe the nature of the contingent liabilities together with their currency and amount.

18. Confirmation of asset repurchase and resale agreements and options outstanding at the relevant date should also be sought. Such confirmation should describe the asset covered by the agreement, the date the transaction was contracted, its maturity date, and the terms on which it was completed.

19. Another category of information, for which independent confirmation is often requested at a date other than the transaction date, concerns forward currency, bullion, securities and other outstanding contracts. It is well established practice for banks to confirm transactions with other banks as they are made. However, it is the practice for audit purposes to confirm independently a sample of transactions selected from a period of time or to confirm all the unmatured transactions with a counterparty. The request should give details of each contract including its number, the deal date, the maturity or value date, the price at which the deal was transacted and the currency and amount of the contract bought and sold, to and from, the requesting bank.

20. Banks often hold securities and other items in safe custody on behalf of customers. A request letter may thus ask for confirmation of such items held by the confirming bank, at a specific date. The confirmation should include a description of the items and the nature of any encumbrances or other rights over them.

Appendix

Glossary

This Appendix defines certain terms used in this Statement. The list is not intended to include all terms used in an inter-bank confirmation request. Definitions have been given within a banking context, although usage and legal application may differ.

Collateral

Security given by a borrower to a lender as a pledge for repayment of a loan, rarely given in the case of inter-bank business. Such lenders thus become secured creditors; in the event of default, such creditors are entitled to proceed against collateral in settlement of their claim. Any kind of property may be employed as collateral. Examples of collateral are: real estate, bonds, stocks, notes, acceptances, chattels, bills of lading, warehouse receipts and assigned debts.

Contingent Liabilities

Potential liabilities, which only crystallize upon the fulfillment of or the failure to fulfill certain conditions. They may arise from the sale, transfer, endorsement, or guarantee of negotiable instruments or from other financial transactions. For example, they may result from:

- Re-discount of notes receivable, trade and bank acceptances arising under commercial letters of credit;
- Guarantees given; or
- Letters of support or comfort.

Encumbrance

A claim or lien, such as a mortgage upon real property, which diminishes the owner's equity in the property.

Offset

The right of a bank, normally evidenced in writing, to take possession of any account balances that a guarantor or debtor may have with it to cover the obligations to the bank of the guarantor, debtor or third party.

Options

The right to buy or sell or to both buy and sell securities or commodities at agreed prices, within a fixed duration of time.

Repurchase (or Resale) Agreement

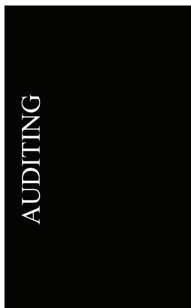
An agreement between seller and buyer that the seller (or buyer) will buy (or sell) back notes, securities, or both property at the expiration of a period of time, or the completion of certain conditions, or both.

Safe Custody

A facility offered by banks to their customers to store valuable property for safe keeping.

Line of Credit/Standby Facility

An agreed maximum amount of funds which a bank has made or undertakes to make available over a specified period of time.



INTERNATIONAL AUDITING PRACTICE STATEMENT 1004

THE RELATIONSHIP BETWEEN BANKING SUPERVISORS AND BANKS' EXTERNAL AUDITORS

(This Statement is effective)

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International Auditing Practice Statement (IAPS) 1004, "The Relationship Between Banking Supervisors and Banks' External Auditors" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of IAPSs.

This International Auditing Practice Statement has been prepared in association with the Basel Committee on Banking Supervision* (the Basel Committee). It was approved for publication by the International Auditing Practices Committee and by the Basel Committee. It is based on ISAs extant at October 1, 2001.

Banks play a vital role in economic life and the continued strength and stability of the banking system is a matter of general public concern. The separate roles of banking supervisors and external auditors are important in this regard. The growing complexity of banking makes it necessary that there be greater mutual understanding and, where appropriate, more communication between banking supervisors and external auditors.

The purpose of this Statement is to provide information and guidance on how the relationship between bank auditors and supervisors can be strengthened to mutual advantage, and it takes into account the Basel Committee's Core Principles for Effective Banking Supervision. However, as the nature of this relationship varies significantly from country to country the guidance may not be applicable in its entirety to all countries. The International Auditing Practices Committee and the Basel Committee hope, however, that it will provide useful guidance about the respective roles of the banking supervisors and external auditors in the many countries where the links are close or where the relationship is currently under study.

* The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

Introduction

1. Banks play a central role in the economy. They hold the savings of the public, provide a means of payment for goods and services and finance the development of business and trade. To perform these functions securely and efficiently, individual banks must command the confidence of the public and those with whom they do business. The stability of the banking system, both nationally and internationally, has therefore come to be recognized as a matter of general public interest. This public interest is reflected in the way banks in almost all countries, unlike most other commercial enterprises, are subject to prudential supervision by central banks or specific official agencies.

2. Banks' financial statements are also subject to audit by external auditors. The external auditor conducts the audit in accordance with applicable ethical and auditing standards, including those calling for independence, objectivity, professional competence and due care, and adequate planning and supervision. The auditor's opinion lends credibility to the financial statements and promotes confidence in the banking system.

3. As the business of banking grows in complexity, both nationally and internationally, the tasks of banking supervisors and external auditors are becoming more and more demanding. In many respects, banking supervisors and external auditors face similar challenges and, increasingly, their roles are being perceived as complementary. Not only do banking supervisors benefit from the results of the auditors' work, but they may also turn to the external auditor to undertake additional tasks when these tasks contribute to the performance of their supervisory roles. At the same time, external auditors, in carrying out their role, also look to banking supervisors for information that can help in discharging their responsibilities more effectively.

4. The International Auditing Practices Committee and the Basel Committee share the view that greater mutual understanding about the respective roles and responsibilities of banking supervisors and external auditors and, where appropriate, communication between them improves the effectiveness of audits of banks' financial statements and supervision to the benefit of both disciplines.

5. The roles and responsibilities of a bank's board of directors[1] and management, the bank's external auditors, and the banking supervisors in

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[1] The notions of "board of directors" and "management" are used, not to identify legal constructs, but rather to label two decision-making functions within a bank. Under the Glossary of Terms for ISAs, management comprises officers and others who also perform senior management functions. The Basel Core Principles refer to the functions of the board of directors to describe the functions of those charged with the governance of a bank. The principles set out in this paper are to be applied in accordance with the corporate governance structure of the country in which the bank is based. The

different countries derive from law, custom and, for external auditors, professional practice. This Statement is not intended to challenge or change these roles or responsibilities. Rather, it is intended to provide a better understanding of the nature of the roles of bank's boards of directors and management, external auditors, and banking supervisors, since misconceptions about such roles could lead to inappropriate reliance being placed by one on the work of another. This Statement seeks to remove possible misconceptions and suggests how each might make more effective use of the work performed by the other. The Statement accordingly:

(a) Sets out the primary responsibility of the board of directors and management (paragraphs 8-13);

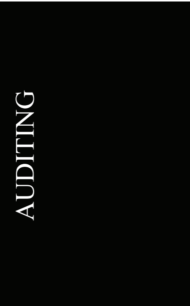
(b) Examines the essential features of the role of external auditors (paragraphs 14-27);

(c) Examines the essential features of the role of banking supervisors (paragraphs 28-45);

(d) Reviews the relationship between the banking supervisor and the bank's external auditor (paragraphs 46-55); and

(e) Describes additional ways in which external auditors and the accountancy profession can contribute to the supervisory process (paragraphs 56-70).

6. In September 1997 the Basel Committee published its Core Principles for Effective Banking Supervision, known as the Basel Core Principles. The Basel Core Principles (which are used in country assessments by organizations such as the World Bank and the International Monetary Fund) are intended to serve as a basic reference for an effective supervisory system internationally and in all countries. This Statement has been prepared taking into account the Basel Core Principles.



7. The Statement has been prepared with full awareness of the significant differences that exist in national institutional and regulatory frameworks, notably in accounting standards, in supervisory techniques and in the extent to which, in some countries, external auditors currently perform tasks at the request of banking supervisors. In some countries, banking supervisors and external auditors already have closer relationships than are indicated in this Statement. The arrangements suggested in this Statement do not replace, existing relationships. While this Statement is not intended to be prescriptive, it is hoped that the guidance expressed in it will be relevant to all situations,

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Basel Committee's paper "Enhancing Corporate Governance for Banking Organisations" published in September 1999 should be referred to.

although it will obviously address the situations in some countries more directly than in others.

The Responsibility of the Bank's Board of Directors and the Management

8. The primary responsibility for the conduct of the business of a bank is vested in the board of directors and the management appointed by it. This responsibility includes, among other things, ensuring that:

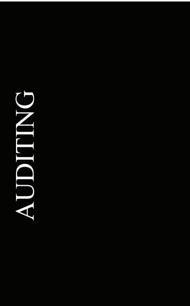
   - Those entrusted with banking tasks have sufficient expertise and integrity and that there are experienced staff in key positions;
   - Adequate policies, practices and procedures related to the different activities of the bank are established and complied with, including the following:
     - The promotion of high ethical and professional standards.
     - Systems that accurately identify and measure all material risks and adequately monitor and control these risks.
     - Adequate internal controls, organizational structures and accounting procedures.
     - The evaluation of the quality of assets and their proper recognition and measurement.
     - "Know your customer" rules that prevent the bank being used, intentionally or unintentionally, by criminal elements.
     - The adoption of a suitable control environment, aimed at meeting the bank's prescribed performance, information and compliance objectives.
     - The testing of compliance and the evaluation of the effectiveness of internal controls by the internal audit function.
   - Appropriate management information systems are established;
   - The bank has appropriate risk management policies and procedures;
   - Statutory and regulatory directives, including directives regarding solvency and liquidity, are observed; and
   - The interests not only of the shareholders but also of the depositors and other creditors are adequately protected.

9. Management is responsible for preparing financial statements in accordance with the appropriate financial reporting framework and for establishing accounting procedures that provide for the maintenance of documentation sufficient to support the financial statements. This responsibility includes

ensuring that the external auditor who examines and reports on the financial statements has complete and unhindered access to, and is provided with, all necessary information that can materially affect them and, consequently, the auditor's report on them.[2] Management also has the responsibility to provide all information to the supervisory agencies that such agencies are entitled by law or regulation to obtain.

10. In many countries, audit committees have been set up to meet the practical difficulties that may arise in the board of directors fulfilling its task of ensuring the existence and maintenance of an adequate system of internal controls. In addition, such a committee reinforces both the internal control system and the internal audit function. In order to reinforce the audit committee's effectiveness, the internal and external auditors should be allowed and encouraged to attend the meetings of the audit committee. Regular meetings of the audit committee with the internal and external auditors help enhance the external auditor's independence and the credibility of the internal auditors, and assist the audit committee to perform its key role on strengthening corporate governance. In some countries, law or regulations prescribe that such meetings must take place.

11. When so required by the board of directors or by applicable law or regulations, management is responsible for the establishment and the effective operation of a permanent internal audit function in a bank appropriate to its size and to the nature of its operations. This function is part of the ongoing monitoring of the system of internal controls because it provides an assessment of the adequacy of, and compliance with, the bank's established policies and procedures and assurance as to the adequacy, effectiveness and sustainability of the bank's risk management and control procedures and infrastructure independent of those with day-to-day responsibility for complying with those policies and procedures. In fulfilling its duties and responsibilities, management should take all necessary measures to ensure that there is a continuous and adequate internal audit function.



12. In order to be fully effective, the internal audit function should be independent of the organizational activities it audits or reviews and also should be independent from the every day internal control process. Every activity and every division, subsidiary or other component of the banking organization should fall within the scope of the internal audit function's review. The professional competence of each internal auditor and of the internal audit

2 In some countries, branches of overseas banks are only required to provide financial information (including abbreviated financial statements) prepared in accordance with group accounting policies or national regulations. This financial information may or may not be subject to an external audit requirement. The guidance in this statement is also applicable in an appropriate and practical manner to such external audits.

function as a whole is essential for the proper performance of that function. Therefore, the internal audit function should be adequately staffed with persons of the appropriate skills and technical competence who are free from operating responsibilities. The internal audit function should regularly report to the board of directors and management on the performance of the internal control and risk management systems and on the achievement of the internal audit function's objectives. Management should establish and approve a procedure ensuring the consideration and, if appropriate, the implementation of the internal audit function's recommendations.

13. The responsibilities of the board of directors and management are in no way diminished by the existence of a system for the supervision of banks by banking supervisors or by a requirement for the bank's financial statements to be audited by an external auditor.

The Role of the Bank's External Auditor

14. The objective of an audit of a bank's financial statements by an external auditor is to enable an independent auditor to express an opinion as to whether the bank's financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The financial statements ordinarily will have been prepared according to the financial reporting framework of the country in which the bank has its head office,[3] and in accordance with any relevant regulations laid down by regulators in that country. Financial reporting frameworks may differ from country to country, and the financial reporting regime for banks in any given country may be quite different from the regimes for other commercial entities. The auditor's opinion on the financial statements, therefore, will be expressed in terms of the applicable national framework and regulations. It is possible for financial statements prepared under different frameworks and regulations to differ substantially while still being in accordance with the applicable national requirements. For this reason, ISA 700, "The Auditor's Report on Financial Statements"[4] requires the auditor to identify the country of origin of the financial reporting framework used to prepare the financial statements when that financial reporting framework is not International Accounting Standards.

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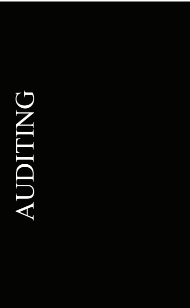
3 In some countries, reporting in accordance with internationally accepted accounting standards, such as those issued or adopted by the International Accounting Standards Board, also is permitted.

4 ISA 700, "The Auditor's Report on Financial Statements" was withdrawn when ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" became effective. The latter is effective for auditors' reports dated on or after December 31, 2006.

15. The external auditor's report is appropriately addressed as required by the circumstances of the engagement, ordinarily to either the shareholders or the board of directors. However, the report may be available to many other parties, such as depositors, other creditors and supervisors. The auditor's opinion helps to establish the credibility of the financial statements. The auditor's opinion, however, should not be interpreted as providing assurance on the future viability of the bank or an opinion as to the efficiency or effectiveness with which the management has conducted the affairs of the bank, since these are not objectives of the audit.

16. The auditor designs audit procedures to reduce to an acceptably low level the risk of giving an inappropriate audit opinion when the financial statements are materially misstated. The auditor assesses the inherent risk of material misstatements occurring (inherent risk) and the risk that the entity's accounting and internal control systems will not prevent or detect and correct material misstatements on a timely basis (control risk). The auditor assesses control risk as being high unless the auditor is able to identify controls that are likely to prevent or detect and correct a material misstatement and conducts tests of the controls that support a lower assessment of control risk. Based on the assessment of inherent and control risk, the auditor carries out substantive procedures to reduce the overall audit risk to an acceptably low level.

17. The auditor considers how the financial statements might be materially misstated and considers whether fraud risk factors are present that indicate the possibility of fraudulent financial reporting or misappropriation of assets. The auditor designs audit procedures to reduce to an acceptably low level the risk that misstatements arising from fraud and error that are material to the financial statements taken as a whole are not detected. ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" lists fraud risk factors whose presence may alert the auditor to the possibility of fraud existing. In some countries, when the auditor determines that evidence of fraud exists, the auditor is required to disclose this information to the bank's supervisor.



18. In carrying out the audit of a bank's financial statements, the external auditor recognizes that banks have the following characteristics that generally distinguish them from most other commercial enterprises, and which the auditor takes into account in assessing the level of inherent risk:

    - They have custody of large amounts of monetary items, including cash and negotiable instruments, whose physical security has to be safeguarded during transfer and while being stored. They also have custody and control of negotiable instruments and other assets that are readily transferable in electronic form. The liquidity characteristics of these items make banks vulnerable to misappropriation and fraud. Banks therefore need to establish formal operating procedures, well-

defined limits for individual discretion and rigorous systems of internal control.

- They often engage in transactions that are initiated in one jurisdiction, recorded in a different jurisdiction and managed in yet another jurisdiction.
- They operate with very high leverage (that is, the ratio of capital to total assets is low), which increases banks' vulnerability to adverse economic events and increases the risk of failure.
- They have assets that can rapidly change in value and whose value is often difficult to determine. Consequentially a relatively small decrease in asset values may have a significant effect on their capital and potentially on their regulatory solvency.
- They generally derive a significant amount of their funding from short-term deposits (either insured or uninsured). A loss of confidence by depositors in a bank's solvency can quickly result in a liquidity crisis.
- They have fiduciary duties in respect of the assets they hold that belong to other persons. This may give rise to liabilities for breach of trust. Banks therefore need to establish operating procedures and internal controls designed to ensure that they deal with such assets only in accordance with the terms on which the assets were transferred to the bank.
- They engage in a large volume and variety of transactions whose value may be significant. This necessarily requires complex accounting and internal control systems and widespread use of information technology (IT).
- They ordinarily operate through a network of branches and departments that are geographically dispersed. This necessarily involves a greater decentralization of authority and dispersal of accounting and control functions with consequential difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
- Transactions can often be directly initiated and completed by the customer without any intervention by the bank's employees, for example over the Internet or through automatic teller machines (ATMs).
- They often assume significant commitments without any initial transfer of funds other than, in some cases, the payment of fees. These commitments may involve only memorandum accounting entries. Consequently their existence may be difficult to detect.

- They are regulated by governmental authorities whose regulatory requirements often influence the accounting principles that banks follow. Non-compliance with regulatory requirements, for example, capital adequacy requirements, could have implications for the bank's financial statements or the disclosures therein.
- Customer relationships that the auditor, assistants, or the audit firm may have with the bank might affect the auditor's independence in a way that customer relationships with other organizations would not.
- They generally have exclusive access to clearing and settlement systems for checks and fund transfers, foreign exchange transactions, etc. They are an integral part of, or are linked to, national and international settlement systems and consequently could pose a systemic risk to the countries in which they operate.
- They may issue and trade in complex financial instruments, some of which may need to be recorded at fair value in the financial statements. They therefore need to establish appropriate valuation and risk management procedures. The effectiveness of these procedures depends on the appropriateness of the methodologies and mathematical models selected, access to reliable current and historical market information, and the maintenance of data integrity.

19. A detailed audit of all transactions of a bank would be not only time-consuming and expensive but also impracticable. The external auditor therefore bases the audit on the assessment of the inherent risk of material misstatement, the assessment of control risk and testing of the internal controls designed to prevent or detect and correct material misstatements, and on substantive procedures performed on a test basis. Such procedures comprise one or more of the following: inspection, observation, inquiry and confirmation, computation and analytical procedures. In particular, the external auditor is concerned about the recoverability and consequently the carrying value of loans, investments and other assets shown in the financial statements and about the identification and adequate disclosure in the financial statements of all material commitments and liabilities, contingent or otherwise.

20. While the external auditor has the sole responsibility for the audit report and for determining the nature, timing and extent of audit procedures, much of the work of internal auditing can be useful to the external auditor in the audit of the financial statements. The auditor, therefore, as part of the audit assesses the internal audit function insofar as the auditor believes that it will be relevant in determining the nature, timing and extent of the audit procedures.

21. ISA 610, "Considering the Work of Internal Auditing" requires external auditors to consider the activities of internal auditors and their effect, if any, on the nature, timing, and extent of the external auditor's procedures. The

external auditor considers the organizational status of the internal audit function, the scope of its function, the technical competence of its members and the professional care they exercise when assessing the work of the department.

22. Judgment permeates the auditor's work. The auditor uses professional judgment in areas such as:

- Assessing inherent and control risk and the risk of material misstatement due to fraud and error;
- Deciding upon the nature, timing and extent of the audit procedures;
- Evaluating the results of those procedures; and
- Assessing the reasonableness of the judgments and estimates made by management in preparing the financial statements.

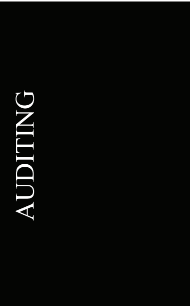
23. An external auditor plans and conducts the audit to obtain reasonable assurance that misstatements in the bank's financial statements which, individually or in aggregate, are material in relation to the financial information presented by those statements are detected. The assessment of what is material is a matter for the auditor's professional judgment, and is influenced by the economic decisions that users of the bank's financial statements will take on the basis of those financial statements. The auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. Materiality may be influenced by other considerations such as legal and regulatory requirements and considerations relating to individual financial statement account balances and relationships. The process may result in different materiality levels depending on the aspect of the financial statements being considered. Similarly, the level of materiality used by an auditor when reporting on a bank's financial statements may be different from the level used when making special reports to banking supervisors. ISA 320, "Audit Materiality" discusses this in more detail.

24. In forming an opinion on the financial statements, the external auditor carries out procedures designed to obtain reasonable assurance that the financial statements are prepared in all material respects in accordance with the applicable financial reporting framework. An audit does not guarantee all material misstatements 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 evidence available to the auditor is persuasive rather than conclusive in nature. 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 designed to conceal it, such as forgery, deliberate failure to record transactions or intentional misrepresentation being

made to the auditor. Such attempts at concealment may be even harder to detect when accompanied by collusion. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because boards of directors and management are often in a position that assumes their integrity and enables them to override the formally established control procedures. Therefore, the auditor plans and performs an audit with an attitude of professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated.

25. When the auditor discovers a misstatement material to the financial statements taken as a whole, including the use of an inappropriate accounting policy or asset valuation or a failure to disclose essential information, the auditor asks management to adjust the financial statements to correct the misstatement. If management refuses to make the correction the auditor issues a qualified or an adverse opinion on the financial statements. Such a report could have a serious effect on the credibility and even stability of the bank, and management therefore usually takes the steps necessary to avoid it. Likewise, an auditor issues a qualified opinion or a disclaimer of opinion if management has not provided the auditor with all the information or explanations the auditor requires.

26. As a supplementary but not necessarily integral part of the audit, the external auditor ordinarily communicates certain information to management. This information customarily contains comments on such matters as material weaknesses in internal control or misstatements that have come to the auditor's attention during the course of the audit, but which do not warrant a modification of the audit report (either because additional procedures have been performed to compensate for a weakness in control or because the misstatements have been corrected in the financial statements or are immaterial in their context). The external auditor also communicates matters of governance to those charged with the governance of the bank. In some countries, the external auditor also submits, either as part of a statutory requirement or by convention, a long-form report to management or to the banking supervisor on specified matters such as the composition of account balances or of the loan portfolio, liquidity and earnings, financial ratios, the adequacy of internal control systems, an analysis of banking risks, or compliance with legal or supervisory requirements.



27. In some countries, the external auditor is required to report promptly to the banking supervisor any fact or decision that is liable to:

- Constitute a material breach of laws or regulations;
- Affect the bank's ability to continue as a going concern; or
- Lead to a modified report.

The Role of the Banking Supervisor

28. The key objective of prudential supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors. In addition, supervision also is often directed toward verifying compliance with laws and regulations governing banks and their activities. However, in this Statement the focus is on the prudential aspect of the banking supervisor's role.

29. Banking supervision is based on a system of licensing, which allows supervisors to identify the population to be supervised and to control entry into the banking system. In order to qualify for and retain a banking license, entities must observe certain prudential requirements. These requirements may differ from country to country in their precise specification; some may be closely defined in regulation and others may be more broadly drawn, allowing the supervisory authority a measure of discretion in their interpretation. However, the following basic requirements for a banking license ordinarily are found in most systems of supervision:

    - The bank must have suitable shareholders and members of the board (this notion includes integrity and standing in the business community as well as the financial strength of all major shareholders).
    - The bank's management must be honest and trustworthy and must possess appropriate skills and experience to operate the bank in a sound and prudent manner.
    - The bank's organization and internal control must be consistent with its business plans and strategies.
    - The bank should have a legal structure in line with its operational structure.
    - The bank must have adequate capital to withstand the risks inherent in the nature and size of its business.
    - The bank must have sufficient liquidity to meet outflows of funds.

30. Further and more detailed requirements are often prescribed, including minimum numerical ratios for the adequacy of the bank's capital and liquidity. Whatever the precise form of the regulations, however, their objective is to set conditions to ensure that a bank conducts its business prudently and has adequate financial resources to overcome adverse circumstances and protect depositors from loss.

31. In addition to licensing new banks, most banking supervisors have the authority to review and reject any proposal to transfer significant ownership or a controlling interest in existing banks to other parties.

32. Ongoing banking supervision ordinarily is conducted on the basis of recommendations and guidance. However, banking supervisors have at their disposal recourse to legal powers to bring about timely corrective action when a bank fails to meet prudential requirements, when there are violations of laws or regulations, or when depositors are faced with a substantial risk of loss. In extreme circumstances, the supervisor may have the authority to revoke the bank's license.

33. One of the foundations of prudential supervision is capital adequacy. In most countries there are minimum capital requirements for the establishment of new banks and capital adequacy tests are a regular element in ongoing supervision. In the consultative package "The New Basel Capital Accord" issued by the Basel Committee in January 2001, the Basel Committee proposes a capital adequacy framework based on three complementary pillars: minimum capital requirements, a supervisory review process and market discipline.

- The first pillar defines the minimum capital requirements for three broad categories of risks: credit risk, market risk and operational risk.
- The second pillar, the supervisory review process, relies on the following principles. Banks must have sufficient solvency in relation to its risk profile and supervisors must have the ability to require banks to hold capital in excess of the minimum. Banks should assess internally and on an ongoing basis their capital adequacy based on their present and future risk profile and supervisors should review the banks' internal capital adequacy assessment procedure. Finally, supervisors must intervene early, taking into account the relatively illiquid nature of most bank assets and the limited options most banks have in raising capital quickly.
- The third pillar, market discipline, enhances the role of market participants in encouraging banks to hold adequate levels of capital. In this respect, banks must disclose quantitative and qualitative information about their capital and risk profile.

34. Banks are subject to a variety of risks. Supervisors monitor and may limit a range of banking risks, such as credit risk, market risk (including interest and foreign exchange risk), liquidity and funding risk, operational risk, legal risk and reputational risk. Increasingly, supervisors are attempting to develop systems of measurement that will capture the extent of exposure to specific risks (for example, the risks involved in derivative financial instruments). These systems often form the basis for specific controls or limits on the various categories of exposure.

35. The most significant of banking risks, in terms of historical loss experience, is the risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter (sometimes referred to as

credit risk). It is not the banking supervisor's role to direct banks' lending policies, but it is essential for the supervisor to be confident that the bank has adopted a sound system for managing credit risk. The supervisor also evaluates the effectiveness of a bank's policies and practices for assessing loan quality. The supervisor seeks to be satisfied that the methods employed and judgments made by management to calculate allowances produce an aggregate amount of specific and general allowances that is adequate to absorb estimated credit losses, on a timely basis, in accordance with appropriate policies and procedures. In addition, the supervisor also seeks to ensure that credit risk is adequately diversified by means of rules to limit exposures, whether in terms of individual borrowers, industrial or commercial sectors or particular countries or economic regions.

36. Although it is difficult to assess, the quality of a bank's loans and other assets is one of the most critical determinants of its financial condition. Accordingly, accurate and prudent valuation of assets is of great importance for supervisors because it has a direct bearing on the determination of the reported amount of the bank's capital. As already indicated, capital is widely used as the supervisory standard against which exposures are measured or limited. While the proper valuation of assets is one of the primary responsibilities of management, the valuation process often involves considerable judgment. In general, unless the supervisor performs its own evaluation of this process to determine its accuracy and compliance with documented policies and procedures, the supervisor relies in large part on the management's judgment of the proper valuation of assets and on the fact that valuations that appear in the financial statements have been subjected to external audit.

37. Supervisors attach considerable importance to the need for banks to have in place internal controls that are adequate for the nature, scope and scale of their business. The purpose of internal controls is to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

38. The development of sophisticated real-time computerized information systems has greatly improved the potential for control, but in turn has brought with it additional risks arising from the possibility of computer failure or fraud. The introduction of electronic commerce has also introduced significant new risks and requires, in turn, additional controls.

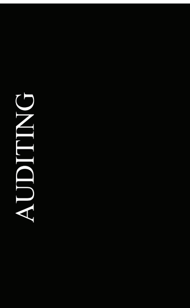
39. Supervisors are concerned to ensure that the quality of management is adequate for the nature and scope of the business. In regulatory environments in which on-site inspections are regularly carried out, the examiners have an opportunity to notice signs of management deficiencies. Elsewhere, the supervisor normally arranges to interview management on a regular basis and

pursues other opportunities for contacts where they arise. Whatever the nature of the regulatory environment, the supervisor tries to use these opportunities to understand management's business plans and strategies and how it expects to achieve them. Similarly, the supervisor seeks to discover whether the bank is properly equipped to carry out its functions in terms of the skills and competence of its staff and the equipment and facilities at its disposal. The information gained from these contacts with management assists the supervisor in forming an opinion about management's competence.

40. Effective supervision requires the collection and analysis of information about supervised banks. For example, supervisors collect, review and analyze prudential reports and statistical returns from banks. These include basic financial statements as well as supporting schedules that provide greater detail. These reports are used to check adherence to certain prudential requirements and they also provide a basis for discussions with the bank's management. Off-site monitoring can often identify potential problems, particularly in the interval between on-site inspections, thereby providing early detection and prompting corrective action before problems become more serious.

41. Supervisors must have a means of validating the information they receive either through on-site inspections or the use of external auditors. On-site work, whether done by the banking supervisor's own staff or commissioned by the supervisor but undertaken by external auditors, is structured to provide independent verification of whether an adequate internal control system, meeting the specific criteria the supervisor mandates, exists at individual banks and whether the information provided by banks is reliable.

42. To enhance their understanding of a bank's corporate governance and system of operation, some supervisory authorities meet periodically with the bank's audit committee or its board of directors. This provides an opportunity for the audit committee or the board of directors to discuss any concerns it may have about the management of the bank and enables the supervisor to form a view as to the audit committee's effectiveness.



43. Banking supervisors are interested in ensuring that all the work performed by external auditors is carried out by auditors who:

- Are properly licensed and in good standing;
- Have relevant professional experience and competence;
- Are subject to a quality assurance program;
- Are independent in fact and appearance of the bank audited;

- Are objective and impartial; and
- Comply with any other applicable ethical requirements.[5]

44. In some countries, the banking supervisor has statutory powers over the appointment of external auditors, such as the right of approval or removal, and the right to commission an independent audit. These powers are intended to ensure that the external auditors the banks appoint have the experience, resources and skills necessary in the circumstances. Where there is no obvious reason for a change of external auditor, supervisors will also normally investigate the circumstances that caused the bank not to reappoint the auditor.

45. Supervisors have a clear interest in ensuring high standards of bank auditing. Moreover, an important concern of supervisors is the independence of the external auditor who performs the audit of a bank, particularly when the auditor also provides certain types of non-audit services to the bank. Accordingly, supervisors seek to maintain close contact with national professional auditing bodies in order to address issues of mutual interest.

The Relationship Between the Banking Supervisor and the Bank's External Auditor

46. In many respects the banking supervisor and the external auditor have complementary concerns regarding the same matters though the focus of their concerns is different.

    - The banking supervisor is primarily concerned with maintaining the stability of the banking system and fostering the safety and soundness of individual banks in order to protect the interests of the depositors. Therefore, the supervisor monitors the present and future viability of banks and uses their financial statements in assessing their condition and performance. The external auditor, on the other hand, is primarily concerned with reporting on the bank's financial statements ordinarily either to the bank's shareholders or board of directors. In doing so, the auditor considers the appropriateness of management's use of the going concern assumption. The auditor considers the period of assessment used by management and, when that period is less than 12 months from the balance sheet date, asks management to extend the assessment period to at least 12 months from the balance sheet date. If management refuses to do so ISA 570, "Going Concern" requires the auditor to consider the need to modify the auditor's report as a result of the

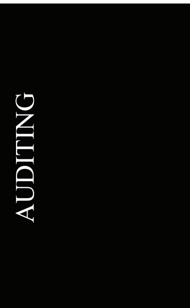
5 The auditor complies with relevant national ethical standards and the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants.

limitation of the auditor's work. The auditor also inquires of management as to its knowledge of events or conditions beyond the period of assessment used by management that may cast significant doubt on the bank's ability to continue as a going concern.

- The banking supervisor is concerned with the maintenance of a sound system of internal control as a basis for safe and prudent management of the bank's business. The external auditor, in most situations, is concerned with the assessment of internal control to determine the degree of reliance to be placed on the system in planning and performing the audit.
- The banking supervisor must be satisfied that each bank maintains adequate records prepared in accordance with consistent accounting policies and practices that enable the supervisor to appraise the financial condition of the bank and the profitability of its business, and that the bank publishes or makes available on a regular basis financial statements that fairly reflect its condition. The external auditor is concerned with whether adequate and sufficiently reliable accounting records are maintained in order to enable the entity to prepare financial statements that do not contain material misstatements and thus enable the external auditor to express an opinion on those statements.

47. When a banking supervisor uses audited financial statements in the course of supervisory activities, the supervisor needs to bear in mind the following factors:

- Supervisory needs are not ordinarily the primary purpose for which the financial statements were prepared.
- An audit in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement.
- The importance of the accounting policies used in the preparation of the financial statements as financial reporting frameworks require the exercise of judgment in their application and may allow choices in certain policies or how they are applied.
- Financial statements include information based on judgments and estimates made by the management and examined by the auditor.
- The financial position of the bank may have been affected by subsequent events since the financial statements were prepared.
- The supervisor cannot assume that the auditor's evaluation of internal control for the purposes of the audit will necessarily be adequate for the purposes for which the supervisor needs an evaluation, given the



different purposes for which internal control is evaluated and tested by the supervisor and the auditor.

- The controls and accounting policies that the external auditor considers may not be the ones that the bank uses when preparing information for the banking supervisor.

48. Nonetheless, there are many areas where the work of the banking supervisor and of the external auditor can be useful to each other. Communications from auditors to management and other reports submitted by auditors can provide supervisors with valuable insight into various aspects of the bank's operations. It is the practice in many countries for such reports to be made available to the supervisors.

49. Similarly, external auditors may obtain helpful insights from information originating from the banking supervisor. When a supervisory inspection or a management interview takes place, the conclusions drawn from the inspection or interview are customarily communicated to the bank. These communications can be useful to auditors inasmuch as they provide an independent assessment in important areas such as the adequacy of the allowance for loan losses and focus attention on specific areas of supervisory concern. Supervisory authorities may also develop certain informal prudential ratios or guidelines that are made available to the banks and that can be of assistance to auditors in performing analytical reviews.

50. When communicating with management, both banking supervisors and external auditors are aware of the benefits that can flow to each other from knowledge of the matters contained in such communications. It is therefore advantageous for communications of this nature to be made in writing, so that they form part of the bank's records to which the other party should have access.

51. In order to preserve the concerns of both parties regarding the confidentiality of information acquired while carrying out their respective functions, it is normal that, when contacts between the banking supervisor and the external auditor become necessary, management of the bank is also present or at least informed. It is recommended that timely and appropriate measures be taken so that external auditors cannot be held liable for information disclosed in good faith to the supervisory authorities in accordance with applicable laws and regulations. These measures can take the form of legal initiatives or can be an agreement among the bank, its management, the external auditor and the supervisory authority. This is particularly true when the presence of management would compromise the discussion, for example, where the auditor believes that management is involved in fraudulent conduct.

52. ISA 260, "Communications of Audit Matters with Those Charged with Governance" identifies matters of governance interest and requires auditors to communicate those matters on a timely basis to those charged with

governance.[6] Audit matters of governance interest include only those matters that have come to the attention of the auditor as a result of the performance of the audit. The auditor is not required, in an audit in accordance with ISAs, to design procedures for the specific purpose of identifying matters of governance interest. Certain audit matters of governance interest are likely to be of interest to banking supervisors, particularly where those matters may require urgent action by the supervisor. When required by the supervisory, legal, or regulatory framework or by a formal agreement or protocol, the auditor communicates such matters to the banking supervisor on a timely basis. In situations where there are no such requirements, agreements or protocols, the auditor encourages the bank's management or those charged with governance to communicate on a timely basis matters that, in the auditor's judgment, may be of urgent interest to the banking supervisor.[7] Furthermore, even if there is no requirement to do so, the auditor considers communicating such matters to the banking supervisor when management or those charged with governance do not do so. In such circumstances, the auditor considers whether the law protects the auditor when such communications are made.

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6 Ordinarily such matters include:

- The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements;
- The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements;
- The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;
- Audit adjustments, whether or not recorded by the entity, that have or could have, a significant effect on the entity's financial statements;
- Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;
- Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter;
- Expected modifications to the auditor's report;
- Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management; and
- Any other matters agreed upon in the terms of the engagement.

7 Clear requirements concerning the auditor's communication to banking supervisors are already established in many countries either by law, by supervisory requirement or by formal agreement or protocol. This is of mutual interest for both auditors and banking supervisors. In countries without such requirements, banking supervisors and accountancy bodies are encouraged to consider initiatives or support for appropriate measures in this regard.

53. The following are examples of types of other matters that may come to the attention of the auditor and may require urgent action by the banking supervisor:

- Information that indicates a failure to fulfill one of the requirements for a banking license.
- A serious conflict within the decision-making bodies or the unexpected departure of a manager in a key function.
- Information that may indicate a material breach of laws and regulations or the bank's articles of association, charter, or by-laws.
- The intention of the auditor to resign or the removal of the auditor from office.
- Material adverse changes in the risks of the bank's business and possible risks going forward.

In many cases the external auditor also communicates these matters to those charged with governance.

54. In a number of countries, the external auditor carries out specific assignments or issues special reports in accordance with statutes or at the request of the banking supervisor to assist the supervisor in discharging its supervisory functions. These duties may include reporting upon whether:

- Licensing conditions have been complied with;
- The systems for maintaining accounting and other records and the systems of internal control are adequate;
- The method used by the bank to prepare reports for the banking supervisor is adequate and the information included in these reports, which may include specified ratios of assets to liabilities and other prudential requirements, is accurate;
- The organization is adequate based on criteria provided by the supervisory authority;
- Laws and regulations are complied with; and
- Appropriate accounting policies are adhered to.

55. Banking supervisors and internal and external auditors cooperate with each other to make their contributions to the supervisory process more efficient and effective. The cooperation optimizes supervision while allowing each party to concentrate on its own responsibilities. In some countries the cooperation may be based on periodic meetings of the supervisor and the external and internal auditors.

Additional Requests for the External Auditor to Contribute to the Supervisory Process

56. A supervisor's request to an external auditor to assist in specific supervisory tasks should be made in the context of a well-defined framework that is set forth in applicable law or a contractual agreement between the bank and the supervisor. These requests may in some cases be the subject of a separate engagement. In this situation, the following criteria should be established.

57. First, the basic responsibility for supplying complete and accurate information to the banking supervisor must remain with the bank's management. The external auditor's role is to report on that information or on the application of particular procedures. As such, the auditor does not assume any supervisory responsibilities, but, by providing this report, enables the supervisor to make judgments about the bank more effectively.

58. Second, the normal relationship between the external auditor and the audited bank needs to be safeguarded. If there are no other statutory requirements or contractual arrangements governing the external auditor's work, all information flows between the banking supervisor and the auditor typically are channeled through the bank except in exceptional circumstances. Thus, the banking supervisor will request the bank to arrange to obtain the information it requires from the auditor and such information will be submitted to the supervisor through the bank. Any meetings between the external auditor and the banking supervisor will, except as indicated in paragraphs 51 and 52 above, be attended by representatives of the bank, and the bank's approval will be required before the auditor transmits copies of communications to management and other reports to the supervisor.[8]

59. Third, before concluding any arrangements with the banking supervisor, the external auditor considers whether any conflicts of interest may arise. If so, these need to be satisfactorily resolved before the commencement of the work, normally by obtaining the prior approval of the bank's management to undertake the assignment.

60. Fourth, the supervisory requirements must be specific and clearly defined in relation to the information required. This means that the supervisor needs, as far as possible, to describe the standards against which the bank's performance can be measured, so that the auditor can report whether or not they have been achieved. If, for example, information is required on the quality of loan assets, the supervisor has to specify what criteria are to be

[8] Many banks furnish copies of the external auditor's communications to management and other special reports directly to the banking supervisor.

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used in classifying the loans according to risk category. Similarly, wherever possible, some understanding must be reached between banking supervisors and external auditors regarding the concept of materiality.

61. Fifth, the tasks that the banking supervisor asks the external auditor to perform need to be within the auditor's competence, both technical and practical. The auditor may, for example, be requested to assess the extent of a bank's exposure to a particular borrower or country. However, without clear and specific guidance, the auditor will not be in a position to judge whether any particular exposures are excessive. In addition, audits are carried out at intervals and not continuously, so that, for example, it is not reasonable to expect the external auditor, in addition to the work necessary to conduct the audit, to carry out a complete evaluation of internal control or to monitor a bank's compliance with all supervisory rules except through an ongoing program of work over a period of time.

62. Sixth, the external auditor's task for the banking supervisor must have a rational basis. This means that except in special circumstances the task must be complementary to the regular audit work and can be performed more economically or more expeditiously than by the supervisor, either because of the auditor's specialized skills or because duplication is thereby avoided.

63. Finally, certain aspects of confidentiality need to be protected, in particular the confidentiality of information obtained by the external auditor through professional relationships with other audit clients and not available to the bank or the public.

64. The way in which the external auditor's role can be extended depends on the nature of the national supervisory environment. For example, if the banking supervisor follows an active approach, with frequent and rigorous inspection, the assistance that might be asked of the external auditor will normally be minimal. If, on the other hand, there is a history of less direct supervision, primarily based on the analysis of reported information provided by bank's management, as opposed to inspection, or if supervisory resources are limited, the supervisor can benefit from the assistance that the external auditor can offer in providing assurance on the information obtained.

65. Currently, however, many countries are practicing a supervisory approach which contains elements of both inspection and analysis of reported information. As banking develops in complexity, inspection is proving more and more demanding in terms of supervisory resources. Many supervisory authorities that practice on-site inspection are thus being driven to place greater reliance on reported information, and look to the external auditor for assistance in those areas for which the auditor's skills are particularly suited.

66. Where banking supervisors have previously relied solely on their analysis of prudential returns, they have found that a certain degree of on-the-spot

examination is a desirable safeguard. In these countries, therefore, the supervisors are relying more than before on external auditors to assist them by performing specific tasks (see paragraph 54).

67. In those countries where contacts between external auditors and banking supervisors have been close over a long period, a bond of mutual trust has been built up and extended experience of collaboration has enabled each to benefit from the other's work. Experience in those countries indicates that the conflicts of interest that auditors may in principle perceive as preventing close collaboration with supervisors assume less importance in practice and do not present an obstacle to a fruitful dialogue.

The Need for a Continuing Dialogue Between Banking Supervisors and the Accountancy Profession

68. If banking supervisors are to derive benefit from the work of external auditors on a continuing basis, supervisors should discuss current areas of supervisory concern with the accounting profession as a whole. This can be achieved through periodic discussions at the national level between the supervisory authorities and the professional accountancy bodies. Such discussions could cover areas of mutual concern. It is of considerable assistance to auditors in making informed judgments if they were to have as clear an understanding as possible of the supervisory authorities' knowledge and attitude on such matters. In the course of such discussions, supervisors should also have an opportunity to express their views on accounting policies and auditing standards generally and on specific audit procedures in particular. This assists in improving the general standard of audits of banks' financial statements. It is advisable for the banks' own industry associations to be involved in discussions on these topics, for example, through the head of the internal audit function, to ensure that the views of all parties are taken into account.

69. Discussions between banking supervisors and professional accountancy bodies could also usefully include major auditing issues and topical accounting problems, such as the appropriate accounting techniques for newly developed instruments, and other aspects of financial innovation and securitization. These discussions could assist in banks' adoption of the most appropriate accounting policies.

70. Both banking supervisors and the accountancy profession have an interest in achieving uniformity among banks in their application of appropriate accounting policies. Banking supervisors are often able to exercise a persuasive influence over banks in achieving uniform policies because of their regulatory powers, while external auditors are often better placed to monitor or review the actual application of such policies. A continuing dialogue between supervisory agencies and the profession could therefore

significantly contribute towards the harmonization of accounting standards for banks at the national level.

INTERNATIONAL AUDITING PRACTICE STATEMENT 1005

THE SPECIAL CONSIDERATIONS IN THE AUDIT OF SMALL ENTITIES

(This Statement is effective)

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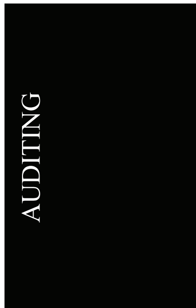
International Auditing Practice Statement (IAPS) 1005, "The Special Considerations in the Audit of Small Entities" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of IAPSs.



In September 2002 the International Auditing and Assurance Standards Board (IAASB) agreed that this International Auditing Practice Statement (IAPS) should be revised to take account of International Standards on Auditing (ISAs) issued between March 1999 and March 2003, and that for ISAs issued subsequent to March 2003, whenever necessary, considerations in the audit of small entities should be included in the body of those ISAs.

Guidance contained in this IAPS will be withdrawn when revisions to related ISAs become effective.

Accordingly, readers are cautioned that, in addition to the guidance in this IAPS, reference should be made to the special considerations in the audit of small entities included in ISAs issued subsequent to March 2003.

Introduction

1. International Standards on Auditing (ISAs) contain basic principles and essential procedures together with related guidance that apply to the audit of the financial statements of any entity, irrespective of its size, its legal form, ownership or management structure, or the nature of its activities. The IAASB[1] recognizes that small entities give rise to a number of special audit considerations. This International Auditing Practice Statement (IAPS) does not establish any new requirements for the audit of small entities; nor does it establish any exemptions from the requirements of ISAs. All audits of small entities are to be conducted in accordance with ISAs.

2. The objective of this IAPS is to describe the characteristics commonly found in small entities and indicate how they may affect the application of ISAs. This IAPS includes:

   (a) Discussion of the characteristics of small entities; and

   (b) Guidance on the application of ISAs issued until March 2003 to the audit of small entities.

3. The owner-manager of a small entity often needs assistance with the preparation of accounting records and financial statements. Section 8 of the IFAC *Code of Ethics for Professional Accountants*[2] (the Code) deals with independence, and auditors considering rendering other services to small entity audit clients are to refer to the Code and their national independence requirements. The appendix to this IAPS contains a commentary on the application of ISAs when auditors also prepare the accounting records and financial statements of small entity audit clients.

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1 The original IAPS was prepared and issued by the International Auditing Practices Committee (IAPC). Effective April 1, 2002, the IAPC was replaced by the International Auditing and Assurance Standards Board (IAASB).

2 Section 290 of the IFAC *Code of Ethics for Professional Accountants* issued in June 2005.

4. In determining the nature and extent of the guidance provided in this IAPS, the IAASB has aimed to provide a level of guidance that will be of general applicability to all audits of small entities and that will assist the auditor in exercising professional judgment with respect to the application of ISAs. However, detailed guidance of a procedural nature has not been provided, as the issue of such guidance may undermine the proper exercise of professional judgment in auditing.

The Characteristics of Small Entities

5. The auditor of any entity adapts the audit approach to the circumstances of the entity and the engagement. The audit of a small entity differs from the audit of a large entity as documentation may be unsophisticated, and audits of small entities are ordinarily less complex and may be performed using fewer assistants.

6. The meaning of "small entity" in this context gives consideration not only to the size of an entity but also to its typical qualitative characteristics. Quantitative indicators of the size of an entity may include balance sheets totals, revenue and the number of employees, but such indicators are not definitive. Therefore it is not possible to give an adequate definition of a small entity solely in quantitative terms.

7. For the purposes of this IAPS, a small entity is any entity in which:

   (a) There is concentration of ownership and management in a small number of individuals (often a single individual[3]); and

   (b) One or more of the following are also found:

      (i) Few sources of income;

      (ii) Unsophisticated record-keeping; or

      (iii) Limited internal controls together with the potential for management override of controls.

8. The qualitative characteristics described above are not exhaustive, they are not exclusive to small entities and small entities do not necessarily display all of those characteristics. For the purposes of this IAPS, small entities will ordinarily display characteristic (a), and one or more of the characteristics included under (b).

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[3] The word "individual" denotes ownership by a natural person, rather than by another entity. An entity owned by another enterprise may, however, be regarded as a "small entity" for the purpose of this IAPS if the owner exhibits the relevant characteristics.

Concentration of Ownership and Management

9. Small business entities ordinarily have few owners; often there is a single proprietor. The owner may employ a manager to run the entity but is in most cases directly involved in running the entity on a day-to-day basis. Likewise, in the case of small not-for-profit organizations and public sector entities, although there are often several individuals charged with formal responsibility for the entity, there may be few people involved in managing the entity on a day-to-day basis.

10. This IAPS uses the term "owner-manager" to indicate the proprietors of entities who are involved in the running of the entity on a day-to-day basis. Where proprietors are not involved on a day-to-day basis, the term "owner-manager" is used to refer to both the proprietors, and to any managers hired to run the entity.

Few Sources of Income

11. Small entities often have a limited range of products or services and operate from a single or limited number of locations. Such characteristics may make it easier for the auditor to acquire, record, and maintain knowledge of the entity than would be the case with a larger entity. The application of a wide range of audit procedures may be straightforward in such circumstances. For example, effective predictive models for use in analytical procedures can sometimes be constructed. Analytical procedures may provide useful evidence, sometimes reducing the need for other substantive procedures. In addition, in many small entities, accounting populations are often small and easily analyzed.

Unsophisticated Record-Keeping

12. Small entities need to keep sufficient accounting records to comply with any relevant statutory or regulatory requirements and to meet the needs of the entity, including the preparation and audit of financial statements. Therefore, the accounting system needs to be designed in such a manner so as to provide reasonable assurance that:

    (a) All the transactions and other accounting information that should have been recorded have in fact been recorded;

    (b) Assets and liabilities recorded in the accounting system exist and are recorded at the correct amounts; and

    (c) Fraud or error in processing accounting information will be detected.

13. Most small entities employ few, if any, personnel who are solely engaged in record-keeping. Consequently the bookkeeping functions and accounting records are often unsophisticated. Record keeping may be unsophisticated or poor, which results in a greater risk that the financial statements may be inaccurate or incomplete. Many small entities outsource some of or all their record keeping.

14. Small entities often find it convenient to use branded accounting software packages designed for use on a personal computer. Many of these packages have been widely tested and accredited and can, if chosen and implemented with care, provide a reasonable basis for a reliable and cost-effective accounting system.

Limited Internal Controls

15. Size and economic considerations in small entities mean that sophisticated internal controls are often neither necessary nor desirable, the fact that there are few employees limits the extent to which segregation of duties is practicable. However, for key areas, even in the very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. Supervisory controls exercised on a day-to-day basis by the owner-manager may also have a significant beneficial effect as the owner-manager has a personal interest in safeguarding the assets of the entity, measuring its performance and controlling its activities.

16. The owner-manager occupies a dominant position in a small entity. The owner-manager's direct control over all decisions, and the ability to intervene personally at any time to ensure an appropriate response to changing circumstances, are often important features of the management of small entities. The exercise of this control can also compensate for otherwise weak internal control procedures. For example, in cases where there is limited segregation of duties in the area of purchasing and cash disbursements, internal control is improved when the owner-manager personally signs all checks. When the owner manager is not involved, there is a greater risk that employee fraud or error may occur and not be detected.

17. While a lack of sophistication in internal controls does not, of itself, indicate a high risk of fraud or error, an owner-manager's dominant position can be abused: management override of controls may have a significant adverse effect on the control environment in any entity, leading to an increased risk of management fraud or material misstatement in the financial statements. For example, the owner-manager may direct personnel to make disbursements that they would otherwise not make in the absence of supporting documentation.

18. The impact of the owner-manager and the potential for management override of internal controls on the audit depend to a great extent on the integrity, attitude, and motives of the owner-manager. As in any other audit, the auditor of a small entity exercises professional skepticism. The auditor neither assumes that the owner-manager is dishonest nor assumes unquestioned honesty. This is an important factor to be considered by the auditor when assessing audit risk, planning the nature and extent of audit work, evaluating audit evidence, and assessing the reliability of management representations.

Commentary on the Application of International Standards on Auditing

19. The commentary that follows provides guidance on the application of ISAs to the audit of a small entity. This guidance is a supplement to, and not a substitute for, the guidance contained in the relevant ISA and takes account of the special considerations relevant to the audit of small entities. For the specific requirements of ISAs, the auditor refers to the ISA concerned. Where an ISA is, in principle, applicable to the audit of the financial statements of small entities and there are no special considerations applicable to the audit of a small entity, no guidance is given in respect of that ISA.

ISA 210: Terms of Audit Engagements

20. In many cases, owner-managers of small entities are not fully aware of their own responsibilities or those of their auditors. In particular, owner-managers may not appreciate that the financial statements are their responsibility, particularly where the owner-manager has outsourced the preparation of the financial statements.

21. One of the purposes of an engagement letter is to communicate clearly the respective responsibilities of the owner-manager and the auditor. The Appendix to ISA 210 provides an example of an audit engagement letter.

22. Paragraph 7 of ISA 210 states that the auditor may wish to include in the engagement letter the auditor's expectation of receiving written confirmation concerning representations made in connection with the audit. ISA 580, "Management Representations" requires the auditor to obtain evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the relevant financial reporting framework, and has approved the financial statements. Other ISAs require certain specific representations. The auditor may consider including in the engagement letter an indication of the anticipated matters on which management representations will be obtained. This provides an opportunity for the auditor to discuss with the owner-manager at the outset of the engagement the reasons for obtaining such

representations and the potential impact on the auditor's report should such representations not be obtained, which may help to avoid a problem arising as the audit is nearing completion. It will also help the auditor consider audit and reporting implications if the owner-manager cannot make or refuse to make the necessary representations.

23. In some cases the auditor may determine that it will not be possible to obtain sufficient evidence to form an opinion on the financial statements because of weaknesses that may arise from the characteristics of the small entity. In these circumstances, and where permitted by the relevant jurisdiction, the auditor may decide not to accept the engagement, or to withdraw from the engagement after acceptance. Alternatively, the auditor may decide to continue with the engagement but qualify or disclaim the audit opinion. The auditor has regard to paragraph 41 of ISA 700 "The Auditor's Report on Financial Statements"[4] which states that the auditor would not ordinarily accept an audit engagement in which the terms of the engagement are such that the auditor believes that the need to express a disclaimer of opinion exists.

ISA 220: Quality Control for Audit Work

24.-28. ISA 220, "Quality Control for Audits of Historical Financial Information" issued in February 2004 is effective for audits of financial information for periods beginning on or after June 15, 2005. Paragraphs 24-28 of this IAPS were withdrawn when ISA 220 became effective.

ISA 230: Documentation

29.-33. ISA 230, "Audit Documentation" issued in September 2005 is effective for audits of financial information for periods beginning on or after June 15, 2006. Paragraphs 29-33 of this IAPS were withdrawn when ISA 230 became effective.

ISA 240: The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements

34.-38. ISA 240 issued in February 2004 is effective for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 34-38 of this IAPS were withdrawn when ISA 240 became effective.

4 ISA 700, "The Auditor's Report on Financial Statements" was withdrawn in December 2006 when ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" became effective.

ISA 250: Consideration of Laws and Regulations in an Audit of Financial Statements

39. ISA 250 requires the auditor to obtain a general understanding of the legal and regulatory framework to which the entity is subject. Apart from those laws and regulations that relate directly to the preparation of the financial statements, there may also be laws and regulations that provide a legal framework for the conduct of the entity and that are central to the entity's ability to conduct its business. As most small entities have uncomplicated activities, the legal and regulatory environment to which they are subject is less complicated than the environment in which larger more diversified entities operate.

40. Once the auditor of a small entity has identified any relevant industry-specific laws and regulations, this information is recorded as permanent information as part of the knowledge of the entity and is reviewed and updated as necessary in subsequent years.

ISA 260: Communications of Audit Matters with Those Charged with Governance

41. Paragraph 5 of ISA 260 requires the auditor to determine the relevant individuals who are charged with governance and with whom audit matters of governance interest are communicated. The governance structure in a small entity may not be well defined, or those charged with governance of the small entity may be the same individuals as those charged with management of the entity. It may also include spouses or other relatives, who may not be involved in the supervision or control of the entity on a day-to-day basis. The auditor determines who are entrusted with the supervision, control and direction of the small entity.

ISA 300: Planning the Audit of Financial Statements

42.-43. ISA 300 issued in June 2004 is effective for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 42 and 43 of this IAPS were withdrawn when ISA 300 became effective.

ISA 315: Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements

44.-46. ISA 315 issued in October 2003 is effective for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 44-46 of this IAPS were withdrawn when ISA 315 became effective.

ISA 320: Audit Materiality

47. "Materiality" is defined in the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" as follows: "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful."

Planning Stage

48. For audit planning purposes, it is generally necessary to assess materiality from a qualitative and quantitative perspective. One purpose of this preliminary judgment about materiality is to focus the auditor's attention on the more significant financial statement items while determining the audit strategy. As there are no authoritative pronouncements on how materiality is assessed in quantitative terms, the auditor in each case applies professional judgment in the light of the circumstances. One approach to the assessment of quantitative materiality is to use a percentage of a key figure in the financial statements such as one of the following:

    - Profit or loss before tax (adjusted, if appropriate, for the effect of any abnormal levels of items of expenditure such as the owner-manager's remuneration).
    - Revenue.
    - Balance sheet total.

49. Often in the case of small entities, draft financial statements are not available to the auditor at the commencement of the audit. When this is the case, the auditor uses the best information available at the time. The current year's trial balance may be used, if available. Often an estimate of revenue for the current period can be more readily obtained than of profit (or loss) or of a balance sheet total. A common approach in the preliminary judgment of materiality is to calculate materiality on the previous year's audited financial statements as amended for known circumstances in relation to the year subject to audit.

50. Assessing materiality as a percentage of pre-tax results may be inappropriate when the entity is at or near the break-even point as it may give an inappropriately low level of materiality, leading to unnecessarily extensive audit procedures. In such cases, the auditor may apply the percentage method, for example, to revenue or balance sheet totals. Alternatively, materiality may be assessed having regard to assessed levels of materiality in prior years and the normal level of results. In addition to

considering materiality at the overall financial statement level, the auditor considers materiality in relation to individual account balances, classes of transactions, and disclosures.

Assessment of Materiality when Evaluating the Results of Audit Procedures

51. Whatever basis may be used to assess materiality for audit planning purposes, the auditor reassesses materiality when evaluating the results of audit procedures. This reassessment takes account of the final version of the draft financial statements, incorporating all agreed adjustments and information obtained during the course of the audit.

52. Although materiality at the reporting stage is considered in quantitative terms, there is no clear threshold value but rather a range of values within which the auditor exercises judgment. Amounts above the upper limit of the range may be presumed material and amounts below the lower limit may be presumed not material, although either presumption may be rebutted by applying qualitative considerations.

53. In addition, although planning may have been based on a quantitative assessment of materiality, the auditor's opinion will take into account not only the amount but also the qualitative nature of unadjusted misstatements within the financial statements.

ISA 330: The Auditor's Procedures in Response to Assessed Risks

54.-65. ISA 330 issued in October 2003 is effective for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 54-65 of this IAPS were withdrawn when ISA 330 became effective.

ISA 500: Audit Evidence

66.-70. ISA 500 issued in October 2003 is effective for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 66-70 of this IAPS were withdrawn when ISA 500 became effective.

ISA 520: Analytical Procedures

Analytical Procedures in Planning the Audit

71. The auditor applies analytical procedures at the planning stage of the audit. The nature and extent of analytical procedures at the planning stage of the audit of a small entity may be limited by the timeliness of processing of transactions by the small entity and the lack of reliable financial information at that point in time. Small entities may not have interim or monthly financial information that can be used in analytical procedures at the planning stage. The auditor may, as an alternative, conduct a brief review of

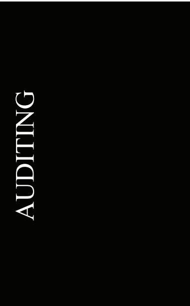
the general ledger or such other accounting records as may be readily available. In many cases, there may be no documented information that can be used for this purpose, and the auditor may obtain the required information through discussion with the owner-manager.

Analytical Procedures as Substantive Procedures

72. Analytical procedures can often be a cost-effective means of obtaining evidence required by the auditor. The auditor assesses the controls over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures.

73. An unsophisticated predictive model can sometimes be effective. For example, where a small entity has employed a known number of staff at fixed rates of pay throughout the period, it will ordinarily be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in analytical procedures to provide evidence to support the reasonableness of recorded items. The extent of analytical procedures in the audit of a small entity may be limited because of the non-availability of information on which the analytical procedures are based.

74. Predictive analytical procedures can often be an effective means of testing for completeness, provided the results can be predicted with a reasonable degree of precision and confidence. Variations from expected results may indicate possible omissions that have not been detected by other substantive tests.



75. However, different types of analytical procedure provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can be a very persuasive source of evidence and may eliminate the need for further verification by means of tests of details. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may be a less persuasive source of evidence, but may provide useful corroboration if used in combination with other audit procedures.

Analytical Procedures as Part of the Overall Review

76. The analytical procedures ordinarily performed at this stage of the audit are very similar to those that would be used at the planning stage of the audit. These include the following:

    - Comparing the financial statements for the current year to those of previous years.
    - Comparing the financial statements to any budgets, forecasts, or management expectations.
    - Reviewing trends in any important financial statement ratios.
    - Considering whether the financial statements adequately reflect any changes in the entity of which the auditor is aware.
    - Inquiring into unexplained or unexpected features of the financial statements.

ISA 530: Audit Sampling and Other Means of Testing

77. There are a variety of methods of selecting items for testing, the auditor's choice of an appropriate method will be guided by considerations of effectiveness and efficiency. The means available to the auditor are:

    (a) Selecting all items (100% examination);

    (b) Selecting specific items; or

    (c) Audit sampling.

78. The small populations ordinarily encountered in small entities may make it feasible to test:

    (a) 100% of the population; or

    (b) 100% of some part of the population, for example, all items above a given amount, applying analytical procedures to the balance of the population, if it is material.

79. When the above methods of obtaining audit evidence are not adopted, the auditor considers the use of procedures involving audit sampling. When the auditor decides to use audit sampling, the same underlying principles apply in both large and small entities. The auditor selects sample items in such a way that the sample can be expected to be representative of the population.

ISA 545: Auditing Fair Value Measurements and Disclosures

80. In accordance with paragraph 4 of ISA 545, management is responsible for making the fair value measurements and disclosures included in the financial statements. Management is also responsible for establishing an accounting and financial reporting process for determining the fair value

measurements and disclosures, selecting appropriate valuation methods, identifying and adequately supporting any significant assumptions used, preparing the valuation and ensuring that the presentation and disclosure of the fair value measurements are in accordance with the entity's applicable financial reporting framework.

81. According to paragraph 11 of ISA 545, in some cases, the measurement of fair value and therefore the process set up by management to determine fair value may be simple and reliable. For example, management may be able to refer to published price quotations to determine fair value for marketable securities held by the entity. Some fair value measurements, however, are inherently more complex than others and involve uncertainty about the occurrence of future events or their outcome, and therefore assumptions that may involve the use of judgment need to be made as part of the measurement process.

82. The owner-manager of a small entity may not have the expertise and experience necessary to fulfill the responsibilities referred to in paragraph 80 for fair value measurements other than those based on published price quotations. The auditor recognizes that the use of an expert, such as an independent valuer, may represent a significant cost to the small entity. However, if considered necessary in the circumstances, the auditor recommends to the owner-manager the use of an expert.

83. Any assistance provided by the auditor may create threats to the independence of the auditor. The auditor is to refer to paragraphs 8.171 to 8.176 of the Code[5] for guidance on valuation services that may pose a threat and the potential safeguards that can be considered.

84. Paragraph 63 of ISA 545 requires the auditor to obtain written representations from management regarding the reasonableness of significant assumptions, including whether they appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity where relevant to the fair value measurements or disclosures. Because of the reasons set out in paragraph 82, the owner-manager may be of the opinion that it is not possible to provide the required representation. The responsibility for making the fair value measurements and disclosures included in the financial statements rests with the owner-manager. If the owner-manager refuses to provide the required representation, this constitutes a scope limitation and the auditor expresses a qualified opinion or a disclaimer of opinion.

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[5] See footnote 2.

ISA 550: Related Parties

85. Significant transactions are often entered into between the small entity and the owner-manager, or between the small entity and entities related to the owner-manager. Small entities seldom have sophisticated policies and codes of conduct on related party transactions. Indeed, related party transactions are a regular feature of many entities that are owned and managed by an individual or by a family. Further, the owner-manager may not fully understand the definition of a related party, especially where relevant accounting standards deem certain relationships to be related and others not. The provision of management representations in respect of the completeness of disclosure may entail some explanation by the auditor of the technical definition of a related party.

86. The auditor of a small entity ordinarily performs substantive procedures on the identification of related parties and related party transactions. However, if the auditor assesses the risk of undisclosed related party transactions as low, such substantive procedures need not be extensive. The auditor often acts as the auditor of other entities related to the small entity, which may assist in identifying related parties.

87. The auditor's in-depth knowledge of the small entity may be of assistance in the identification of related parties, which in many instances, will be with entities controlled by the owner-manager. This knowledge can also help the auditor assess whether related party transactions might have taken place without recognition in the entity's accounting records.

ISA 560: Subsequent Events

Subsequent Events Between the Period End and the Date of the Auditor's Report

88. It is not common for small entities to be required to report shortly after their period-end. It is often the case that more time elapses between the period end and the approval or signature of the financial statements by the owner-manager in the case of small entities, than in the case of large entities. The period to be covered by the auditor's subsequent events procedures is therefore often longer in the audit of a small entity, allowing more opportunity for the occurrence of subsequent events that can affect the financial statements. ISA 560 requires the auditor to perform procedures to cover the entire period from the period-end up to the date of the auditor's report.

89. The subsequent events procedures that the auditor of a small entity performs will depend on the information that is available and, in particular, the extent to which the accounting records have been written up since the period-end. When the accounting records are not up-to-date and minutes of meetings of the directors have not been prepared, relevant procedures can take the form of inquiry of the owner-manager, recording the owner-manager's responses

and inspection of bank statements. Paragraph 5 of ISA 560 gives examples of some of the matters that it may be appropriate for the auditor to consider in the course of these inquiries.

90. The auditor may, depending on the circumstances, consider that the letter of representation should cover subsequent events. The letter of representation is ordinarily dated on the same day as the auditor's report, thus covering the entire period since the period end.

91. Guidance on the auditor's procedures relating to subsequent events (if any) in the period between the approval of the financial statements and the date of the auditor's report is given in the guidance provided in this IAPS on ISA 700, "The Auditor's Report on Financial Statements."[6]

Subsequent Events Between the Date of the Auditor's Report and the Financial Statements being Issued

92. Where, as in many small entities, the meeting at which the financial statements are approved or signed is immediately followed by the annual general meeting, the interval between the two does not require any separate consideration by the auditor as it is so short.

93. If the auditor becomes aware of a fact that materially affects the financial statements, the auditor considers whether the financial statements require amendment, discusses the matter with management, and takes action appropriate in the circumstances.

ISA 570: Going Concern

94. The size of an entity affects its ability to withstand adverse conditions. Small entities can respond quickly to exploit opportunities, but may lack reserves to sustain operations.

95. ISA 570 requires that the auditor considers whether there are any events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Conditions of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, the possibility of the loss of a principal supplier, major customer or key employee, and the possible loss of the right to operate under a license, franchise or other legal agreement.

96. ISA 570 gives guidance on additional audit procedures that may be relevant when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern. Such procedures may include a review of documentation such as cash flows and profit forecasts. In the audit of a small entity, the auditor does not ordinarily

[6] See footnote 4.

expect to find detailed forecasts relevant to the consideration of going concern. Nevertheless, the auditor discusses with the owner-manager the going concern status of the entity and, in particular, the financing of the entity in the medium and long-term. The auditor considers these discussions in the light of corroborative documentation and the auditor's knowledge of the business. The auditor seeks written representation from the owner-manager of the matters identified.

97. Where the small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating his loan to the entity in favor of banks or other financial institutions. In such circumstances the auditor inspects appropriate, documentary evidence of the subordination of the owner-manager's loan. Where an entity is dependent on additional support from the owner-manager, the auditor considers the owner-manager's ability to meet the obligation under the support arrangement. In addition, the auditor may ask for a written representation confirming the owner-manager's intention or understanding.

ISA 580: Management Representations

98. Paragraph 6 of ISA 580 states that, when representations relate to matters that are material to the financial statements, the auditor:

    (a) Seeks corroborative audit evidence from sources inside or outside the entity;

    (b) Evaluates whether the representations made by management appear reasonable and are consistent with other audit evidence obtained, including other representations; and

    (c) Considers whether the individuals making the representations can be expected to be well-informed on the particular matters.

99. Paragraph 7 of ISA 580 states that representations from management cannot be a substitute for other audit evidence that the auditor expects to be available. If such audit evidence cannot be obtained, this may constitute a limitation on the scope of the audit and the auditor considers the implications for the auditor's report. However, in certain instances, a representation by management may be the only audit evidence that the auditor can reasonably expect to be available.

100. In view of the particular characteristics of small entities, the auditor may judge it appropriate to obtain written representations from the owner-manager as to the completeness and accuracy of the accounting records and of the financial statements (for example, that all income has been recorded). Such representations, on their own, do not provide sufficient audit evidence.

The auditor assesses the representations in conjunction with the results of other relevant audit procedures, the auditor's knowledge of the business and of its owner-manager, and considers whether, in the particular circumstances, it would be reasonable to expect other audit evidence to be available. The possibility of misunderstandings between the auditor and the owner-manager is reduced when oral representations are confirmed by the owner-manager in writing.

101. Due to the nature of small entities, owner-managers may be of the opinion that it is not possible to provide certain specific representations. This may particularly be the case for the specific representations in ISA 240, ISA 545 and ISA 570 (refer paragraphs 84, 96 and 97 of this IAPS). The auditor is encouraged to discuss with the owner-manager the reasons for obtaining such representations and the potential impact on the auditor's report should such representations not be obtained. As noted in paragraph 22 of this IAPS, it may be useful to discuss these representations with management when agreeing the terms of engagement.

ISA 700: The Auditor's Report on Financial Statements

102.-105. ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" and ISA 701, "Modifications to the Independent Auditor's Report" were issued in December 2004 and are effective for auditors' reports dated on or after December 31, 2006. Paragraphs 102-105 of this IAPS were withdrawn when ISA 700 and ISA 701 became effective.

ISA 720: Other Information in Documents Containing Audited Financial Statements

106. The auditor reads the other information to identify material inconsistencies with the audited financial statements. Examples of "other information" often included with the financial statements of a small entity are the detailed income and expenditure statement, that is often attached with audited financial statements for taxation purposes, and the management report.

Appendix 1

Commentary on the Application of ISAs when the Auditor Also Prepares the Accounting Records and Financial Statements of the Small Entity

This appendix is relevant to auditors who are legally and professionally permitted to prepare accounting records and financial statements for their small entity audit clients. In preparing the accounting records and financial statements, the auditor may obtain useful information about the entity and its owner-manager's aims, management style, and ethos. The auditor also acquires an in-depth knowledge of the entity, which assists in planning and conducting the audit. The auditor nevertheless remembers that the preparation of accounting records and financial statements for the small entity audit client does not relieve the auditor from obtaining sufficient and appropriate audit evidence. The matters set out below may be relevant in the application of the ISAs by the auditor who also prepares the accounting records and financial statements for the small entity audit client.

ISA 210: Terms of Audit Engagements

1. Where the auditor has assisted with the preparation of the financial statements, owner-managers of small entities may not be fully aware of their own legal responsibilities or those of the auditor. Owner-managers may not appreciate that the financial statements are their responsibility, or that the audit of the financial statements is legally quite distinct from any other services that the auditor provides. One of the purposes of an engagement letter is to avoid any such misunderstandings.

2. In the case of a small entity, it may be practical to combine terms of engagement for audit and other services in a single combined letter of engagement.

ISA 230: Documentation

3. When the auditor prepares the accounting records or financial statements for a small entity, such services are not audit work and the requirements of ISA 230[7] do not ordinarily apply to, for example, documentation of the work done in preparing the financial statements.

4. A consideration when establishing a retention policy for the working papers of a small entity is that owner-managers often request copies of the working papers containing accounting information to assist them in the administration

[7] ISA 230, "Documentation" was withdrawn when ISA 230, "Audit Documentation" became effective. The latter is effective for audits of financial information for periods beginning on or after June 15, 2006.

of their entity. Paragraph 14 of ISA 230 states that working papers are the property of the auditor. Although portions of, or extracts from, the working papers may be made available to the entity at the discretion of the auditor, they are not a substitute for the entity's accounting records. It may be helpful for the engagement letter to set out these requirements regarding the accounting records.

ISA 240: The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements

5. The auditor may have obtained knowledge of the owner-manager's personal financial position and lifestyle through the provision of other services to the entity or the owner manager. This knowledge may enhance the quality of the auditor's assessment of the inherent risk of fraud. Unexplained demands to prepare the financial statements and complete the audit in an unreasonably short period of time may also indicate that there is an increased risk of fraud or error occurring.

ISA 250: Consideration of Laws and Regulations in an Audit of Financial Statements

6. Most entities are subject to requirements relating directly to the preparation of financial statements, including the relevant companies legislation. The accounting expertise of the auditor as regards the legislation relating to the preparation of the financial statements helps the owner-manager ensure that the relevant statutory obligations have been complied with.

ISA 300: Planning an Audit of Financial Statements

7. When the auditor prepares the accounting records or financial statements, sufficient flexibility is required in the overall audit plan to take account of any areas of audit risk identified, and evidence obtained in performing those services. The auditor of a small entity therefore plans to take into consideration knowledge obtained from the preparation of the accounting records or financial statements so that the approach to obtaining evidence is properly co-ordinated and that efficiency of work and cost can be secured.

ISA 315: Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement and ISA 330: The Auditor's Procedures in Response to Assessed Risks

8. In preparing the accounting records or financial statements, the auditor may obtain an understanding of the accounting and internal control system. Consideration is given to whether there are certain internal controls the auditor may wish to assess and test, which may affect the nature, timing and extent of substantive procedures required for the audit.

ISA 500: Audit Evidence

9. The auditor of a small entity when preparing the accounting records or financial statements, applies professional judgment in considering whether those services result in a reduction in the audit work necessary to support the auditor's opinion. The preparation of accounting records or financial statements will seldom provide all, and may not even provide any, of the audit evidence required by the auditor. In particular, those services will ordinarily do no more than provide *some* of the necessary evidence regarding the completeness of a population, or the value at which items are stated in the financial statements. However, audit evidence can often be obtained at the same time that the accounting records or financial statements are being prepared. Specific audit work will ordinarily be required, for example, on the recoverability of debtors, the valuation and ownership of inventories, the carrying value of fixed assets and investments and the completeness of creditors.

ISA 520: Analytical Procedures

10. In small entities where the auditor has been engaged to prepare accounting records or financial statements, analytical procedures carried out at the planning stage of the audit will be more effective if those services have been completed before the audit planning is finalized.

ISA 540: Audit of Accounting Estimates

11. Although the owner-manager is responsible for determining the amount of the estimate to be included in the financial statements, the auditor of a small entity is often asked to assist with or advise on the preparation of any accounting estimates. By assisting with the process of preparing the accounting estimate, the auditor at the same time gains evidence relevant to meeting the requirements of ISA 540. However, assisting with this process does not relieve the auditor from obtaining sufficient and appropriate audit evidence regarding the reasonableness and appropriateness of the underlying assumptions used in arriving at the estimates.

ISA 545: Auditing Fair Value Measurements and Disclosures

12. Although the owner-manager is responsible for fair value measurements and disclosures, the auditor of a small entity may be asked to assist with the process of preparing the fair value measurements or disclosures. Management remains responsible for the reasonableness of the assumptions on which the fair value measurements and disclosures are based and, as a result, the auditor takes appropriate steps to obtain the owner-manager's agreement and acknowledgement of responsibility.

13. By assisting with the process of preparing the fair value measurements or disclosures, the auditor at the same time gains evidence relevant to meeting the requirements of ISA 545. However, assisting with this process does not relieve the auditor from obtaining sufficient and appropriate audit evidence regarding the reasonableness and appropriateness of the underlying assumptions used in arriving at the measurements or disclosures.

ISA 550: Related Parties

14. When assessing the risk of undisclosed related party transactions, the auditor considers matters arising when preparing the accounting records or financial statements of the small entity, assisting with the preparation of personal and corporate tax matters, or reviewing the owner-manager's current accounts.

15. This, taken together with information obtained through discussion with the owner-manager, assists in the assessment of the risk in this area and may provide a reasonable basis for the risk to be assessed as low.

16. This assistance and the close relationship between the auditor and the owner-manager can assist in the identification of related parties, which, in most instances, will be with entities controlled by the owner-manager.

ISA 570: Going Concern

17. In some small entities, the auditor may be asked to assist the owner-manager with the assessment of going concern and sometimes with the preparation of any necessary cash flows or profit forecasts. In all cases, the owner-manager remains responsible for the assessment of going concern for any information prepared (even if the auditor assisted in its compilation), and for the reasonableness of the assumptions on which it is based. In such circumstances, the auditor takes appropriate steps to obtain the owner-manager's agreement and acknowledgment of responsibility.

ISA 580: Management Representations

18. In the audit of a small entity, it is particularly important for the auditor to obtain management representations in which the owner-manager acknowledges responsibility for the fair presentation of the financial statements. This is particularly necessary where the auditor has prepared the financial statements, because of the danger of the auditor's role and responsibility in relation to the financial statements being misunderstood. In order to ensure that the representations are meaningful, the auditor considers explaining these matters to management before the representations are obtained.

Appendix 2

Where to Find Small Entity Audit Considerations

The table below lists the ISAs on which the IAASB (and its predecessor, the IAPC) has prepared small entity audit considerations, and provides an indication of where the considerations can be found.

ISA	Title	Where to Find Small Entity Considerations
210	Terms of Audit Engagements	IAPS 1005
220	Quality Control for Audits of Historical Financial Information	ISA 220. Effective for audits of financial information for periods beginning on or after June 15, 2005.
230	Audit Documentation	ISA 230. Effective for audits of financial information for periods beginning on or after June 15, 2006.
240	The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements	ISA 240. Effective for audits of financial statements for periods beginning on or after December 15, 2004.
250	Consideration of Laws and Regulations in an audit of Financial Statements	IAPS 1005
260	Communications of Audit Matters with Those Charged with Governance	IAPS 1005
300	Planning an Audit of Financial Statements	ISA 300. Effective for Audits of financial statements for periods beginning on or after December 15, 2004.

ISA	Title	Where to Find Small Entity Considerations
315	Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement	ISA 315. Effective for audits of financial statements for periods beginning on or after December 15, 2004.
320	Audit Materiality	IAPS 1005
330	The Auditor's Procedures in Response to Assessed Risks	ISA 330. Effective for audits of financial statements for periods beginning on or after December 15, 2004.
500	Audit Evidence	ISA 500. Effective for audits of financial statements for periods beginning on or after December 15, 2004.
520	Analytical Procedures	IAPS 1005
530	Audit Sampling and Other Means of Testing	IAPS 1005
545	Auditing Fair Value Measurements and Disclosures	IAPS 1005
550	Related Parties	IAPS 1005
560	Subsequent Events	IAPS 1005
570	Going Concern	IAPS 1005
580	Management Representations	IAPS 1005
700 & 701	The Auditor's Report on Financial Statements	ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" and ISA

ISA	Title	Where to Find Small Entity Considerations
		701, "Modifications to the Independent Auditor's Report." Effective for auditors' reports dated on or after December 31, 2006.
720	Other Information in Documents Containing Audited Financial Statements	IAPS 1005

INTERNATIONAL AUDITING PRACTICE STATEMENT 1006

AUDITS OF THE FINANCIAL STATEMENTS OF BANKS

(This Statement is effective)

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International Auditing Practice Statement (IAPS) 1006, "Audits of the Financial Statements of Banks" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of IAPSs.

This Statement has been prepared by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants. The IAPC bank audit sub-committee included observers from the Basel Committee on Banking Supervision (the Basel Committee).* The document was approved for publication by the IAPC at its meeting in October 2001. It is based on ISAs extant at October 1, 2001.

* The Basel Committee on Banking Supervision is a committee of banking and supervisory authorities that was established by the central bank governors of ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent secretariat is located.

Introduction

1. The purpose of this Statement is to provide practical assistance to auditors and to promote good practice in applying International Standards on Auditing (ISAs) to the audit of banks' financial statements. It is not, however, intended to be an exhaustive listing of the procedures and practices to be used in such an audit. In conducting an audit in accordance with ISAs the auditor complies with all the requirements of all the ISAs.

2. In many countries, banking supervisors require that the auditor report certain events to the regulators or make regular reports to them in addition to the audit report on the banks' financial statements. This Statement does not deal with such reports, the requirements for which often vary significantly between countries. IAPS 1004, "The Relationship Between Banking Supervisors and Bank's External Auditors" discusses that subject in more detail.

3. For the purpose of this Statement, a bank is a type of financial institution whose principal activity is the taking of deposits and borrowing for the purpose of lending and investing and that is recognized as a bank by the regulatory authorities in any countries in which it operates. There are a number of other types of entity that carry out similar functions, for example, building societies, credit unions, friendly societies, savings and loan associations and thrift institutions. The guidance in this Statement is applicable to audits of financial statements that cover the banking activities carried out by those entities. It also applies to the audits of consolidated financial statements that include the results of banking activities carried out by any group member. This Statement addresses the assertions made in respect of banking activities in the entity's financial statements and so indicates which assertions in a bank's financial statements cause particular difficulties and why they do so. This necessitates an approach based on the elements of the financial statements. However, when obtaining audit evidence to support the financial statement assertions, the auditor often carries out procedures based on the types of activities the entity carries out and the way in which those activities affect the financial statement assertions.

4. Banks commonly undertake a wide range of activities. However, most banks continue to have in common the basic activities of deposit taking, borrowing, lending, settlement, trading and treasury operations. This Statement's primary purpose is the provision of guidance on the audit implications of such activities. In addition, this Statement provides limited guidance in respect of securities underwriting and brokerage, and asset management, which are activities that auditors of banks' financial statements frequently encounter. Banks typically undertake activities involving derivative financial instruments. This Statement gives guidance

on the audit implications of such activities when they are part of the bank's trading and treasury operations. IAPS 1012, "Auditing Derivative Financial Instruments" gives guidance on such activities when the bank holds derivatives as an end user.

5. This Statement is intended to highlight those risks that are unique to banking activities. There are many audit-related matters that banks share with other commercial entities. The auditor is expected to have a sufficient understanding of such matters and so, although those matters may affect the audit approach or may have a material affect on the bank's financial statements, this Statement does not discuss them. This Statement describes in general terms aspects of banking operations with which an auditor becomes familiar before undertaking the audit of a bank's financial statements: it is not intended to describe banking operations. Consequently, this Statement on its own does not provide an auditor with sufficient background knowledge to undertake the audit of a bank's financial statements. However, it does point out areas where that background knowledge is required. Auditors will supplement the guidance in this Statement with appropriate reference material and by reference to the work of experts as required.

6. Banks have the following characteristics that generally distinguish them from most other commercial enterprises:

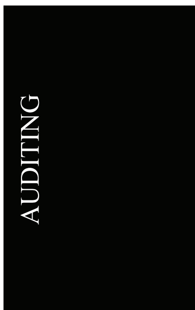
   - They have custody of large amounts of monetary items, including cash and negotiable instruments, whose physical security has to be safeguarded during transfer and while being stored. They also have custody and control of negotiable instruments and other assets that are readily transferable in electronic form. The liquidity characteristics of these items make banks vulnerable to misappropriation and fraud. Banks therefore need to establish formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.

   - They often engage in transactions that are initiated in one jurisdiction, recorded in a different jurisdiction and managed in yet another jurisdiction.

   - They operate with very high leverage (that is, the ratio of capital to total assets is low), which increases banks' vulnerability to adverse economic events and increases the risk of failure.

   - They have assets that can rapidly change in value and whose value is often difficult to determine. Consequentially a relatively small decrease in asset values may have a significant effect on their capital and potentially on their regulatory solvency.

- They generally derive a significant amount of their funding from short-term deposits (either insured or uninsured). A loss of confidence by depositors in a bank's solvency may quickly result in a liquidity crisis.
- They have fiduciary duties in respect of the assets they hold that belong to other persons. This may give rise to liabilities for breach of trust. They therefore need to establish operating procedures and internal controls designed to ensure that they deal with such assets only in accordance with the terms on which the assets were transferred to the bank.
- They engage in a large volume and variety of transactions whose value may be significant. This ordinarily requires complex accounting and internal control systems and widespread use of information technology (IT).
- They ordinarily operate through networks of branches and departments that are geographically dispersed. This necessarily involves a greater decentralization of authority and dispersal of accounting and control functions, with consequential difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
- Transactions can often be directly initiated and completed by the customer without any intervention by the bank's employees, for example over the Internet or through automatic teller machines (ATMs).
- They often assume significant commitments without any initial transfer of funds other than, in some cases, the payment of fees. These commitments may involve only memorandum accounting entries. Consequently their existence may be difficult to detect.
- They are regulated by governmental authorities, whose regulatory requirements often influence the accounting principles that banks follow. Non-compliance with regulatory requirements, for example, capital adequacy requirements, could have implications for the bank's financial statements or the disclosures therein.
- Customer relationships that the auditor, assistants, or the audit firm may have with the bank might affect the auditor's independence in a way that customer relationships with other organizations would not.
- They generally have exclusive access to clearing and settlement systems for checks, fund transfers, foreign exchange transactions, etc.
- They are an integral part of, or are linked to, national and international settlement systems and consequently could pose a systemic risk to the countries in which they operate.



- They may issue and trade in complex financial instruments, some of which may need to be recorded at fair values in the financial statements. They therefore need to establish appropriate valuation and risk management procedures. The effectiveness of these procedures depends on the appropriateness of the methodologies and mathematical models selected, access to reliable current and historical market information, and the maintenance of data integrity.

7. Special audit considerations arise in the audits of banks because of matters such as the following:
   - The particular nature of the risks associated with the transactions undertaken by banks.
   - The scale of banking operations and the resultant significant exposures that may arise in a short period.
   - The extensive dependence on IT to process transactions.
   - The effect of the regulations in the various jurisdictions in which they operate.
   - The continuing development of new products and banking practices that may not be matched by the concurrent development of accounting principles or internal controls.

8. This Statement is organized into a discussion of the various aspects of the audit of a bank with emphasis being given to those matters that are either peculiar to, or of particular importance in, such an audit. Included for illustrative purposes are appendices that contain examples of:

   (a) Typical warning signs of fraud in banking operations;

   (b) Typical internal controls, tests of control and substantive audit procedures for two of the major operational areas of a bank: treasury and trading operations and lending activities;

   (c) Financial ratios commonly used in the analysis of a bank's financial condition and performance; and

   (d) Risks and issues in securities operations, private banking and asset management.

Audit Objectives

9. ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" states:

   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.

10. The objective of the audit of a bank's financial statements conducted in accordance with ISAs is, therefore, to enable the auditor to express an opinion on the bank's financial statements, which are prepared in accordance with the applicable financial reporting framework.

11. The auditor's report indicates the financial reporting framework that has been used to prepare the bank's financial statements (including identifying the country of origin of the financial reporting framework when the framework used is not International Accounting Standards). When reporting on financial statements of a bank prepared specifically for use in a country other than that under whose rules it is established, the auditor considers whether the financial statements contain appropriate disclosures about the financial reporting framework used. Paragraphs 101-103 of this Statement discuss the auditor's report in more detail.

Agreeing the Terms of the Engagement

12. As stated in ISA 210, "Terms of Audit Engagements":

    The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports.

13. Paragraph 6 lists some of the characteristics that are unique to banks and indicates the areas where the auditor and assistants may require specialist skills. In considering the objective and scope of the audit and the extent of the responsibilities, the auditor considers his own skills and competence and those of his assistants to conduct the engagement. In doing so, the auditor considers the following factors:

    - The need for sufficient expertise in the aspects of banking relevant to the audit of the bank's business activities.
    - The need for expertise in the context of the IT systems and communication networks the bank uses.
    - The adequacy of resources or inter-firm arrangements to carry out the work necessary at the number of domestic and international locations of the bank at which audit procedures may be required.

14. In addition to the general factors set out in ISA 210, the auditor considers including comments on the following when issuing an engagement letter:

    - The use and source of specialized accounting principles, with particular reference to:
        - Any requirements contained in the law or regulations applicable to banks;

    - Pronouncements of the banking supervisory and other regulatory authorities;
    - Pronouncements of relevant professional accounting bodies, for example, the International Accounting Standards Board;
    - Pronouncements of the Basel Committee on Banking Supervision; and
    - Industry practice.
- The contents and form of the auditor's report on the financial statements and any special-purpose reports required from the auditor in addition to the report on the financial statements. This includes whether such reports refer to the application of regulatory or other special purpose accounting principles or describe procedures undertaken especially to meet regulatory requirements.
- The nature of any special communication requirements or protocols that may exist between the auditor and the banking supervisory and other regulatory authorities.
- The access that bank supervisors will be granted to the auditor's working papers when such access is required by law, and the bank's advance consent to this access.

Planning the Audit

Introduction

15. The audit plan includes, among other things:
    - Obtaining a sufficient knowledge of the entity's business and governance structure, and a sufficient understanding of the accounting and internal control systems, including risk management and internal audit functions;
    - Considering the expected assessments of inherent and control risks, being the risk that material misstatements occur (inherent risk) and the risk that the bank's system of internal control does not prevent or detect and correct such misstatements on a timely basis (control risk);
    - Determining the nature, timing and extent of the audit procedures to be performed; and
    - Considering the going concern assumption regarding the entity's ability to continue in operation for the foreseeable future, which will be the period used by management in making its assessment under the financial reporting framework. This period will ordinarily be for a period of at least one year after the balance sheet date.

Obtaining a Knowledge of the Business

16. Obtaining a knowledge of the bank's business requires the auditor to understand:

    - The bank's corporate governance structure;
    - The economic and regulatory environment prevailing for the principal countries in which the bank operates; and
    - The market conditions existing in each of the significant sectors in which the bank operates.

17. Corporate governance plays a particularly important role in banks; many regulators set out requirements for banks to have effective corporate governance structures. Accordingly the auditor obtains an understanding of the bank's corporate governance structure and how those charged with governance discharge their responsibilities for the supervision, control and direction of the bank.

18. Similarly the auditor obtains and maintains a good working knowledge of the products and services offered by the bank. In obtaining and maintaining that knowledge, the auditor is aware of the many variations in the basic deposit, loan and treasury services that are offered and continue to be developed by banks in response to market conditions. The auditor obtains an understanding of the nature of services rendered through instruments such as letters of credit, acceptances, interest rate futures, forward and swap contracts, options and other similar instruments in order to understand the inherent risks and the auditing, accounting and disclosure implications thereof.

19. If the bank uses service organizations to provide core services or activities, such as cash and securities settlement, back office activities or internal audit services, the responsibility for compliance with rules and regulations and sound internal controls remains with those charged with governance and the management of the outsourcing bank. The auditor considers legal and regulatory restrictions, and obtains an understanding of how the management and those charged with governance monitor that the system of internal control (including internal audit) operates effectively. ISA 402, "Audit Considerations Relating to Entities Using Service Organizations" gives further guidance on this subject.

20. There are a number of risks associated with banking activities that, while not unique to banking, are important in that they serve to shape banking operations. The auditor obtains an understanding of the nature of these risks and how the bank manages them. This understanding allows the auditor to assess the levels of inherent and control risks associated with different aspects of a bank's operations and to determine the nature, timing and extent of the audit procedures.

Understanding the Nature of Banking Risks

21. The risks associated with banking activities may broadly be categorized as:

Country risk:	The risk of foreign customers and counterparties failing to settle their obligations because of economic, political and social factors of the counterparty's home country and external to the customer or counterparty.
Credit risk:	The risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter. Credit risk, particularly from commercial lending, may be considered the most important risk in banking operations. Credit risk arises from lending to individuals, companies, banks and governments. It also exists in assets other than loans, such as investments, balances due from other banks and in off-balance sheet commitments. Credit risk also includes country risk, transfer risk, replacement risk and settlement risk.
Currency risk:	The risk of loss arising from future movements in the exchange rates applicable to foreign currency assets, liabilities, rights and obligations.
Fiduciary risk:	The risk of loss arising from factors such as failure to maintain safe custody or negligence in the management of assets on behalf of other parties.
Interest rate risk:	The risk that a movement in interest rates would have an adverse effect on the value of assets and liabilities or would affect interest cash flows.
Legal and documentary risk:	The risk that contracts are documented incorrectly or are not legally enforceable in the relevant jurisdiction in which the contracts are to be enforced or where the counterparties operate. This can include the risk that assets will turn out to be worth less or liabilities will turn out to be greater than expected because of inadequate or incorrect legal advice or documentation. In addition, existing laws may fail to resolve legal issues involving a bank; a court case involving a particular bank may have wider implications for the banking business and involve costs to it and

	many or all other banks; and laws affecting banks or other commercial enterprises may change. Banks are particularly susceptible to legal risks when entering into new types of transactions and when the legal right of a counterparty to enter into a transaction is not established.
Liquidity risk:	The risk of loss arising from the changes in the bank's ability to sell or dispose of an asset.
Modeling risk:	The risk associated with the imperfections and subjectivity of valuation models used to determine the values of assets or liabilities.
Operational risk:	The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
Price risk:	The risk of loss arising from adverse changes in market prices, including interest rates, foreign exchange rates, equity and commodity prices and from movements in the market prices of investments.
Regulatory risk:	The risk of loss arising from failure to comply with regulatory or legal requirements in the relevant jurisdiction in which the bank operates. It also includes any loss that could arise from changes in regulatory requirements.
Replacement risk:	(Sometimes called performance risk) The risk of failure of a customer or counterparty to perform the terms of a contract. This failure creates the need to replace the failed transaction with another at the current market price. This may result in a loss to the bank equivalent to the difference between the contract price and the current market price.
Reputational risk:	The risk of losing business because of negative public opinion and consequential damage to the bank's reputation arising from failure to properly manage some of the above risks, or from involvement in improper or illegal activities by the bank or its senior management, such as money laundering or attempts to cover up losses.

Settlement risk:	The risk that one side of a transaction will be settled without value being received from the customer or counterparty. This will generally result in the loss to the bank of the full principal amount.
Solvency risk:	The risk of loss arising from the possibility of the bank not having sufficient funds to meet its obligations, or from the bank's inability to access capital markets to raise required funds.
Transfer risk:	The risk of loss arising when a counterparty's obligation is not denominated in the counterparty's home currency. The counterparty may be unable to obtain the currency of the obligation irrespective of the counterparty's particular financial condition.

22. Banking risks increase with the degree of concentration of a bank's exposure to any one customer, industry, geographic area or country. For example, a bank's loan portfolio may have large concentrations of loans or commitments to particular industries, and some, such as real estate, shipping and natural resources, may have highly specialized practices. Assessing the relevant risks relating to loans to entities in those industries may require a knowledge of these industries, including their business, operational and reporting practices.

23. Most transactions involve more than one of the risks identified above. Furthermore, the individual risks set out above may be correlated with one another. For example, a bank's credit exposure in a securities transaction may increase as a result of an increase in the market price of the securities concerned. Similarly, non-payment or settlement failure can have consequences for a bank's liquidity position. The auditor therefore considers these and other risk correlations when analyzing the risks to which a bank is exposed.

24. Banks may be subject to risks arising from the nature of their ownership. For example, a bank's owner or a group of owners might try to influence the allocation of credit. In a closely held bank, the owners may have significant influence on the bank's management affecting their independence and judgment. The auditor considers such risks.

25. In addition to understanding the external factors that could indicate increased risk, the auditor considers the nature of risks arising from the bank's operations. Factors that contribute significantly to operational risk include the following:

(a) The need to process high volumes of transactions accurately within a short time. This need is almost always met through the large-scale use of IT, with the resultant risks of:

  (i) Failure to carry out executed transactions within the required time, causing an inability to receive or make payments for those transactions;

  (ii) Failure to carry out complex transactions properly;

  (iii) Wide-scale misstatements arising from a breakdown in internal control;

  (iv) Loss of data arising from systems' failure;

  (v) Corruption of data arising from unauthorized interference with the systems; and

  (vi) Exposure to market risks arising from lack of reliable up-to-date information.

(b) The need to use electronic funds transfer (EFT) or other telecommunications systems to transfer ownership of large sums of money, with the resultant risk of exposure to loss arising from payments to incorrect parties through fraud or error.

(c) The conduct of operations in many locations with a resultant geographic dispersion of transaction processing and internal controls. As a result:

  (i) There is a risk that the bank's worldwide exposure by customer and by product may not be adequately aggregated and monitored; and

  (ii) Control breakdowns may occur and remain undetected or uncorrected because of the physical separation between management and those who handle the transactions.

(d) The need to monitor and manage significant exposures that can arise over short time-frames. The process of clearing transactions may cause a significant build-up of receivables and payables during a day, most of which are settled by the end of the day. This is ordinarily referred to as intra-day payment risk. These exposures arise from transactions with customers and counterparties and may include interest rate, currency and market risks.

(e) The handling of large volumes of monetary items, including cash, negotiable instruments and transferable customer balances, with the resultant risk of loss arising from theft and fraud by employees or other parties.

(f) The inherent complexity and volatility of the environment in which banks operate, resulting in the risk of inappropriate risk management strategies or accounting treatments in relation to such matters as the development of new products and services.

(g) Operating restrictions may be imposed as a result of the failure to adhere to laws and regulations. Overseas operations are subject to the laws and regulations of the countries in which they are based as well as those of the country in which the parent entity has its headquarters. This may result in the need to adhere to differing requirements and a risk that operating procedures that comply with regulations in some jurisdictions do not meet the requirements of others.

26. Fraudulent activities may take place within a bank by, or with the knowing involvement of, management or personnel of the bank. Such frauds may include fraudulent financial reporting without the motive of personal gain, (for example, to conceal trading losses), or the misappropriation of the bank's assets for personal gain that may or may not involve the falsification of records. Alternatively, fraud may be perpetrated on a bank without the knowledge or complicity of the bank's employees. ISA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements"[1] gives more guidance on the nature of the auditor's responsibilities with respect to fraud. Although many areas of a bank's operations are susceptible to fraudulent activities, the most common take place in the lending, deposit-taking and dealing functions. The methods commonly used to perpetrate fraud and a selection of the fraud risk factors that indicate that a fraud may have occurred are set out in Appendix 1.

27. By the nature of their business, banks are ready targets for those engaged in money laundering activities by which the proceeds of crime are converted into funds that appear to have a legitimate source. In recent years drug traffickers in particular have greatly added to the scale of money laundering that takes place within the banking industry. In many jurisdictions, legislation requires banks to establish policies, procedures and controls to deter and to recognize and report money laundering activities. These policies, procedures and controls commonly extend to the following:

- A requirement to obtain customer identification (know your client).
- Staff screening.
- A requirement to know the purpose for which an account is to be used.

[1] ISA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" was withdrawn in December 2004 when the revised ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" became effective.

- The maintenance of transaction records.
- The reporting to the authorities of suspicious transactions or of all transactions of a particular type, for example, cash transactions over a certain amount.
- The education of staff to assist them in identifying suspicious transactions.

In some jurisdictions, auditors may have an express obligation to report to the authorities certain types of transactions that come to their attention. Even where no such obligation exists, an auditor who discovers a possible instance of noncompliance with laws or regulations considers the implications for the financial statements and the audit opinion thereon. ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" gives further guidance on this matter.

Understanding the Risk Management Process

28. Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

- Oversight and involvement in the control process by those charged with governance

  Those charged with governance should approve written risk management policies. The policies should be consistent with the bank's business strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable. Those charged with governance are also responsible for establishing a culture within the bank that emphasizes their commitment to internal controls and high ethical standards, and often establish special committees to help discharge their functions. Management is responsible for implementing the strategies and policies set by those charged with governance and for ensuring that an adequate and effective system of internal control is established and maintained.

- Identification, measurement and monitoring of risks

  Risks that could significantly impact the achievement of the bank's goals should be identified, measured and monitored against pre-approved limits and criteria. This function may be conducted by an independent risk management unit, which is also responsible for validating and stress testing the pricing and valuation models used by the front and back offices. Banks ordinarily have a risk management unit that monitors risk management activities and evaluates the effectiveness of risk management models, methodologies and

assumptions used. In such situations, the auditor considers whether and how to use the work of that unit.

- Control activities

  A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliations of positions and results, setting of limits, reporting and approval of exceptions to limits, physical security and contingency planning.

- Monitoring activities

  Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by an independent risk management unit. Internal auditing should test the risk management process periodically to check whether management polices and procedures are complied with and whether the operational controls are effective. Both the risk management unit and internal auditing should have a reporting line to those charged with governance and management that is independent of those on whom they are reporting.

- Reliable information systems

  Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

Development of an Overall Audit Plan

29. In developing an overall plan for the audit of the financial statements of a bank, the auditor gives particular attention to:

    - The complexity of the transactions undertaken by the bank and the documentation in respect thereof;
    - The extent to which any core activities are provided by service organizations;
    - Contingent liabilities and off-balance sheet items;
    - Regulatory considerations;
    - The extent of IT and other systems used by the bank;
    - The expected assessments of inherent and control risks;
    - The work of internal auditing;
    - The assessment of audit risk;

- The assessment of materiality;
- Management's representations;
- The involvement of other auditors;
- The geographic spread of the bank's operations and the co-ordination of work between different audit teams;
- The existence of related party transactions; and
- Going concern considerations.

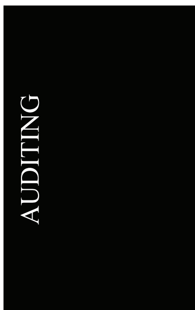
These matters are discussed in subsequent paragraphs.

The Complexity of Transactions Undertaken

30. Banks typically have a wide diversity of activities, which means that it is sometimes difficult for an auditor to fully understand the implications of particular transactions. The transactions may be so complex that management itself fails to analyze properly the risks of new products and services. The wide geographic spread of a bank's activities can also lead to difficulties. Banks undertake transactions that have complex and important underlying features that may not be apparent from the documentation that is used to process the transactions and to enter them into the bank's accounting records. This results in the risk that all aspects of a transaction may not be fully or correctly recorded or accounted for, with the resultant risks of:

    - Loss due to the failure to take timely corrective action;
    - Failure to make adequate provisions for loss on a timely basis; and
    - Inadequate or improper disclosure in the financial statements and other reports.

    The auditor obtains an understanding of the bank's activities and the transactions it undertakes sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report.



31. Many of the amounts to be recorded or disclosures made in the financial statements involve the exercise of judgment by management, for example, loan loss provisions, and provisions against financial instruments such as liquidity risk provision, modeling risk provision and reserve for operational risk. The greater the judgment required, the greater the inherent risk and the greater the professional judgment required by the auditor. Similarly, there may be other significant items in the financial statements that involve accounting estimates. The auditor considers the guidance set out in ISA 540, "Audit of Accounting Estimates."

The Extent to which any Core Activities are Provided by Service Organizations

32. In principle, the considerations when a bank uses service organizations are no different from the considerations when any other entity uses them. However, banks sometimes use service organizations to perform parts of their core activities, such as credit and cash management. When the bank uses service organizations for such activities, the auditor may find it difficult to obtain sufficient appropriate audit evidence without the cooperation of the service organization. ISA 402, "Audit Considerations Relating to Entities Using Service Organizations" provides further guidance on the auditing considerations and the types of reports that auditors of service organizations provide to the organization's clients.

Contingent Liabilities and Off-balance Sheet Items

33. Banks also typically engage in transactions that:

    - Have a low fee revenue or profit element as a percentage of the underlying asset or liability;
    - Local regulations may not require to be disclosed in the balance sheet, or even in the notes to the financial statements;
    - Are recorded only in memorandum accounts; or
    - Involve securitizing and selling assets so that they no longer appear in the bank's financial statements.

    Examples of such transactions are safe custody services, guarantees, comfort letters and letters of credit, interest rate and currency swaps and commitments and options to purchase and sell foreign exchange.

34. The auditor reviews the bank's sources of revenue, and obtains sufficient appropriate audit evidence regarding the following:

    (a) The accuracy and completeness of the accounting records relating to such transactions.

    (b) The existence of proper controls to limit the banking risks arising from such transactions.

    (c) The adequacy of any provisions for loss which may be required.

    (d) The adequacy of any financial statement disclosures which may be required.

Regulatory Considerations

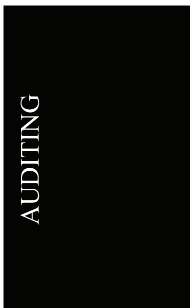
35. The International Auditing Practices Statement 1004 provides information and guidance on the relationship between bank auditors and banking supervisors. The Basel Committee has issued supervisory guidance regarding sound banking practices for managing risks, internal control systems, loan accounting and disclosure, other disclosures and for other areas of bank activities. In addition, the Basel Committee has issued guidance on the assessment of capital adequacy and other important supervision topics. This guidance is available to the auditor and to the public on the internet website of the Bank for International Settlements (BIS).

36. In accordance with ISA 310, "Knowledge of the Business"[2] the auditor considers whether the assertions in the financial statements are consistent with the auditor's knowledge of the business. In many regulatory frameworks, the level and types of business a bank is allowed to undertake depend upon the level of its assets and liabilities and the types and perceived risks attached to those assets and liabilities (a risk-weighted capital framework). In such circumstances there are greater pressures for management to engage in fraudulent financial reporting by miscategorizing assets and liabilities or by describing them as being less risky than they actually are, particularly when the bank is operating at, or close to, the minimum required capital levels.

37. There are many procedures that both auditors and bank supervisors perform, including:

    - The performance of analytical procedures;
    - Obtaining evidence regarding the operation of the internal control system; and
    - The review of the quality of a bank's assets and the assessment of banking risks.

    The auditor therefore finds it advantageous to interact with the supervisors and to have access to communications that the supervisors may have addressed to the bank management on the results of their work. The assessment made by the supervisors in important areas such as the adequacy of risk management practices and provisions for loan losses, and the prudential ratios used by the supervisors can be of assistance to the auditor in performing analytical procedures and in focusing attention on specific areas of supervisory concern.



2 ISA 310, "Knowledge of the Business" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" became effective.

The Extent of IT and Other Systems

38. The high volume of transactions and the short times in which they must be processed typically result in most banks making extensive use of IT, EFT and other telecommunications systems.

    The control concerns arising from the use of IT by a bank are similar to those arising when IT is used by other organizations. However, the matters that are of particular concern to the auditor of a bank include the following:

    - The use of IT to calculate and record substantially all of the interest income and interest expense, which are ordinarily two of the most important elements in the determination of a bank's earnings.
    - The use of IT and telecommunications systems to determine the foreign exchange security and derivative trading positions, and to calculate and record the gains and losses arising from them.
    - The extensive, and in some cases almost total, dependence on the records produced by IT because they represent the only readily accessible source of detailed up-to-date information on the bank's assets and liability positions, such as customer loan and deposit balances.
    - The use of complex valuation models incorporated in the IT systems.
    - The models used to value assets and the data used by those models are often kept in spreadsheets prepared by individuals on personal computers not linked to the bank's main IT systems and not subject to the same controls as applications on those systems. IAPS 1001, "IT Environments—Stand-Alone Personal Computers"[3] provides guidance to auditors in respect of these applications.
    - The use of different IT systems resulting in the risk of loss of audit trail and incompatibility of different systems.

    EFT systems are used by banks both internally (for example, for transfers between branches and between automated banking machines and the computerized files that record account activity) and externally between the bank and other financial institutions (for example, through the SWIFT network) and also between the bank and its customers through the internet or other electronic commerce media.

39. The auditor obtains an understanding of the core IT, EFT and telecommunication applications and the links between those applications. The auditor relates this understanding to the major business processes or

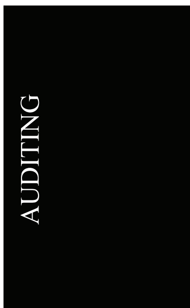
[3] IAPS 1001, "IT Environments—Stand-Alone Personal Computers" was withdrawn in December 2004.

balance sheet positions in order to identify the risk factors for the organization and therefore for the audit. In addition, it is important to identify the extent of the use of self-developed applications or integrated systems, which will have a direct effect on the audit approach. (Self-developed systems require the auditor to focus more extensively on the program change controls.)

40. When auditing in a distributed IT environment, the auditor obtains an understanding of where the core IT applications are located. If the bank's wide area network (WAN) is dispersed over several countries, specific legislative rules might apply to cross-border data processing. In such an environment, audit work on the access control system, especially on the access violation system, is an important part of the audit.

41. An electronic commerce environment changes significantly the way the bank conducts its business. Electronic commerce presents new aspects of risk and other considerations that the auditor addresses. For example, the auditor considers the following:

- The business risks the bank's e-commerce strategy presents.
- The risks inherent in the technology the bank has chosen to implement its electronic commerce strategy.
- Management's responses to the risks identified, including control considerations regarding:
    - Compliance with legal and regulatory requirements in respect of cross-border transactions;
    - The security and privacy of transmissions across the Internet; and
    - The completion, accuracy, timeliness and authorization of Internet transactions as they are recorded in the bank's accounting system.
- The level of IT and electronic commerce skill and competence the auditor and assistants possess.



42. An organization may outsource IT or EFT related activities to an external service provider. The auditor gains an understanding of the outsourced services and the system of internal controls within the outsourcing bank and the vendor of the services, in order to determine the nature, extent and timing of substantive procedures. ISA 402 gives further guidance on this subject.

Expected Assessment of Inherent and Control Risks

43. The nature of banking operations is such that the auditor may not be able to reduce audit risk to an acceptably low level by the performance of

substantive procedures alone. This is because of factors such as the following:

- The extensive use of IT and EFT systems, which means that much of the audit evidence is available only in electronic form and is produced by the entity's own IT systems.
- The high volume of transactions entered into by banks, which makes reliance on substantive procedures alone impracticable.
- The geographic dispersion of banks' operations, which makes obtaining sufficient coverage extremely difficult.
- The difficulty in devising effective substantive procedures to audit complex trading transactions.

In most situations the auditor will not be able to reduce audit risk to an acceptably low level unless management has instituted an internal control system that allows the auditor to be able to assess the level of inherent and control risks as less than high. The auditor obtains sufficient appropriate audit evidence to support the assessment of inherent and control risks. Paragraphs 56-70 discuss matters relating to internal control in more detail.

The Work of Internal Auditing

44. The scope and objectives of internal auditing may vary widely depending upon the size and structure of the bank and the requirements of management and those charged with governance. However, the role of internal auditing ordinarily includes the review of the accounting system and related internal controls, monitoring their operation and recommending improvements to them. It also generally includes a review of the means used to identify, measure and report financial and operating information and specific inquiry into individual items including detailed testing of transactions, balances and procedures. The factors referred to in paragraph 44 also often lead the auditor to use the work of internal auditing. This is especially relevant in the case of banks that have a large geographic dispersion of branches. Often, as a part of the internal audit department or as a separate component, a bank has a loan review department that reports to management on the quality of loans and the adherence to established procedures in respect thereof. In either case, the auditor often considers making use of the work of the loan review department after an appropriate review of the department and its work. Guidance on the use of the work of internal auditing is provided in ISA 610, "Considering the Work of Internal Auditing."

Audit Risk

45. The three components of audit risk are:

    (a) Inherent risk (the risk that material misstatements occur);

(b) Control risk (the risk that the bank's system of internal control does not prevent or detect and correct such misstatements on a timely basis); and

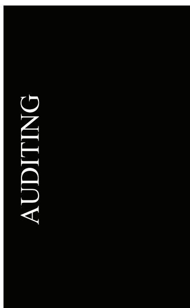
(c) Detection risk (the risk that the auditor will not detect any remaining material misstatements).

Inherent and control risks exist independently of the audit of financial information and the auditor cannot influence them. The nature of risks associated with banking activities, which are discussed in paragraphs 21-25 indicate that the assessed level of inherent risk in many areas will be high. It is therefore necessary for a bank to have an adequate system of internal control if the levels of inherent and control risks are to be less than high. The auditor assesses these risks and designs substantive procedures so as to reduce audit risk to an acceptably low level.

Materiality

46. In making an assessment of materiality, in addition to the considerations set out in ISA 320, "Audit Materiality," the auditor considers the following factors:

- Because of high leverage, relatively small misstatements may have a significant effect on the results for the period and on capital, even though they may have an insignificant effect on total assets.
- A bank's earnings are low when compared to its total assets and liabilities and its off-balance sheet commitments. Therefore, misstatements that relate only to assets, liabilities and commitments may be less significant than those that may also relate to the statement of earnings.
- Banks are often subject to regulatory requirements, such as the requirement to maintain minimum levels of capital. A breach of these requirements could call into question the appropriateness of management's use of the going concern assumption. The auditor therefore establishes a materiality level so as to identify misstatements that, if uncorrected, would result in a significant contravention of such regulatory requirements.
- The appropriateness of the going concern assumption often depends upon matters related to the bank's reputation as a sound financial institution and actions by regulators. Because of this, related party transactions and other matters that would not be material to entities other than banks may become material to a bank's financial statements if they might affect the bank's reputation or actions by regulators.



Management's Representations

47. Management's representations are relevant in the context of a bank audit to assist the auditor in determining whether the information and evidence obtained is complete for the purposes of the audit. This is particularly true of the bank's transactions that may not ordinarily be reflected in the financial statements (off-balance sheet items), but which may be evidenced by other records of which the auditor may not be aware. It is often also necessary for the auditor to obtain from management representations regarding significant changes in the bank's business and its risk profile. It may also be necessary for the auditor to identify areas of a bank's operations where audit evidence likely to be obtained may need to be supplemented by management's representations, for example, loan loss provisions and the completeness of correspondence with regulators. ISA 580, "Management Representations" provides guidance as to the use of management representations as audit evidence, the procedures that the auditor applies in evaluating and documenting them, and the circumstances in which representations should be obtained in writing.

Involvement of Other Auditors

48. As a result of the wide geographic dispersion of offices in most banks, it is often necessary for the auditor to use the work of other auditors in many of the locations in which the bank operates. This may be achieved by using other offices of the auditor's firm or by using other auditing firms in those locations.

49. Before using the work of another auditor, the auditor:

- Considers the independence of those auditors and their competence to undertake the necessary work (including their knowledge of banking and applicable regulatory requirements);
- Considers whether the terms of the engagement, the accounting principles to be applied and the reporting arrangements are clearly communicated; and
- Performs procedures to obtain sufficient appropriate audit evidence that the work performed by the other auditor is adequate for this purpose by discussion with the other auditor, by a review of a written summary of the procedures applied and findings, by a review of the working papers of the other auditor, or in any other manner appropriate to the circumstances.

ISA 600, "Using the Work of Another Auditor" provides further guidance on the issues to be addressed and procedures to be performed in such situations.

Co-Ordinating the Work to be Performed

50. Given the size and geographic dispersion of most banks, co-ordinating the work to be performed is important to achieve an efficient and effective audit. The co-ordination required takes into account factors such as the following:

    - The work to be performed by:
        - Experts;
        - Assistants;
        - Other offices of the auditor's firm; and
        - Other audit firms.
    - The extent to which it is planned to use the work of internal auditing.
    - Required reporting dates to shareholders and the regulatory authorities.
    - Any special analyses and other documentation to be provided by bank management.

51. The best level of co-ordination between assistants can often be achieved by regular audit-status meetings. However, given the number of assistants and the number of locations at which they will be involved, the auditor ordinarily communicates all or relevant portions of the audit plan in writing. When setting out the requirements in writing, the auditor considers including commentary on the following matters:

    - The financial statements and other information that are to be audited (and if considered necessary, the legal or other mandate for the audit).
    - Details of any additional information requested by the auditor, for example, information on certain loans, portfolio composition, narrative commentary on the audit work to be performed (especially on the areas of risk described in paragraphs 21-25 which are important to the bank) and on the results of the audit work, potential points for inclusion in letters to management on internal control, local regulatory concerns, and if relevant, the forms of any required reports.
    - That the audit is to be conducted in accordance with ISAs and any local regulatory requirements (and, if considered necessary, information on those requirements).
    - The relevant accounting principles to be followed in the preparation of the financial statements and other information (and, if considered necessary, the details of those principles).
    - Interim audit status reporting requirements and deadlines.
    - Particulars of the entity's officials to be contacted.

- Fee and billing arrangements.
- Any other concerns of a regulatory, internal control, accounting or audit nature of which those conducting the audit should be aware.

Related Party Transactions

52. The auditor remains alert for related party transactions during the course of the audit, particularly in the lending and investment areas. Procedures performed during the planning phase of the audit, including obtaining an understanding of the bank and the banking industry, may be helpful in identifying related parties. In some jurisdictions, related party transactions may be subject to quantitative or qualitative restrictions. The auditor determines the extent of any such restrictions.

Going Concern Considerations

53. ISA 570, "Going Concern" provides guidance as to the auditor's consideration of the appropriateness of management's use of the going concern assumption. In addition to matters identified in that ISA, events or conditions such as the following may also cast significant doubt on the bank's ability to continue as a going concern:

    - Rapid increases in levels of trading in derivatives. This may indicate that the bank is carrying out trading activities without the necessary controls in place.
    - Profitability performance or forecasts that suggest a serious decline in profitability, particularly if the bank is at or near its minimum regulatory capital or liquidity levels.
    - Rates of interest being paid on money market and depositor liabilities that are higher than normal market rates. This may indicate that the bank is viewed as a higher risk.
    - Significant decreases in deposits from other banks or other forms of short term money market funding. This may indicate that other market participants lack confidence in the bank.
    - Actions taken or threatened by regulators that may have an adverse effect on the bank's ability to continue as a going concern.
    - Increased amounts due to central banks, which may indicate that the bank was unable to obtain liquidity from normal market sources.
    - High concentrations of exposures to borrowers or to sources of funding.

54. ISA 570 also provides guidance to auditors when an event or condition that may cast significant doubt on the bank's ability to continue as a going concern has been identified. The ISA indicates a number of procedures that

may be relevant, and in addition to those, the following procedures may also be relevant:

- Reviewing correspondence with regulators.
- Reviewing reports issued by regulators as a result of regulatory inspections.
- Discussing the results of any inspections currently in process.

55. The regulatory regime under which the bank operates may require the auditor to disclose to the regulator any intention to issue a modified opinion or any concerns that the auditor may have about the bank's ability to continue as a going concern. IAPS 1004 provides further discussion of the relationship between the auditor and the banking supervisor.

Internal Control

Introduction

56. The Basel Committee on Banking Supervision has issued a policy paper, "Framework for Internal Control Systems in Banking Organisations" (September 1998), which provides banking supervisors with a framework for evaluating banks' internal control systems. This framework is used by many banking supervisors, and may be used during supervisory discussions with individual banking organizations. Auditors of banks' financial statements may find a knowledge of this framework useful in understanding the various elements of a bank's internal control system.

57. Management's responsibilities include the maintenance of an adequate accounting system and internal control system, the selection and application of accounting policies, and the safeguarding of the assets of the entity.

    The auditor obtains an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. After obtaining the understanding, the auditor considers the assessment of inherent and control risks so as to determine the appropriate detection risk to accept for the financial statement assertions and to determine the nature, timing and extent of substantive procedures for such assertions.

    Where the auditor assesses control risk at less than high, substantive procedures are ordinarily less extensive than are otherwise required and may also differ in their nature and timing.

Identifying, Documenting and Testing Control Procedures

58. ISA 400, "Risk Assessments and Internal Control"[4] indicates that internal controls relating to the accounting system are concerned with achieving objectives such as the following:

    - Transactions are executed in accordance with management's general or specific authorization (paragraphs 59-61).
    - All transactions and other events are promptly recorded at the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable financial reporting framework (paragraphs 62 and 63).
    - Access to assets is permitted only in accordance with management's authorization (paragraphs 64 and 65).
    - Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken regarding any differences (paragraphs 66 and 67).

    The audit considerations in relation to each of these objectives are discussed in the subsequent paragraphs.

    In the case of banks, a further objective of internal controls is to ensure that the bank adequately fulfills its regulatory and fiduciary responsibilities arising out of its trustee activities. The auditor is not directly concerned with these objectives except to the extent that any failure to comply with such responsibilities might have led to the financial statements being material misstated.

Transactions are Executed in Accordance with Management's General or Specific Authorization

59. The overall responsibility for the system of internal control in a bank rests with those charged with governance, who are responsible for governing the bank's operations. However, since banks' operations are generally large and dispersed, decision-making functions need to be decentralized and the authority to commit the bank to material transactions is ordinarily dispersed and delegated among the various levels of management and staff. Such dispersion and delegation will almost always be found in the lending, treasury and funds transfer functions, where, for example, payment instructions are sent via a secure message. This feature of banking operations creates the need for a structured system of delegation of authority, resulting in the formal identification and documentation of:

[4] ISA 400, "Risk Assessments and Internal Control" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" became effective.

(a) Those who may authorize specific transactions;

(b) Procedures to be followed in granting that authorization; and

(c) Limits on the amounts that can be authorized, by individual employee or by staff level, as well as any requirements that may exist for concurring authorization.

Those charged with governance also need to ensure that appropriate procedures exist for monitoring the level of exposures. This will ordinarily involve the aggregation of exposures, not only within, but also across, the different activities, departments and branches of the bank.

60. An examination of the authorization controls will be important to the auditor in considering whether transactions have been entered into in accordance with the bank's policies and, for example, in the case of the lending function, that they have been subject to appropriate credit assessment procedures prior to the disbursement of funds. The auditor will typically find that limits for levels of exposures exist in respect of various transaction types. When performing tests of controls, the auditor considers whether these limits are being adhered to and whether positions in excess of these limits are reported to the appropriate level of management on a timely basis.

61. From an audit perspective, the proper functioning of a bank's authorization controls is particularly important in respect of transactions entered into at or near the date of the financial statements. This is because aspects of the transaction have yet to be fulfilled, or there may be a lack of evidence with which to assess the value of the asset acquired or liability incurred. Examples of such transactions are commitments to purchase or sell specific securities after the period-end and loans, where principal and interest payments from the borrower have yet to be made.

All Transactions and Other Events are Promptly Recorded at the Correct Amount, in the Appropriate Accounts and in the Proper Accounting Period so as to Permit Preparation of Financial Statements in Accordance with the Applicable Financial Reporting Framework

62. In considering the internal controls that management use to ensure that all transactions and other events are properly recorded, the auditor takes into account a number of factors that are especially important in a banking environment. These include the following:

- Banks deal in large volumes of transactions that can individually or cumulatively involve large sums of money. Accordingly, the bank needs to have balancing and reconciliation procedures that are carried out within a time-frame that allows the detection of errors and discrepancies so that they can be investigated and corrected with

minimal loss to the bank. Such procedures may be carried out hourly, daily, weekly, or monthly, depending on the volume and nature of the transaction, level of risk, and transactions settlement time-frame. The purpose of these reconciliations is often to ensure the completeness of transaction processing across highly complex integrated IT systems and the reconciliations themselves are normally automatically generated by these systems.

- Many of the transactions entered into by banks are subject to specialized accounting rules. Banks should have control procedures in place to ensure those rules are applied in the preparation of appropriate financial information for management and external reporting. Examples of such control procedures are those that result in the market revaluation of foreign exchange and security purchase and sale commitments so as to ensure that all unrealized profits and losses are recorded.

- Some of the transactions entered into by banks may not be required to be disclosed in the financial statements (for example, transactions that the accounting framework allows to be regarded as off balance sheet items). Accordingly, control procedures must be in place to ensure that such transactions are recorded and monitored in a manner that provides management with the required degree of control over them and that allows for the prompt determination of any change in their status that needs to result in the recording of a profit or loss.

- Banks are constantly developing new financial products and services. The auditor considers whether the necessary revisions are made in accounting procedures and related internal controls.

- End of day balances may reflect the volume of transactions processed through the systems or of the maximum exposure to loss during the course of a business day. This is particularly relevant in executing and processing foreign exchange and securities transactions. The assessment of controls in these areas takes into account the ability to maintain control during the period of maximum volumes or maximum financial exposure.

- The majority of banking transactions must be recorded in a manner that is capable of being verified both internally and by the bank's customers and counterparties. The level of detail to be recorded and maintained on individual transactions must allow the bank's management, transaction counterparties, and customers to verify the accuracy of the amounts and terms. An example of such a control is the continuous verification of foreign exchange trade tickets by having an employee not involved in the transaction match the tickets to incoming confirmations from counterparties.

63. The extensive use of IT and EFT systems has a significant effect on how the auditor evaluates a bank's accounting system and related internal controls. ISA 400, ISA 401, "Auditing in a Computer Information Systems Environment," and IAPS 1008, "Risk Assessments and Internal Control—CIS Characteristics and Considerations,"[5] provide guidance on the IT aspects of such an evaluation, as do other IAPSs dealing with information technology. The audit procedures include an assessment of those controls that affect system development and modifications, system access and data entry, the security of communications networks, and contingency planning. Similar considerations apply to EFT operations within the bank. To the extent that EFT and other transaction systems are external to the bank, the auditor gives additional emphasis to the assessment of the integrity of pre-transaction supervisory controls and post-transaction confirmation and reconciliation procedures. Reports from the auditors of service organizations may be of use here, and ISA 402 gives guidance on the auditor's consideration of such reports.

Access to Assets is Permitted Only in Accordance with Management's Authorization

64. A bank's assets are often readily transferable, of high value and in a form that cannot be safeguarded solely by physical procedures. In order to ensure that access to assets is permitted only in accordance with management's authorization, a bank generally uses controls such as the following:

- Passwords and joint access arrangements to limit IT and EFT system access to authorized employees.
- Segregation of the record-keeping and custody functions (including the use of computer generated transaction confirmation reports available immediately and only to the employee in charge of the record-keeping functions).
- Frequent third-party confirmation and reconciliation of asset positions by an independent employee.

65. The auditor considers whether each of these controls is operating effectively. However, given the materiality and transferability of the amounts involved, the auditor also ordinarily reviews the confirmation and reconciliation procedures that occur in connection with the preparation of the year-end financial statements and may carry out confirmation procedures himself.

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[5] ISA 400, "Risk Assessments and Internal Control," ISA 401, "Auditing in a Computer Information Systems Environment," and IAPS 1008, "Risk Assessments and Internal Control—CIS Characteristics and Considerations" were withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" became effective.

Recorded Assets are Compared with the Existing Assets at Reasonable Intervals and Appropriate Action is Taken Regarding Any Differences

66. The large amounts of assets handled by banks, the volumes of transactions undertaken, the potential for changes in the value of those assets due to fluctuations in market prices and the importance of confirming the continued operation of access and authorization controls necessitates the frequent operation of reconciliation controls. This is particularly important for:

    (a) Assets in negotiable form, such as cash, bearer securities and assets in the form of deposit and security positions with other institutions where failure to detect errors and discrepancies quickly (which may mean daily where money market transactions are involved) could lead to an irrecoverable loss: reconciliation procedures used to achieve this control objective will ordinarily be based on physical counting and third party confirmation;

    (b) Assets whose value is determined with reference to valuation models or external market prices, such as securities and foreign exchange contracts; and

    (c) Assets held on behalf of clients.

67. In designing an audit plan to assess the effectiveness of a bank's reconciliation controls, the auditor considers factors such as the following.

    - Because of the number of accounts requiring reconciliation and the frequency with which these reconciliations need to be performed:
        - Much of the audit effort is directed to the documentation, testing and evaluation of the reconciliation controls; and
        - The work of the internal auditor will also be similarly directed. The auditor therefore can ordinarily use the work of internal auditing.
    - Since reconciliations are cumulative in their effect, most reconciliations can be satisfactorily audited at the year-end date, assuming that they are prepared as of that date, soon enough for the auditor to use and that the auditor is satisfied that the reconciliation control procedures are effective.
    - In examining a reconciliation, the auditor considers whether items have not been improperly transferred to other accounts that are not subject to reconciliation and investigation at the same time.

Examples of Controls

68. Appendix 2 to this Statement contains examples of controls over authorization, recording, access and reconciliation ordinarily found in the treasury and trading and lending operations of a bank.

Inherent Limitations of Internal Control

69. ISA 400[6] describes the procedures to be followed by the auditor in identifying, documenting and testing internal controls. In doing so, the auditor is aware of the inherent limitations of internal control. The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. Irrespective of the assessed levels of inherent and control risks, the auditor performs some substantive procedures for material account balances and classes of transactions.

Considering the Influence of Environmental Factors

70. In assessing the effectiveness of specific control procedures, the auditor considers the environment in which internal control operates. Some of the factors that may be considered include the following:

    - The organizational structure of the bank and the manner in which it provides for the delegation of authority and responsibilities.
    - The quality of management supervision.
    - The extent and effectiveness of internal auditing.
    - The extent and effectiveness of the risk management and compliance systems
    - The skills, competence and integrity of key personnel.
    - The nature and extent of inspection by supervisory authorities.

AUDITING

Performing Substantive Procedures

Introduction

71. As a result of the assessment of the level of inherent and control risks, the auditor determines the nature, timing and extent of the substantive tests to be performed on individual account balances and classes of transactions. In designing these substantive tests, the auditor considers the risks and factors that served to shape the bank's systems of internal control. In addition, there are a number of audit considerations significant to these risk areas to which the auditor directs attention. These are discussed in subsequent paragraphs.

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[6] See footnote 4.

72. ISA 500, "Audit Evidence"[7] lists the assertions embodied in the financial statements as: existence, rights and obligations, occurrence, completeness, valuation, measurement, and presentation and disclosure.

Tests of the completeness assertion are particularly important in the audit of bank's financial statements particularly in respect of liabilities. Much of the audit work on liabilities of other commercial entities can be carried out by substantive procedures on a reciprocal population. Banking transactions do not have the same type of regular trading cycle, and reciprocal populations are not always immediately in evidence. Large assets and liabilities can be created and realized very quickly and, if not captured by the systems, may be overlooked. Third party confirmations and the reliability of controls become important in these circumstances.

Audit Procedures

73. To address the assertions discussed above, the auditor may perform the following procedures:

(a) Inspection.

(b) Observation.

(c) Inquiry and confirmation.

(d) Computation.

(e) Analytical procedures.

In the context of the audit of a bank's financial statements, inspection, inquiry and confirmation, computation and analytical procedures require particular attention and are discussed in the following paragraphs.

Inspection

74. Inspection consists of examining records, documents, or tangible assets. The auditor inspects in order to:

- Be satisfied as to the physical existence of material negotiable assets that the bank holds; and
- Obtain the necessary understanding of the terms and conditions of agreements (including master agreements) that are significant individually or in the aggregate in order to:
  - Consider their enforceability; and

[7] ISA 500, "Audit Evidence" was withdrawn in December 2004 when the revised ISA 500, "Audit Evidence" became effective.

    - Assess the appropriateness of the accounting treatment they have been given.

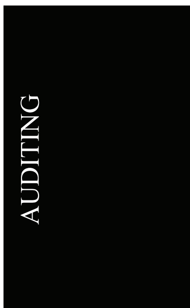
75. Examples of areas where inspection is used as an audit procedure are:
    - Securities;
    - Loan agreements;
    - Collateral; and
    - Commitment agreements, such as:
        - Asset sales and repurchases; and
        - Guarantees.

76. In carrying out inspection procedures, the auditor remains alert to the possibility that some of the assets the bank holds may be held on behalf of third parties rather than for the bank's own benefit. The auditor considers whether adequate internal controls exist for the proper segregation of such assets from those that are the property of the bank and, where such assets are held, considers the implications for the financial statements. As noted in paragraph 58 the auditor is concerned with the existence of third party assets only to the extent that the bank's failure to comply with its obligations may lead to the financial statements being materially misstated.

Inquiry and Confirmation

77. Inquiry consists of seeking information of knowledgeable persons inside or outside the entity. Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. The auditor inquires and confirms in order to:
    - Obtain evidence of the operation of internal controls;
    - Obtain evidence of the recognition by the bank's customers and counterparties of amounts, terms and conditions of certain transactions; and
    - Obtain information not directly available from the bank's accounting records.

    A bank has significant amounts of monetary assets and liabilities, and of off-balance-sheet commitments. External confirmation may an effective method of determining the existence and completeness of the amounts of assets and liabilities disclosed in the financial statements. In deciding the nature and extent of external confirmation procedures that the auditor will perform, the auditor considers any external confirmation procedures undertaken by internal auditing. ISA 505, "External Confirmations" provides guidance on the external confirmation process.



78. Examples of areas for which the auditor may use confirmation including the following:

- Collateral.
- Verifying or obtaining independent confirmation of, the value of assets and liabilities that are not traded or are traded only on over-the-counter markets.
- Asset, liability and forward purchase and sale positions with customers and counterparties such as:
  - Outstanding derivative transactions;
  - *Nostro* and *vostro* account holders;
  - Securities held by third parties;
  - Loan accounts;
  - Deposit accounts;
  - Guarantees; and
  - Letters of credit.
- Legal opinions on the validity of a bank's claims.

Computation

79. Computation consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations. In the context of the audit of a bank's financial statements, computation is a useful procedure for checking the consistent application of valuation models.

Analytical Procedures

80. Analytical procedures consist of the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or deviate from predicted amounts. ISA 520, "Analytical Procedures" provides guidance on the auditor's use of this technique.

81. A bank invariably has individual assets (for example, loans and, possibly, investments) that are of such a size that the auditor considers them individually. However, for most items, analytical procedures may be effective for the following reasons:

- Ordinarily two of the most important elements in the determination of a bank's earnings are interest income and interest expense. These have direct relationships to interest bearing assets and interest bearing liabilities, respectively. To establish the reasonableness of these

relationships, the auditor can examine the degree to which the reported income and expense vary from the amounts calculated on the basis of average balances outstanding and the bank's stated rates during the year. This examination is ordinarily made in respect of the categories of assets and liabilities used by the bank in the management of its business. Such an examination could, for example, highlight the existence of significant amounts of non-performing loans or unrecorded deposits. In addition, the auditor may also consider the reasonableness of the bank's stated rates to those prevailing in the market during the year for similar classes of loans and deposits. In the case of loan assets, evidence of rates charged or allowed above market rates may indicate the existence of excessive risk. In the case of deposit liabilities, such evidence may indicate liquidity or funding difficulties. Similarly, fee income, which is also a large component of a bank's earnings, often bears a direct relationship to the volume of obligations on which the fees have been earned.

- The accurate processing of the high volume of transactions entered into by a bank, and the auditor's assessment of the bank's internal controls, may benefit from the review of ratios and trends and of the extent to which they vary from previous periods, budgets and the results of other similar entities.
- By using analytical procedures, the auditor may detect circumstances that call into question the appropriateness of the going concern assumption, such as undue concentration of risk in particular industries or geographic areas and potential exposure to interest rate, currency and maturity mismatches.
- In most countries there is a wide range of statistical and financial information available from regulatory and other sources that the auditor can use to conduct an in-depth analytical review of trends and peer group analyses.

A useful starting point in considering appropriate analytical procedures is to consider what information and performance or risk indicators management use in monitoring the bank's activities. Appendix 3 to this Statement contains examples of the most frequently used ratios in the banking industry.

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Specific Procedures in Respect of Particular Items in the Financial Statements

82. Paragraphs 83-100 identify the assertions that are ordinarily of particular importance in relation to the typical items in a bank's financial statements. They also describe some of the audit considerations that help the auditor to plan substantive procedures and suggest some of the techniques that could be used in relation to the items selected by the auditor for testing. The

procedures do not represent an exhaustive list of procedures that it is possible to perform, nor do they represent a minimum requirement that should always be performed.

Financial Statement Item	Financial Statement Assertions of Particular Importance
83.	BALANCES WITH OTHER BANKS
	Existence
	The auditor considers third party confirmations of the balance. Where the balances held with other banks are the result of large volumes of transactions, the receipt of confirmations from those other banks is likely to provide more cogent evidence as to the existence of the transactions and of the resultant inter-bank balances than is the testing of the related internal controls. Guidance on inter-bank confirmation procedures, including terminology and the content of confirmation requests, can be found in the IAPS 1000, "Inter-Bank Confirmation Procedures."
	Valuation
	The auditor considers whether to assess the collectability of the deposit in light of the credit-worthiness of the depository bank. The procedures required in such an assessment are similar to those used in the audit of loan valuation, discussed later.
	Presentation and Disclosure
	The auditor considers whether the balances with other banks as at the date of the financial statements represent bona fide commercial transactions or whether any significant variation from normal or expected levels reflects transactions entered into primarily to give a misleading impression of the financial position of the bank or to improve liquidity and asset ratios (often known as "window-dressing").
	Where window-dressing occurs in a magnitude which may distort the true and fair view of the financial statements, the auditor requests management to adjust the balances shown in the financial statements, or make additional disclosure in the notes. If management fails to do so, the auditor considers whether to modify the audit report.

84. MONEY MARKET INSTRUMENTS

Existence

The auditor considers the need for physical inspection or confirmation with external custodians and the reconciliation of the related amounts with the accounting records.

Rights and Obligations

The auditor considers the feasibility of checking for receipt of the related income as a means of establishing ownership. The auditor pays particular attention to establishing the ownership of instruments held in bearer form. The auditor also considers whether there are any encumbrances on the title to the instruments.

The auditor tests for the existence of sale and forward repurchase agreements for evidence of unrecorded liabilities and losses.

Valuation

The auditor considers the appropriateness of the valuation techniques employed in light of the creditworthiness of the issuer.

Measurement

The auditor considers whether there is a need to test for the proper accrual of income earned on money market instruments, which in some cases is through the amortization of a purchase discount.

The auditor also considers whether:

- The relationship between the types of securities owned and the related income is reasonable; and
- All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities).

85. SECURITIES HELD FOR TRADING PURPOSES

Appendix 2 gives further examples of internal control considerations and audit procedures in respect of trading operations.

Existence

The auditor considers physical inspection of securities or confirmation with external custodians and the reconciliation of the amounts with the accounting records.

Rights and Obligations

The auditor considers the feasibility of checking for receipt of the related income as a means of establishing ownership. The auditor pays particular attention to establishing the ownership of securities held in bearer form. The auditor also considers whether there are any encumbrances on the title to the securities.

The auditor tests for the existence of sale and forward repurchase agreements for evidence of unrecorded liabilities and losses.

Valuation

Financial reporting frameworks often prescribe different valuation bases for securities depending on whether they are held for trading purposes, held as portfolio investments, or held for hedging purposes. For example, a financial reporting framework might require trading securities to be carried at market value, portfolio investments at historic cost subject to impairment reviews, and hedging securities on the same basis as the underlying assets they hedge. Management's intentions determine whether any particular security is held for a given purpose, and hence the valuation basis to be used. If management's intentions change, the valuation basis changes too. Accordingly, when securities have been transferred from one category to another, the auditor obtains sufficient appropriate audit evidence to support management's assertions as to their revised intentions. The possibility of changing an asset's categorization provides management with an opportunity for fraudulent financial reporting, as it would be possible to recognize a profit or avoid recognizing a loss by changing the categorization of particular securities.

When securities held for trading purposes are carried at market value, the auditor considers whether securities whose market value has increased have been arbitrarily transferred from Portfolio Investments (see paragraph 87) primarily so that an unrealized gain can be taken into income.

The auditor also considers whether to reperform the valuation calculations and the extent of tests of the controls over the bank's valuation procedures.

Measurement

The auditor also considers whether:

- The relationship between the types of securities owned and the related income is reasonable; and
- All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities).

86. (Those involving current investment of funds, for example, blocks of loans purchased for resale, purchases of securitized assets)

OTHER FINANCIAL ASSETS

Rights and Obligations

The auditor examines the underlying documentation supporting the purchase of such assets in order to determine whether all rights and obligations, such as warranties and options, have been properly accounted for.

Valuation

The auditor considers the appropriateness of the valuation techniques employed. Since there may not be established markets for such assets, it may be difficult to obtain independent evidence of value. Additionally, even where such evidence exists, there may be a question as to whether there is sufficient depth to existing markets to **rely** on quoted values for the asset in question and for any related offsetting hedge transactions that the bank has entered into in those markets. The auditor also considers the nature and extent of any impairment reviews that management has carried out and whether their results are reflected in the assets' valuations.

87.

PORTFOLIO INVESTMENTS

In many cases the audit of a bank's portfolio investments does not differ from the audit of portfolio investments held by any other entity. However, there are some special aspects that pose particular problems in respect of banking operations.

Valuation

The auditor considers the value of the assets supporting the security value, particularly in respect of securities that are not readily marketable. The auditor also considers the nature and extent of any impairment reviews that management has carried out and whether their results are reflected in the assets' valuations.

Measurement

As discussed in paragraph 85, financial reporting frameworks frequently allow different valuation bases for securities held for different purposes. Where securities have been transferred from the Trading Account, the auditor determines whether any unrealized losses in market value are recorded if so required by relevant financial reporting framework. When the financial reporting framework does not require the recording of unrealized losses, the auditor considers whether the transfer was made to avoid the need to recognize reductions in the securities' market value.

The auditor also considers whether:

- The relationship between the types of securities owned and the related income is reasonable; and
- All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework (for example, where gains and losses on trading securities are treated differently from those on investment securities).

88. INVESTMENTS IN SUBSIDIARIES AND ASSOCIATED ENTITIES

In many cases the audit of a bank's investments in subsidiaries and associated entities does not differ from the audit of such investments held by any other entity. However, there are some special aspects that pose particular problems in respect of banking operations.

Valuation

The auditor considers the implications of any legal or practical requirement for the bank to provide future financial support to ensure the maintenance of operations (and hence the value of the investment) of subsidiaries

and associated companies. The auditor considers whether the related financial obligations are recorded as liabilities of the bank.

The auditor determines whether appropriate adjustments are made when the accounting policies of companies accounted for on an equity basis or consolidated do not conform to those of the bank.

89. (Comprising advances, bills of exchange, letters of credit, acceptances, guarantees, and all other lines of credit extended to customers, including those in connection with foreign exchange and money market activities)

- Personal
- Commercial
- Government
- Domestic
- Foreign

LOANS

Existence

The auditor considers the need for external confirmation of the existence of loans.

Valuation

The auditor considers the appropriateness of the provision for loan losses. The auditor understands the laws and regulations that may influence the amounts determined by management. The Basel Committee has published a set of Sound Practices for Loan Accounting and Disclosure, which provides guidance to banks and banking supervisors on recognition and measurement of loans, establishment of loan loss provisions, credit risk disclosure and related matters. It sets out banking supervisors' views on sound loan accounting and disclosure practices for banks and so may influence the financial reporting framework within which a bank prepares its financial statements. However, the bank's financial statements are prepared in accordance with a specified financial reporting framework, and the loan loss provision must be made in accordance with that framework.

Appendix 2 gives further information on the auditor's consideration of loans.

The major audit concern is the adequacy of the recorded provision for loan losses.

In establishing the nature, extent and timing of the work to be performed, the auditor considers the following factors:

- The degree of reliance it is reasonable to place on the bank's system of loan quality classification, on its procedures for ensuring that all documentation is properly completed, on its internal loan review procedures and on the work

of internal auditing.

- Given the relative importance of foreign lending, the auditor ordinarily examines:
  - The information on the basis of which the bank assesses and monitors the country risk and the criteria (for example, specific classifications and valuation ratios) it uses for this purpose; and
  - Whether and, if so, by whom credit limits are set for the individual countries, what the limits are and the extent to which they have been reached.
- The composition of the loan portfolio, with particular attention to:

  The concentration of loans to specific:
  - Borrowers and parties connected to them (including the procedures in place to identify such connections);
  - Commercial and industrial sectors;
  - Geographic regions; and
  - Countries;
  - The size of individual credit exposures (few large loans versus numerous small loans);
  - The trends in loan volume by major categories, especially categories having exhibited rapid growth, and in delinquencies, non-accrual and restructured loans; and
  - Related party lending.

  Identified potential non-performing loans, with particular attention to:
  - The previous loss and recovery experience, including the adequacy and timeliness of provisions and charge-offs; and
  - Results of regulatory examinations.

Local, national and international economic and environmental conditions, including restrictions on the transfer of foreign currency that may affect the repayment of loans by borrowers.

In addition to those non-performing loans identified by management and, where applicable, by bank regulators,

the auditor considers additional sources of information to determine those loans that may not have been so identified. These include:

- Various internally generated listings, such as "watchlist" loans, past due loans, loans on non-accrual status, loans by risk classification, loans to insiders (including directors and officers), and loans in excess of approved limits;
- Historical loss experience by type of loan; and
- Those loan files lacking current information on borrowers, guarantors or collateral.

Presentation and Disclosure

Banks are often subject to particular disclosure requirements concerning their loans and provisions for loan losses. The auditor considers whether the information disclosed is in accordance with the applicable financial or regulatory reporting framework.

90. ACCOUNTS WITH DEPOSITORS

(a) General deposits

Completeness

The auditor assesses the system of internal control over accounts with depositors. The auditor also considers performing confirmation and analytical procedures on average balances and on interest expense to assess the reasonableness of the recorded deposit balances.

Presentation and Disclosure

The auditor determines whether deposit liabilities are classified in accordance with regulations and relevant accounting principles.

Where deposit liabilities have been secured by specific assets, the auditor considers the need for appropriate disclosure.

The auditor also considers the need for disclosure where the bank has a risk due to economic dependence on a few large depositors or where there is an excessive concentration of deposits due within a specific time.

(b) Items in transit

Existence

The auditor determines whether items in transit between branches, between the bank and its consolidated subsidiaries, and between the bank and counterparties,

AUDITING

are eliminated and that reconciling items have been appropriately addressed and accounted for.

Additionally, the auditor examines individual items comprising the balance that have not been cleared within a reasonable time period and also considers whether the related internal control procedures are adequate to ensure that such items have not been temporarily transferred to other accounts in order to avoid their detection.

91. CAPITAL AND RESERVES

Banking regulators pay close attention to a bank's capital and reserves in monitoring the level of a bank's activities and in determining the extent of a bank's operations. Small changes in capital or reserves may have a large effect on a bank's ability to continue operating, particularly if it is near to its permitted minimum capital ratios. In such circumstances there are greater pressures for management to engage in fraudulent financial reporting by miscategorizing assets and liabilities or by describing them as being less risky than they actually are.

Presentation and Disclosure

The auditor considers whether capital and reserves are adequate for regulatory purposes (for example, to meet capital adequacy requirements), the disclosures have been appropriately calculated and that the disclosures are both appropriate and in accordance with the applicable financial reporting framework. In many jurisdictions auditors are required to report on a wide range of disclosures about the bank's capital and its capital ratios, either because that information is included in the financial statements or because there is requirement to make a separate report to banking supervisors.

In addition, where applicable regulations provide for restrictions on the distribution of retained earnings, the auditor considers whether the restrictions are adequately disclosed.

The auditor also determines whether the requirements of the applicable financial reporting framework with respect to the disclosure of hidden reserves have been complied with (see also paragraph 103).

92. (For example, commitments to lend funds and to guarantee repayment of funds by customers to third parties)

PROVISIONS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES (OTHER THAN DERIVATIVES AND OFF-BALANCE SHEET FINANCIAL INSTRUMENTS)

Completeness

Many contingent assets and liabilities are recorded without there being a corresponding liability or asset (memorandum items). The auditor therefore:

- Identifies those activities that have the potential to generate contingent assets or liabilities (for example, securitizations);
- Considers whether the bank's system of internal control is adequate to ensure that contingent assets or liabilities arising out of such activities are properly identified and recorded and that evidence is retained of the customer's agreement to the related terms and conditions;
- Performs substantive procedures to test the completeness of the recorded assets and liabilities. Such procedures may include confirmation procedures as well as examination of related fee income in respect of such activities and are determined having regard to the degree of risk attached to the particular type of contingency being considered;
- Reviews the reasonableness of the period-end contingent asset and liability figures in the light of the auditor's experience and knowledge of the current year's activities; and
- Obtains representation from management that all contingent assets and liabilities have been recorded and disclosed as required by the financial reporting framework.

Valuation

Many of these transactions are either credit substitutes or depend for their completion on the credit-worthiness of the counterparty. The risks associated with such transactions are in principle no different from those associated with "Loans." The audit objectives and considerations of particular importance discussed in paragraph 89 is equally relevant in respect of these transactions.

Presentation and Disclosure

Where assets or liabilities have been securitized or otherwise qualify for an accounting treatment that removes them from the bank's balance sheet, the auditor considers the appropriateness of the accounting treatment and whether appropriate provisions have been made. Similarly, where the bank is a counterparty to a transaction that allows a client entity to remove an asset or liability from the client's balance sheet, the auditor considers whether there is any asset or liability that the financial reporting framework requires to be shown in the balance sheet or in the notes to the financial statements.

Although the relevant financial reporting framework ordinarily requires disclosure of such obligations in the notes to the financial statements rather than in the balance sheet, the auditor nevertheless considers the potential financial impact on the bank's capital, funding and profitability of the need to honor such obligations and whether this needs to be specifically disclosed in the financial statements.

93. (For example, foreign exchange contracts, interest rate and currency swaps, futures, options, and forward rate agreements)

DERIVATIVES AND OFF-BALANCE SHEET FINANCIAL INSTRUMENTS

Many of these instruments are dealt with as part of the bank's treasury and trading activities. Appendix 2 gives more information on the auditor's consideration of treasury and trading activities. For transactions involving derivatives that the bank enters into as an end user, IAPS 1012 provides further guidance.

Rights and Obligations

The auditor examines the underlying documentation supporting such transactions in order to determine whether all rights and obligations, such as warranties and options, have been properly accounted for.

Existence

The auditor considers the need for third party confirmations of outstanding balances, which are selected from back office records of open transactions and from lists of approved counterparties, brokers and exchanges. It may be necessary to perform confirmation tests separately on the various products as the systems may not facilitate a combined selection of

all transactions with any given counterparty.

Completeness

Due to the continuing development of new financial instruments, there may be a lack of established procedures between participants and within the bank. The auditor therefore assesses the adequacy of the system of internal control, particularly with respect to:

- The adequacy of the procedures and the division of duties regarding the matching of documentation received from counterparties and reconciliation of accounts with counterparties; and
- The adequacy of internal audit review.

The auditor considers assessing the adequacy of the related system of internal control, including regular profit and loss account reconciliations at appropriate intervals and period-end reconciliation procedures, particularly in respect of the completeness and accuracy of the recording of outstanding positions as at the period end. (This requires the auditor to be familiar with standard inter-bank transaction confirmation procedures);

The auditor may also find it useful to examine post period-end transactions for evidence of items that should have been recorded in the year-end financial statements. ISA 560, "Subsequent Events" provides further guidance on the auditor's consideration of events occurring after the period end.

Valuation

Similar considerations arise here as arise for Other Financial Assets above. However, the following further considerations also arise.

Derivatives and off-balance sheet financial instruments are ordinarily valued at market or fair value, except that, in some financial reporting frameworks, hedging instruments are valued on the same basis as the underlying item being hedged. The applicable financial reporting framework may not require financial instruments to be shown on the balance sheet, or may require them to be to be valued at cost. In such instances, there may be an obligation to disclose the market or fair values of derivatives or off-balance sheet instruments in the notes to the financial statements.

If the instrument is traded on an investment exchange, the value may be determined through independent sources. If the transaction is not traded, independent experts may be required to assess the value.

Additionally, the auditor considers the need for and adequacy of fair value adjustments to financial instruments, such as a liquidity risk provision, a modeling risk provision and a provision for operational risk. The auditor considers matters such as the following:

- The appropriateness of the exchange rates, interest rates or other underlying market rates used at the financial statement date to calculate unrealized gains and losses.
- The appropriateness of the valuation models and assumptions used to determine the fair value of financial instruments outstanding as at the financial statement date. In addition, the auditor considers whether details of individual contracts, valuation rates and assumptions used are appropriately entered into the models.
- The appropriateness of the accounting policies used having regard to relevant accounting principles particularly with regard to the distinction between realized and unrealized profits and losses.

When market values need to be considered, but are not available, the auditor considers whether appropriate alternative valuation techniques have been employed, based, where appropriate, on current interest or foreign exchange rates.

As some of these instruments have been developed only recently, the auditor examines their valuation with a special degree of caution, and in doing so bears in mind the following factors:

- There may be no legal precedents concerning the terms of the underlying agreements. This makes it difficult to assess the enforceability of those terms.
- There may be a relatively small number of management personnel who are familiar with the inherent risks of these instruments. This may lead to a higher risk of misstatements occurring and a

greater difficulty in establishing controls that would prevent misstatements or detect and correct them on a timely basis.

- Some of these instruments have not existed through a full economic cycle (bull and bear markets, high and low interest rates, high and low trading and price volatility) and it may therefore be more difficult to assess their value with the same degree of certainty as for more established instruments. Similarly, it may be difficult to predict with a sufficient degree of certainty the price correlation with other offsetting instruments used by the bank to hedge its positions.
- The models used for valuing such instruments may not operate properly in abnormal market conditions.

Measurement

The auditor considers the purpose for which the transaction resulting in the instrument was entered into, in particular whether the transaction was a trading transaction or a hedging one. The bank may have been dealing as principal to create a dealing position or to hedge another asset, or it may have been dealing as an intermediary or broker. The purpose may determine the appropriate accounting treatment.

Since settlement of such transactions is at a future date, the auditor considers whether a profit or loss has arisen by the period end that is required to be recorded in the financial statements.

The auditor considers whether there has been a reclassification of hedging and trading transactions/positions that may have been made primarily with a view to taking advantage of differences in the timing of profit and loss recognition.

Presentation and Disclosure

In some financial reporting frameworks, the relevant accounting principles require the recording of accrued gains and losses on open positions, whether or not these positions are recorded on the balance sheet. In other financial reporting frameworks there is only an obligation to disclose the commitment. Where the latter is the case, the auditor considers whether the

unrecorded amounts are of such significance as to require a disclosure in the financial statements or qualification in the audit report.

The following additional considerations may arise:

- The auditor considers the appropriate accounting treatment and presentation of such transactions in accordance with relevant financial reporting requirements. Where those requirements have different treatments for transactions that are entered into for hedging purposes, the auditor considers whether transactions have been appropriately identified and treated.
- Some financial reporting frameworks require the disclosure of the potential risk arising from open positions, as for example, the credit risk equivalent and replacement value of outstanding off-balance sheet instruments.

94. INTEREST INCOME AND INTEREST EXPENSE

Measurement

Interest income and expense ordinarily comprise two of the main items in a bank's income statement. The auditor considers:

- Whether satisfactory procedures exist for the proper accounting of accrued income and expenditure at the year-end;
- Assessing the adequacy of the related system of internal control; and
- Using analytical procedures in assessing the reasonableness of the reported amounts. Such techniques include comparison of reported interest yields in percentage terms:
    - To market rates;
    - To central bank rates;
    - To advertised rates (by type of loan or deposit); and
    - Between portfolios.

  In making such comparisons, average rates in effect (for example, by month) are used in order to avoid distortions caused by changes in interest rates.

The auditor considers the reasonableness of the policy applied to income recognition on non-performing loans, especially where such income is not being received on a current basis. The auditor also considers whether income recognition on non-performing loans complies with the policy of the bank, as well as the requirements of the applicable financial reporting framework.

95. PROVISIONS FOR LOAN LOSSES

Measurement

The major audit concerns in this area are discussed above under "Loans." Usually, provisions take two forms, namely specific provisions in respect of identified losses on individual loans and general provisions to cover losses that are thought to exist but have not been specifically identified. The auditor assesses the adequacy of such provisions based on such factors as past experience and other relevant information and considers whether the specific and general provisions are adequate to absorb estimated credit losses associated with the loan portfolio. Appendix 2 to this Statement contains examples of substantive procedures for the evaluation of loan loss provisions. In some countries the levels of general provisions are prescribed by local regulations. In those countries, the auditor determines whether the reported provision expense is calculated in accordance with such regulations. The auditor also considers the adequacy of the disclosures in the financial statements and, when the provisions are not adequate, the implications for the audit report.

96. FEE AND COMMISSION INCOME

Completeness

The auditor considers whether the amount recorded is complete (that is, all individual items have been recorded). In this respect, the auditor considers using analytical procedures in assessing the reasonableness of the reported amounts.

Measurement

The auditor considers matters such as the following:

- Whether the income relates to the period covered by the financial statements and that those amounts relating to future periods have been deferred.
- Whether the income is collectible (this is considered as part of the loan review audit procedures where the fee has been added to a loan balance outstanding).
- Whether the income is accounted for in accordance with the applicable financial reporting framework.

97. PROVISION FOR TAXES ON INCOME

Measurement

The auditor becomes familiar with the special taxation rules applicable to banks in the jurisdiction in which the bank being reported on is located. The auditor also considers whether any auditors on whose work it is intended to rely in respect of the bank's foreign operations are similarly familiar with the rules in their jurisdiction. The auditor is aware of the taxation treaties between the various jurisdictions in which the bank operates.

98. RELATED PARTY TRANSACTIONS

Presentation and Disclosure

Financial reporting frameworks often require the disclosure of the existence of related parties and of transactions with them. Related party transactions may occur in the ordinary course of a bank's business. For example, a bank may extend credit to its officers or directors or to entities that are owned or controlled by officers or directors. The auditor remains aware of the risk that where such lending transactions with related parties exist, normal measures of banking prudence, such as credit assessment and collateral requirements, may not be exercised properly. The auditor becomes familiar with the applicable regulatory requirements for lending to related parties and performs procedures to identify the bank's controls over related party lending, including approval of related party credit extensions and monitoring of performance of related party loans.

Other related party transactions that may occur in the ordinary course of a bank's business include deposit and

other transactions with directors, officers, or affiliated entities. A bank may also guarantee loans to, or the financial performance of, an affiliated entity. The guarantee may be formalized in a written agreement or the guarantee may be informal. Informal guarantees may be oral agreements, "understood" agreements based on the affiliate's historical performance, or the result of the business culture in which the bank operates. Such agreements, whether formal or informal, are of particular concern when the guarantee relates to an unconsolidated affiliate, as the guarantee is not disclosed in the bank's consolidated financial statements. The auditor makes inquiries of management and reviews the minutes of the board of directors to determine if such guarantees exist and whether there is appropriate disclosure of the guarantees in the bank's financial statements.

Valuation

Related party transactions may also result from management's attempts to avoid adverse circumstances. For example, a bank's management may transfer problem assets to an unconsolidated affiliated entity at or near the period end, or prior to a regulatory examination, to avoid a deficiency in the provision for loan losses or to avoid criticism about asset quality. The auditor considers reviewing transactions involving related parties that have been accounted for as sales transactions to determine whether there are unrecorded recourse obligations involved.

Representations from management or others are often required to understand the business purpose of a particular transaction. Such representations are evaluated in the light of apparent motives and other audit evidence. In order to obtain a complete understanding of a transaction, certain circumstances may warrant a discussion with the related party, their auditor, or other parties such as legal counsel, who are familiar with the transaction. ISA 580, "Management Representations" gives further guidance on the use of management representations.

99.		FIDUCIARY ACTIVITIES Completeness The auditor considers whether all the bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. The auditor also considers whether the bank has incurred any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets. Presentation and Disclosure The auditor considers whether the financial reporting framework requires disclosure of the nature and extent of its fiduciary activities in the notes to its financial statements, and whether the required disclosures have been made.
100.	(Including, where applicable, a Statement of Accounting Policies)	NOTES TO THE FINANCIAL STATEMENTS Presentation and Disclosure The auditor determines whether the notes to the bank's financial statements are in accordance with the applicable financial reporting framework.

Reporting on the Financial Statements

101. In expressing an opinion on the bank's financial statements, the auditor:

- Adheres to any specific formats and terminology specified by the law, the regulatory authorities, professional bodies and industry practice; and
- Determines whether adjustments have been made to the accounts of foreign branches and subsidiaries that are included in the consolidated financial statements of the bank to bring them into conformity with the financial reporting framework under which the bank is reporting. This is particularly relevant in the case of banks because of the large number of countries in which such branches and subsidiaries may be located and the fact that in most countries local regulations prescribe specialized accounting principles applicable primarily to banks. This may lead to a greater divergence in the accounting principles followed by branches and subsidiaries, than is the case in respect of other commercial entities.

102. The financial statements of banks are prepared in the context of the legal and regulatory requirements prevailing in different countries, and accounting policies are influenced by such regulations. In some countries the financial reporting framework for banks (the banking framework) differs materially from the financial reporting framework for other entities (the general framework). When the bank is required to prepare a single set of financial statements that comply with both frameworks, the auditor may express a totally unqualified opinion only if the financial statements have been prepared in accordance with both frameworks. If the financial statements are in accordance with only one of the frameworks, the auditor expresses an unqualified opinion in respect of compliance with that framework and a qualified or adverse opinion in respect of compliance with the other framework. When the bank is required to comply with the banking framework instead of the general framework, the auditor considers the need to refer to this fact in an emphasis of matter paragraph.

103. Banks often present additional information in annual reports that also contain audited financial statements. This information frequently contains details of the bank's risk adjusted capital, and other information relating to the bank's stability, in addition to any disclosures in the financial statements. ISA 720, "Other Information in Documents Containing Audited Financial Statements" provides guidance on the procedures to be undertaken in respect of such additional information.

Appendix 1

Risks and Issues in Respect of Fraud and Illegal Acts

Paragraph 26 of this Statement indicates some of the general considerations in respect of fraud. These are also discussed in more detail in ISA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements."[8] ISA 240 requires the auditor to consider whether fraud risk factors are present that indicate the possibility of either fraudulent financial reporting or misappropriation of assets. Appendix 1 to the ISA gives an indication of general fraud risk factors: this appendix gives examples of fraud risk factors applicable to banks.

The risk of fraudulent activities or illegal acts arises at banks both from within the institution and from outsiders. Among the many fraudulent activities and illegal acts that banks may face are check-writing fraud, fraudulent lending and trading arrangements, money laundering and misappropriation of banking assets. Fraudulent activities may involve collusion by management of banks and their clients. Those perpetrating fraudulent activities may prepare false and misleading records to justify inappropriate transactions and hide illegal activities. Fraudulent financial reporting is another serious concern.

In addition, banks face an ongoing threat of computer fraud. Computer hackers, and others who may gain unauthorized access to banks computer systems and information databases, can misapply funds to personal accounts and steal private information about the institution and its customers. Also, as is the case for all businesses, fraud and criminal activity perpetrated by authorized users inside banks is a particular concern.

Fraud is more likely to be perpetrated at banks that have serious deficiencies in corporate governance and internal control. Significant losses from fraud may arise from the following categories of breakdowns in corporate governance and internal control:

- Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank. Major losses due to fraud often arise as a consequence of management's lack of attention to, and laxity in, the control culture of the bank, insufficient guidance and oversight by those charged with governance and management, and a lack of clear management accountability through the assignment of roles and responsibilities. These situations also may involve a lack of appropriate incentives for management to carry out strong line supervision and maintain a high level of control consciousness within business areas.

[8] See footnote 1.

- Inadequate recognition and assessment of the risk of certain banking activities, whether on- or off-balance sheet. When the risks of new products and activities are not adequately assessed and when control systems that function well for simpler traditional products are not updated to address newer complex products, a bank may be exposed to a greater risk of loss from fraud.
- The absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliations, and reviews of operating performance. In particular, the lack of a segregation of duties has played a major role in fraudulent activities that resulted in significant losses at banks.
- Inadequate communication of information between levels of management within the bank, especially in the upward communication of problems. When policies and procedures are not appropriately communicated to all personnel involved in an activity, an environment is created that may foster fraudulent activities. In addition, fraud may go undetected when information about inappropriate activities that should be brought to the attention of higher level management is not communicated to the appropriate level until the problems become severe.
- Inadequate or ineffective internal audit programs and monitoring activities. When internal auditing or other monitoring activities are not sufficiently rigorous to identify and report control weaknesses, fraud may go undetected at banks. When adequate mechanisms are not in place to ensure that management corrects deficiencies reported by auditors, fraud may continue unabated.

The following table and discussion in this appendix provide examples of fraud risk factors.

	Deposit Taking	**Dealing**	**Lending**
Management & Employee Fraud	Depositors' camouflage Unrecorded deposits Theft of customer deposits or investments, particularly from dormant accounts	Off-market rings Related party deals Broker kickbacks False deals Unrecorded deals Delayed deal allocations Misuse of	Loans to fictitious borrowers Use of nominee companies Deposit transformation Transactions with connected companies Kickbacks and inducements

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	Deposit Taking	Dealing	Lending
		discretionary accounts Exploiting weaknesses in matching procedures Mismarking of book Collusion in providing valuations (Valuation rings) Theft or misuse of collateral held as security	Use of parallel organizations Funds transformation Selling recovered collateral at below market prices Bribes to obtain the release of security or to reduce the amount claimed Theft or misuse of collateral held as security
External Fraud	Money laundering Fraudulent instructions Counterfeit currency or drafts Fraudulent use of Check float periods (Check kiting)	Fraudulent custodial sales False information or documents regarding counterparties	Impersonation and false information on loan applications and subsequently provided documents Double-pledging of collateral Fraudulent valuations (Land flips) Forged or valueless collateral Misappropriation of loan funds by

	Deposit Taking	Dealing	Lending
			agents/ customers Unauthorized sale of collateral

Fraud Risk Factors in Respect of the Deposit Taking Cycle

Depositors' Camouflage

(Hiding the identity of a depositor, possibly in connection with funds transformation or money laundering.)

- Similar or like-sounding names across various accounts.
- Offshore company depositors with no clearly defined business or about which there are few details.

Unrecorded Deposits

- Any evidence of deposit-taking by any other company of which there are details on the premises, whether part of the bank or not.
- Documentation held in management offices that it is claimed has no connection with the business of the bank or evasive replies regarding such documents.

Theft of Customer Deposits/Investments

- Customers with hold-mail arrangements who only have very occasional contact with the bank.
- No independent resolution of customer complaints or review of hold-mail accounts.

Fraud Risk Factors in Respect of the Dealing Cycle

Off-market Rings/Related Party Deals

- No spot checks on the prices at which deals are transacted.
- Unusual levels of activity with particular counterparties.

Broker Kickbacks

- High levels of business with a particular broker.
- Unusual trends in broker commissions.

False Deals

- A significant number of cancelled deals.
- Unusually high value of unsettled transactions.

Unrecorded Deals

- High levels of profit by particular dealers in relation to stated dealing strategy.
- Significant number of unmatched counterparty confirmations.

Delayed Deal Allocations

- No time stamping of deal tickets or a review of the time of booking.
- Alterations to or overwriting of details on deal sheets.

Misuse of Discretionary Accounts

- Unusual trends on particular discretionary accounts.
- Special arrangements for preparation and issue of statements.

Mismarking of the Book

- No detailed valuation policies and guidelines.
- Unusual trends in the value of particular books.

Fraud Risk Factors in Respect of the Lending Cycle

Loans to Fictitious Borrowers/Transactions with Connected Companies

- "Thin" loan files with sketchy, incomplete financial information, poor documentation or management claim the borrower is wealthy and undoubtedly creditworthy.
- Valuations which seem high, valuers used from outside the usually permitted area or the same valuer used on numerous applications.
- Generous extensions or revised terms when the borrower defaults.

Deposit Transformation or Back-to-back Lending

A bank deposit is made by another bank, which is then used to secure a loan to a beneficiary nominated by the fraudulent staff member of the first bank, who hides the fact that the deposit is pledged.

- Pledges over deposits (disclosed by confirmations which have specifically requested such pledges to be disclosed).
- Documentation of files held in directors' or senior managers' offices outside the usual filing areas; deposits continually rolled over or made even when liquidity is tight.

Use of Nominee Companies/Transactions with Connected Companies

- Complex structures which are shrouded in secrecy.
- Several customers with sole contact, that is, handled exclusively by one member of staff.
- Limited liability partnerships without full disclosure of ownership or with complex common ownership structures.

Kickbacks and Inducements

- Excessive amounts of business generated by particular loan officers.
- Strong recommendation by director or lending officer but missing data or documentation on credit file.
- Indications of week documentation controls, for example providing funding before documentation is complete.

Use of Parallel Organizations

(Companies under the common control of directors/shareholders)

- Unexpected settlement of problem loans shortly before the period end or prior to an audit visit or unexpected new lending close to the period end.
- Changes in the pattern of business with related organizations.

Funds Transformation

(Methods used to conceal the use of bank funds to make apparent loan repayments)

- Loans which suddenly become performing shortly before the period end or prior to an audit visit.
- Transactions with companies within a group or with its associated companies where the business purpose is unclear.
- Lack of cash flow analysis that supports the income generation and repayment ability of the borrower.

Impersonation and False Information on Loan Applications/Double-pledging of Collateral/Fraudulent Valuations/Forged or Valueless Collateral

- No on-site appraisal of or visit by the borrower.
- Difficulty in obtaining corroboration of the individual's credentials, inconsistent or missing documentation and inconsistencies in personal details.
- Valuer from outside the area in which the property is situated.
- Valuation is ordered and received by the borrower rather than the lender.
- Lack of verification of liens to substantiate lien positions and priorities

- Lack of physical control of collateral that requires physical possession to secure a loan (for example, jewelry, bearer bonds and art work).

Appendix 2

Examples of Internal Control Considerations and Substantive Procedures for Two Areas of a Bank's Operations

1. The internal controls and substantive procedures listed below represent neither an exhaustive list of controls and procedures that should be undertaken, nor do they represent any minimum requirement that should be satisfied. Rather, they provide guidance on the controls and procedures that the auditor may consider in dealing with the following areas:

   (a) Treasury and trading operations; and

   (b) Loans and advances.

Treasury and Trading Operations

Introduction

2. Treasury operations, in this context, represent all activities relating to the purchase, sale, borrowing and lending of financial instruments. Financial instruments may be securities, money market instruments or derivative instruments. Banks usually enter into such transactions for their own use (for example, for the purpose of hedging risk exposures) or for meeting customers' needs. They also carry out, to a larger or smaller extent, trading activities. Trading may be defined as the purchase and sale (or origination and closing) of financial instruments (including derivatives) with the intention of deriving a gain from the change in market price parameters (for example, foreign exchange rates, interest rates, equity prices) over time. Banks manage and control their treasury activities on the basis of the various risks involved rather than on the basis of the particular type of financial instrument dealt with. The auditor ordinarily adopts the same approach when obtaining audit evidence. IAPS 1012 gives guidance on the audit implications of derivatives acquired by the bank as an end user.

Internal Control Considerations

3. Generally, treasury operations involve transactions that are recorded by IT systems. The risk of processing error in such transactions is ordinarily low provided they are processed by reliable systems. Consequently, the auditor tests whether key processing controls and procedures are operating effectively before assessing the level of inherent and control risks as low. Typical controls in a treasury environment are listed below. These include controls that address business risks of banks and do not necessarily represent controls that address audit risks and that are tested by the auditor in order to assess the levels of inherent and control risks.

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Typical Control Questions

Strategic Controls

4. Have those charged with governance established a formal policy for the bank's treasury business that sets out:
    - The authorized activities and products the bank can trade on its own or a third party's behalf, ideally broken down by product or risk group;
    - The markets in which trading activities take place: these could be regional markets, or Over-the-Counter (OTC) versus Exchange markets;
    - The procedures for measuring, analyzing, supervising and controlling risks;
    - The extent of risk positions permissible, after taking into account the risk they regard as acceptable;
    - The appropriate limits and procedures covering excesses over defined limits;
    - The procedures, including documentation, that must be complied with before new products or activities are introduced;
    - The type and frequency of reports to those charged with governance; and
    - The schedule and frequency with which the policy is reviewed, updated and approved?

Operational Controls

5. Is there appropriate segregation of duties between the front office and back office?
6. Are the following activities conducted independently of the front office/business unit:
    - Confirmation of trades;
    - Recording and reconciliation of positions and results;
    - Valuation of trades or independent verification of market prices; and
    - Settlement of trades?
7. Are trade tickets pre-numbered (if not automatically generated)?
8. Does the bank have a code of conduct for its dealers that addresses the following:
    - Prohibiting dealers from trading on their own account;

- Restricting acceptance of gifts and entertainment activities;
- Confidentiality of customer information;
- Identification of approved counterparties; and
- Procedures for the review of dealers' activities by management?

9. Are remuneration policies structured to avoid encouraging excessive risk taking?
10. Are new products introduced only after appropriate approvals are obtained and adequate procedures and risk control systems are in place?

Limits and Trading Activity

11. Does the bank have a comprehensive set of limits in place to control the market, credit and liquidity risks for the whole institution, business units and individual dealers? Some commonly used limits are notional or volume limits (by currency or counterparty), stop loss limits, gap or maturity limits, settlement limits and value-at-risk limits (for both market and credit risks).
12. Are limits allocated to risks in line with the overall limits of the bank?
13. Do all dealers know their limits and the use thereof? Does every new transaction reduce the available limit immediately?
14. Are procedures in place that cover excesses over limits?

Risk Measurement and Management

15. Is there an independent risk management function (sometimes referred to as Middle Office) for measuring, monitoring and controlling risk? Does it report directly to those charged with governance and senior management?
16. Which method is employed to measure the risk arising from trading activities (for example, position limits, sensitivity limits, value at risk limits, etc.)?
17. Are the risk control and management systems adequately equipped to handle the volume, complexity and risk of treasury activities?
18. Does the risk measurement system cover all portfolios, all products and all risks?
19. Is appropriate documentation in place for all elements of the risk system (methodology, calculations, parameters)?
20. Are all trading portfolios revalued and risk exposures calculated regularly, at least daily for active dealing operations?

21. Are risk management models, methodologies and assumptions used to measure risk and to limit exposures regularly assessed, documented and updated continuously to take account of altered parameters, etc?

22. Are stress situations analyzed and "worst case" scenarios (which take into account adverse market events such as unusual changes in prices or volatilities, market illiquidity or default of a major counterparty) conducted and tested?

23. Does management receive timely and meaningful reports?

Confirmations

24. Does the bank have written procedures in use:

    - For the independent dispatch of pre-numbered outward confirmations to counterparties for all trades entered into by the dealers;
    - For the independent receipt of all incoming confirmations and their matching to pre-numbered copies of internal trade tickets;
    - For independent comparison of signatures on incoming confirmations to specimen signatures;
    - For the independent confirmation of all deals for which no inward confirmation has been received; and
    - For the independent follow-up of discrepancies on confirmations received?

Settlement of Transactions

25. Are settlement instructions exchanged in writing with counterparties by the use of inward and outward confirmations?

26. Are settlement instructions compared to the contracts?

27. Are settlements made only by appropriate authorized employees independent of the initiation and recording of transactions and only on the basis of authorized, written instructions?

28. Are all scheduled settlements (receipts and payments) notified daily in writing to the settlement department so that duplicate requests and failures to receive payments can be promptly detected and followed-up?

29. Are accounting entries either prepared from or checked to supporting documentation by operational employees, other than those who maintain records of uncompleted contracts or perform cash functions?

Recording

30. Are exception reports generated for excesses in limits; sudden increases in trading volume by any one trader, customer or counterparty; transactions at unusual contract rates, etc? Are these monitored promptly and independently of the dealers?

31. Does the bank have written procedures that require:
    - The accounting for all used and unused trade tickets;
    - The prompt recording into the accounting records by an independent party of all transactions, including procedures to identify and correct rejected transactions;
    - The daily reconciliation of dealer's positions and profits with the accounting records and the prompt investigation of all differences; and
    - Regular reports to management in appropriate detail to allow the monitoring of the limits referred to above?

32. Are all *nostro* and *vostro* account reconciliations performed frequently and by employees independent of the settlement function?

33. Are suspense accounts regularly reviewed?

34. Does the bank have an accounting system that allows it to prepare reports that show its spot, forward, net open and overall positions for the different types of products, for example:
    - By purchase and sale, by currency;
    - By maturity dates, by currency; and
    - By counterparty, by currency?

35. Are open positions revalued periodically (for example, daily) to current values based on quoted rates or rates obtained directly from independent sources?

General Audit Procedures

36. Certain audit procedures apply to the environment in which treasury activities are carried out. To understand this environment, the auditor initially obtains an understanding of the:
    - Scale, volume, complexity and risk of treasury activities;
    - Importance of treasury activities relative to other business of the bank;
    - Framework within which treasury activities take place; and
    - Organizational integration of the treasury activities.

37. Once the auditor has obtained this understanding and has performed tests of controls with satisfactory results, the auditor ordinarily assesses:

    - The accuracy of the recording of transactions entered into during the period and related profits and losses, by reference to deal tickets and confirmation slips;
    - The completeness of transactions and proper reconciliation between the front office and accounting systems of open positions at the period end;
    - The existence of outstanding positions by means of third party confirmations at an interim date or at the period end;
    - The appropriateness of the exchange rates, interest rates or other underlying market rates used at the year end date to calculate unrealized gains and losses;
    - The appropriateness of the valuation models and assumptions used to determine the fair value of financial instruments outstanding as at the period end; and
    - The appropriateness of the accounting policies used particularly around income recognition and the distinction between hedged and trading instruments.

38. Relevant aspects of treasury operations that generally pose increased audit risks are addressed below:

Changes in Products or Activities

39. Particular risks often arise where new products or activities are introduced. To address such risks the auditor initially seeks to confirm that predefined procedures are in place for these cases. Generally, the bank should commence such activities only when the smooth flow of the new transactions through the controls system is ensured, the relevant IT systems are fully in place (or where adequate interim system support is in place) and the relevant procedures are properly documented. Newly traded instruments are ordinarily subject to careful review by the auditor, who initially obtains a list of all new products introduced during the period (or a full list of all instruments transacted). Based on this information, the auditor establishes the associated risk profile and seeks to confirm the reliability of the internal control and accounting systems.

Reliance on Computer Experts

40. Due to the volume of transactions, virtually all banks support the treasury transactions cycle using IT systems. Due to the complexity of systems in use and the procedures involved, the auditor ordinarily seeks the assistance of IT experts to supply appropriate skills and knowledge in the testing of systems and relevant account balances.

Purpose for which Transactions are Undertaken

41. The auditor considers whether the bank holds speculative positions in financial instruments or hedges them against other transactions. The purpose for entering such transactions, whether hedging or trading, should be identified at the dealing stage in order for the correct accounting treatment to be applied. Where transactions are entered for hedging purposes, the auditor considers the appropriate accounting treatment and presentation of such transactions and the matched assets/liabilities, in accordance with relevant accounting requirements.

Valuation Procedures

42. Off-balance sheet financial instruments are ordinarily valued at market or fair value, except for instruments used for hedging purposes, which, under many financial reporting frameworks, are valued on the same basis as the underlying item being hedged. Where market prices are not readily available for an instrument, financial models that are widely used by the banking industry may be used to determine the fair value. In addition to disclosure of the notional amounts of open positions, several countries require the disclosure of the potential risk arising, as for example, the credit risk equivalent and replacement value of such outstanding instruments.

43. The auditor ordinarily tests the valuation models used, including the controls surrounding their operation, and considers whether details of individual contracts, valuation rates and assumptions are appropriately entered into such models. As many of these instruments have been developed only recently, the auditor pays particular attention to their valuation, and in doing so bears in mind the following factors:

- There may be no legal precedents concerning the terms of the underlying agreements. This makes it difficult to assess the enforceability of those terms.
- There may be a relatively small number of management personnel who are familiar with the inherent risks of these instruments. This may lead to a higher risk of misstatements occurring and a greater difficulty in establishing controls that would prevent misstatements or detect and correct them on a timely basis.
- Some of these instruments have not existed through a full economic cycle (bull and bear markets, high and low interest rates, high and low trading and price volatility) and it may therefore be more difficult to assess their value with the same degree of certainty as for more established instruments. Similarly, it may be difficult to predict with a sufficient degree of certainty the price correlation with other offsetting instruments used by the bank to hedge its positions.

- The models used for valuing such instruments may not operate properly in abnormal market conditions.

44. In addition, the auditor considers the need for, and adequacy of, provisions against financial instruments, such as liquidity risk provision, modeling risk provision and reserve for operational risk. The complexity of certain instruments requires specialist knowledge. If the auditor does not have the professional competence to perform the necessary audit procedures, advice is sought from appropriate experts.

45. A further issue of particular interest to the auditor is transactions entered into at rates outside the prevailing market rates; these often involve the risk of hidden losses or fraudulent activity. As a result, the bank ordinarily provides mechanisms that are capable of detecting transactions out of line with market conditions. The auditor obtains sufficient appropriate audit evidence concerning the reliability of the function performing this task. The auditor also considers reviewing a sample of the identified transactions.

Loans and Advances

Introduction

46. According to a consultative paper, "Principles for the Management of Credit Risk," issued by the Basel Committee on Banking Supervision, credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.

47. Loans and advances are the primary source of credit risk for most banks, because they usually are a bank's most significant assets and generate the largest portion of revenues. The overriding factor in making a loan is the amount of credit risk associated with the lending process. For individual loans, credit risk pertains to the borrower's ability and willingness to pay. Aside from loans, other sources of credit risk include acceptances, inter-bank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions.

48. Credit risk represents a major cause of serious banking problems, and is directly related to lax credit standards for borrowers and counterparties, lack of qualified lending expertise, poor portfolio risk management, and a lack of attention to changes in economic or other circumstances that may lead to a deterioration in the credit standing of a bank's counterparties. Effective credit risk management is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization. In managing credit risk, banks should consider the level of risk inherent in both individual credits or transactions and in the

entire asset portfolio. Banks also need to analyze the risk between credit risk and other risks.

Typical Control Questions

49. Credit risks arise from characteristics of the borrower and from the nature of the exposure. The creditworthiness, country of operation and nature of borrower's business affect the degree of credit risk. Similarly, the credit risk is influenced by the purpose and security for the exposure.

50. The credit function may conveniently be divided into the following categories:

    (a) Origination and disbursement.

    (b) Monitoring.

    (c) Collection.

    (d) Periodic review and evaluation.

Origination and Disbursement

51. Does the bank obtain complete and informative loan applications, including financial statements of the borrower, the source of the loan repayment and the intended use of proceeds?

52. Does the bank have written guidelines as to the criteria to be used in assessing loan applications (for example, interest coverage, margin requirements, debt-to-equity ratios)?

53. Does the bank obtain credit reports or have independent investigations conducted on prospective borrowers?

54. Does the bank have procedures in use to ensure that related party lending has been identified?

55. Is there an appropriate analysis of customer credit information, including projected sources of loan servicing and repayments?

56. Are loan approval limits based on the lending officer's expertise?

57. Is appropriate lending committee or board of director approval required for loans exceeding prescribed limits?

58. Is there appropriate segregation of duties between the loan approval function and the loan disbursement monitoring, collection and review functions?

59. Is the ownership of loan collateral and priority of the security interest verified?

60. Does the bank ensure that the borrower signs a legally enforceable document as evidence of an obligation to repay the loan?

61. Are guarantees examined to ensure that they are legally enforceable?

62. Is the documentation supporting the loan application reviewed and approved by an employee independent of the lending officer?

63. Is there a control to ensure the appropriate registration of security (for example, recording of liens with governmental authorities)?

64. Is there adequate physical protection of notes, collateral and supporting documents?

65. Is there a control to ensure that loan disbursements are recorded immediately?

66. Is there a control to ensure that to the extent possible, loan proceeds are used by the borrower for the intended purpose?

Monitoring

67. Are trial balances prepared and reconciled with control accounts by employees who do not process or record loan transactions?

68. Are reports prepared on a timely basis of loans on which principal or interest payments are in arrears?

69. Are these reports reviewed by employees independent of the lending function?

70. Are there procedures in use to monitor the borrower's compliance with any loan restrictions (for example, covenants) and requirements to supply information to the bank?

71. Are there procedures in place that require the periodic reassessment of collateral values?

72. Are there procedures in place to ensure that the borrower's financial position and results of operations are reviewed on a regular basis?

73. Are there procedures in place to ensure that key administrative dates, such as the renewal of security registrations, are accurately recorded and acted upon as they arise?

Collection

74. Are the records of principal and interest collections and the updating of loan account balances maintained by employees independent of the credit granting function?

75. Is there a control to ensure that loans in arrears are followed up for payment on a timely basis?

76. Are there written procedures in place to define the bank's policy for recovering outstanding principal and interest through legal proceedings, such as foreclosure or repossession?

77. Are there procedures in place to provide for the regular confirmation of loan balances by direct written communication with the borrower by employees independent of the credit granting and loan recording functions, as well as the independent investigation of reported differences?

Periodic Review and Evaluation

78. Are there procedures in place for the independent review of all loans on a regular basis, including:
    - The review of the results of the monitoring procedures referred to above; and
    - The review of current issues affecting borrowers in relevant geographic and industrial sectors?

79. Are there appropriate written policies in effect to establish the criteria for:
    - The establishment of loan loss provisions;
    - The cessation of interest accruals (or the establishment of offsetting provisions);
    - The valuation of collateral security for loss provisioning purposes;
    - The reversals of previously established provisions;
    - The resumption of interest accruals; and
    - The writing off of loans?

80. Are there procedures in place to ensure that all required provisions are entered into the accounting records on a timely basis?

General Audit Procedures

81. The following audit procedures are intended to allow the auditor to discover the operating standards and processes that the bank has established and to consider whether controls regarding credit risk management are adequate.

Planning

82. The auditor obtains a knowledge and understanding of the bank's method of controlling credit risk. This includes matters such as the following:
    - The bank's exposure monitoring process, and its system for ensuring that all connected party lending has been identified and aggregated.

- The bank's method for appraising the value of exposure collateral and for identifying potential and definite losses.
- The bank's lending practices and customer base.

83. The auditor considers whether the exposure review program ensures independence from the lending functions including whether the frequency is sufficient to provide timely information concerning emerging trends in the portfolio and general economic conditions and whether the frequency is increased for identified problem credits.

84. The auditor considers the qualifications of the personnel involved in the credit review function. The industry is changing rapidly and fundamentally creating a lack of qualified lending expertise. The auditor considers whether credit review personnel possess the knowledge and skills necessary to manage and evaluate lending activities.

85. The auditor considers, through information previously generated, the causes of existing problems or weaknesses within the system. The auditor considers whether these problems or weaknesses present the potential for future problems.

86. The auditor reviews management reports and considers whether they are sufficiently detailed to evaluate risk factors.

87. Note that defining and auditing related party lending transactions are difficult because the transactions with related parties are not easily identifiable. Reliance is primarily upon management to identify all related parties and related-party transactions and such transactions may not be easily detected by the bank's internal control systems.

Tests of Control

88. The auditor obtains a knowledge and understanding of the bank's method of controlling credit risk. This includes matters such as:
    - The exposure portfolio and the various features and characteristics of the exposures;
    - The exposure documentation used by the bank;
    - What constitutes appropriate exposure documentation for different types of exposures; and
    - The bank's procedures and authority levels for granting an exposure.

89. The auditor reviews the lending policies and considers:
    - Whether the policies are reviewed and updated periodically to ensure they are relevant with changing market conditions and new business lines of the bank; and

- Whether those charged with governance have approved the policies and whether the bank is in compliance.

90. The auditor examines the exposure review reporting system, including credit file memoranda and an annual schedule or exposure review plan, and considers whether it is thorough, accurate and timely and whether it will provide sufficient information to allow management to both identify and control risk. Do the reports include:

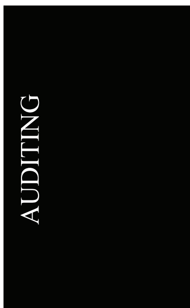
- Identification of problem credits;
- Current information regarding portfolio risk; and
- Information concerning emerging trends in the portfolio and lending areas?

91. The auditor considers the nature and extent of the scope of the exposure review, including the following:

- Method of exposure selection.
- Manner in which exposures are reviewed including:
  - An analysis of the current financial condition of the borrower which addresses repayment ability; and
  - Tests for documentation exceptions, policy exceptions, noncompliance with internal procedures, and violations of laws and regulations.

92. The auditor considers the effectiveness of the credit administration and portfolio management by examining the following:

- Management's general lending philosophy in such a manner as to elicit management responses.
- The effect of credits not supported by current and complete financial information and analysis of repayment ability.
- The effect of credits for which exposure and collateral documentation are deficient.
- The volume of exposures improperly structured, for example, where the repayment schedule does not match exposure purpose.
- The volume and nature of concentrations of credit, including concentrations of classified and criticized credits.
- The appropriateness of transfers of low quality credits to or from another affiliated office.
- The accuracy and completeness of reports.



- Competency of senior management, exposure officers and credit administration personnel.

Substantive Procedures

93. The auditor considers the extent of management's knowledge of the bank's own credit exposure problems through selective exposure file reviews. Selection criteria include the following:

    - Accounts with an outstanding balance equal to or greater than a specified amount.
    - Accounts on a "Watch List" with an outstanding balance in excess of a specified amount.
    - Accounts with a provision in excess of a specified amount.
    - Accounts that are handled by the department that manages the bank's problem or higher risk accounts.
    - Accounts where principal or interest of more than a specified amount is in arrears for more than a specified period.
    - Accounts where the amount outstanding is in excess of the authorized credit line.
    - Accounts with entities operating in industries or countries that the auditor's own general economic knowledge indicates could be at risk.
    - Problem accounts identified by the bank regulatory authorities and problem accounts selected in the prior year.
    - The extent of exposure to other financial institutions on inter-bank lines.

94. In addition, where the bank's personnel have been requested to summarize characteristics of all exposures over a specified size grouped on a connection basis, the auditor reviews the summaries. Exposures with the following characteristics may indicate a need for a more detailed review:

    - Large operating loss in the most recent fiscal year.
    - Sustained operating losses (for example, 2 or more years).
    - A high debt/equity ratio (for example, in excess of 2:1—the ratio will vary by industry).
    - Failure to comply with terms of agreement on covenants.
    - Modified auditor's report.
    - Information provided not current or complete.

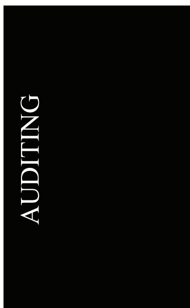
- Advances significantly unsecured or secured substantially by a guarantee.
- Accounts where reviews not performed by bank management on a timely basis.

95. The auditor selects the exposures for detailed review from the exposure listings above using the sample selection criteria determined above and obtains the documents necessary to consider the collectability of the exposures. These may include the following:

- The exposure and security documentation files.
- Arrears listings or reports.
- Activity summaries.
- Previous doubtful accounts listings.
- The non-current exposure report.
- Financial statements of the borrower.
- Security valuation reports.

96. Using the exposure documentation file, the auditor:

- Ascertains the exposure type, interest rate, maturity date, repayment terms, security and stated purpose of the exposure;
- Considers whether security documents bear evidence of registration as appropriate, and that the bank has receive appropriate legal advice about the security's legal enforceability;
- Considers whether the fair value of the security appears adequate (particularly for those exposures where a provision may be required) to secure the exposure and that where applicable, the security has been properly insured. Critically evaluates the collateral appraisals, including the appraiser's methods and assumptions;
- Evaluates the collectability of the exposure and considers the need for a provision against the account;
- Determines whether the appropriate authority levels within the bank have approved the exposure application or renewal;
- Reviews periodic financial statements of the borrower and notes significant amounts and operating ratios (that is, working capital, earnings, shareholders' equity and debt-to-equity ratios); and
- Reviews any notes and correspondence contained in the exposure review file. Notes the frequency of review performed by the bank's staff and considers whether it is within bank guidelines.



97. The auditor considers whether policies and procedures exist for problem and workout exposures, including the following:

    - A periodic review of individual problem credits.
    - Guidelines for collecting or strengthening the exposure, including requirements for updating collateral values and lien positions, documentation review, officer call reports.
    - Volume and trend of past due and non-accrual credits.
    - Qualified officers handling problem exposures.
    - Guidelines on proper accounting for problem exposures, for example, non-accrual policy, specific reserve policy.

98. In addition to assessing the adequacy of the provisions against individual exposures, the auditor considers whether any additional provisions need to be established against particular categories or classes of exposures (for example, credit card exposures and country risk exposures) and assesses the adequacy of any provisions that the bank may have established through discussions with management.

Appendix 3

Examples of Financial Information, Ratios and Indicators Commonly Used in the Analysis of a Bank's Financial Condition and Performance

There are a large number of financial ratios that are used to analyze a bank's financial condition and performance. While these ratios vary somewhat between countries and between banks, their basic purpose tends to remain the same, that is, to provide measures of performance in relation to prior years, to budget and to other banks. The auditor considers the ratios obtained by one bank in the context of similar ratios achieved by other banks for which the auditor has, or may obtain, sufficient information.

These ratios generally fall into the following categories:

- Asset quality.
- Liquidity.
- Earnings.
- Capital adequacy.
- Market risk.
- Funding risk.

Set out below are those overall ratios that the auditor is likely to encounter. Many other, more detailed ratios are ordinarily prepared by management to assist in the analysis of the condition and performance of the bank and its various categories of assets and liabilities, departments and market segments.

(a) Asset quality ratios:

- Loan losses to total loans
- Non-performing loans to total loans
- Loan loss provisions to non-performing loans
- Earnings coverage to loan losses
- Increase in loan loss provisions to gross income
- Size, credit risk concentration, provisioning

(b) Liquidity ratios:

- Cash and liquid securities (for example, those due within 30 days) to total assets
- Cash, liquid securities and highly marketable securities to total assets

- Inter-bank and money market deposit liabilities to total assets

(c) Earnings ratios:

- Return on average total assets
- Return on average total equity
- Net interest margin as a percentage of average total assets and average earning assets
- Interest income as a percentage of average interest bearing assets
- Interest expense as a percentage of average interest bearing liabilities
- Non-interest income as a percentage of average commitments
- Non-interest income as a percentage of average total assets
- Non-interest expense as a percentage of average total assets
- Non-interest expense as a percentage of operating income

(d) Capital adequacy ratios:

- Equity as a percentage of total assets
- Tier 1 capital as a percentage of risk-weighted assets
- Total capital as a percentage of risk-weighted assets

(e) Market risk:

- Concentration of risk of particular industries or geographic areas
- Value at risk
- Gap and duration analysis (basically a maturity analysis and the effect of changes in interest rates on the bank's earnings or own funds)
- Relative size of engagements and liabilities
- Effect of changes in interest rates on the bank's earnings or own funds

(f) Funding risk:

- Clients' funding to total funding (clients' plus interbank)
- Maturities
- Average borrowing rate

Appendix 4

Risks and Issues in Securities Underwriting and Securities Brokerage

Securities Underwriting

Many banks provide such financial services as underwriting publicly offered securities or assisting in the private placement of securities. Banks engaging in these activities may be exposed to substantial risks that have audit implications. These activities and the risks associated with them are quite complex, and consideration is given to consulting with experts in such matters.

The type of security being underwritten, as well as the structure of the offering, influence the risks present in securities underwriting activities. Depending upon how a security offering is structured, an underwriter may be required to buy a portion of the positions offered. This creates the need to finance the unsold portions, and exposes the entity to the market risk of ownership.

There is also a significant element of legal and regulatory risk that is driven by the jurisdiction in which the security offering is taking place. Examples of legal and regulatory risk areas include an underwriter's exposure for material misstatements included in a securities registration or offering statement and local regulations governing the distribution and trading in public offerings. Also included are risks arising from insider trading and market manipulation by management or the bank's staff. Private placements are ordinarily conducted on an agency basis and therefore result in less risk than that associated with a public offering of securities. However, the auditor considers local regulations covering private placements.

Securities Brokerage

Many banks also are involved in securities brokerage activities that include facilitating customers' securities transactions. As with securities underwriting, banks engaging in these activities (as a broker, dealer, or both) may be exposed to substantial risks that have audit implications. These activities and the risks associated with them are quite complex, and consideration is given to consulting with experts in such matters.

The types of services offered to customers and the methods used to deliver them determine the type and extent of risks present in securities brokerage activities. The number of securities exchanges on which the bank conducts business and executes trades for its customers also influences the risk profile. One service often offered is the extension of credit to customers who have bought securities on margin, resulting in credit risk to the bank. Another common service is acting as a depository for securities owned by customers. Entities are also exposed to liquidity risks associated with funding securities brokerage operations. The related audit risk factors are similar to those set out in Appendix 5, "Risks and Issues in Asset Management."

There is also a significant element of legal and regulatory risk that is driven by the jurisdiction in which the security brokerage activities are taking place. This may be a consideration for regulatory reporting by the bank, reports directly by the auditor to regulators and also from the point of view of reputation and financial risk that may occur in the event of regulatory breaches by the bank.

Appendix 5

Risks and Issues in Private Banking and Asset Management

Private Banking

Provision of superior levels of banking services to individuals, typically people with high net worth, is commonly known as private banking. Such individuals may often be domiciled in a country different from that of the bank. Before auditing private banking activities, the auditor understands the basic controls over these activities. The auditor considers the extent of the entity's ability to recognize and manage the potential reputational and legal risks that may be associated with inadequate knowledge and understanding of its clients' personal and business backgrounds, sources of wealth, and uses of private banking accounts. The auditor considers the following:

- Whether management oversight over private banking activities includes the creation of an appropriate corporate culture. Additionally, high levels of management should set goals and objectives and senior management must actively seek compliance with corporate policies and procedures.
- Policies and procedures over private banking activities should be in writing and should include sufficient guidance to ensure there is adequate knowledge of the entity's customers. For example, the policies and procedures should require that the entity obtain identification and basic background information on their clients, describe the clients' source of wealth and lines of business, request references, handle referrals, and identify suspicious transactions. The entity should also have adequate written credit policies and procedures that address, among other things, money laundering related issues, such as lending secured by cash collateral.
- Risk management practices and monitoring systems should stress the importance of the acquisition and retention of documentation relating to clients, and the importance of due diligence in obtaining follow-up information where needed to verify or corroborate information provided by a customer or his or her representative. Inherent in sound private banking operations is the need to comply with any customer identification requirements. The information systems should be capable of monitoring all aspects of an entity's private banking activities. These include systems that provide management with timely information necessary to analyze and effectively manage the private banking business, and systems that enable management to monitor accounts for suspicious transactions and to report any such instances to law enforcement authorities and banking supervisors as required by regulations or laws.

The auditor considers the assessed levels of inherent and control risk related to private banking activities when determining the nature, timing and extent of substantive procedures. The following list identifies many of the common audit risk factors to consider when determining the nature, timing and extent of procedures to be performed. Since private banking frequently involves asset management activities the audit risk factors associated with asset management activities are also included below.

- *Compliance with regulatory requirements*. Private banking is highly regulated in many countries. This may be a consideration for regulatory reporting by the client, reports directly by the auditor to regulators and also from the point of view of the reputation and financial risk that may occur in the event of regulatory breaches by the bank. Also, the nature of private banking activities may increase the bank's susceptibility to money laundering, and thus may have increased operational, regulatory, and reputational risks, which may have audit implications.
- *Confidentiality.* This is generally a feature of private banking. In addition to the normal secrecy which most countries accord bank/client relationships, many jurisdictions where private banking is common have additional banking secrecy legislation which may reduce the ability of regulators, taxing authorities or police, from their own or other jurisdictions, to access client information. A bank may seek to impose restrictions on an auditor's access to the names of the bank's private clients, affecting the auditor's ability to identify related party transactions. A related issue is that the bank may be requested by a client not to send correspondence, including account statements (hold mail accounts). This may reduce the auditor's ability to gain evidence as to completeness and accuracy and, in the absence of adequate alternative procedures, the auditor considers the implications of this for the auditor's report.
- *Management fraud*. The tight confidentiality and personal nature of private banking relationships may reduce the effectiveness of internal controls that provide supervision and oversight over staff who deal with private clients' affairs. The high degree of personal trust that may exist between a client and their private banker may add to the risk in that many private bankers are given some degree of autonomy over the management of their clients' affairs. This risk is exacerbated to the extent private clients may not be in a position to verify their affairs on a regular basis as explained above.
- *Services designed to legally transfer some degree of ownership/control of assets to third parties, including trusts and other similar legal arrangements.* Such arrangements are not confined to private banking relationships, however, they are commonly present in them. For the bank, the risk is that the terms of the trust or other legal arrangement are not complied with or do not comply with the applicable law. This exposes the bank to possible liability to the beneficiaries. Controls in this area are particularly important, given that errors are often identified only when the trust or other arrangement is wound up, possibly

decades after its creation. Private bankers often are also involved in preparing wills or other testamentary documents, and act as executors. Improper drafting of a will may carry financial consequences to the bank. Controls should exist in this area and in the area of monitoring executor activity. The auditor considers whether there are any undisclosed liabilities in respect of such services. Confidentiality requirements may affect the auditor's ability to obtain sufficient appropriate audit evidence, and if so, the auditor considers the implications for the auditor's report. Finally, trust and similar arrangements provided by private banks are often outsourced to third parties. The auditor considers what audit risk factors remain for outsourced services, the procedures needed to understand the risks and relationships and assess the controls over and within the outsourced service provider.

- *Credit risk.* Credit risk is often more complex when private banking services are provided because of the nature of their customers' borrowing requirements. The following services often make credit risk difficult to judge: structured facilities (credit transactions with multiple objectives which address client requirements in areas such as tax, regulation, hedging, etc.); unusual assets pledged as security (for example, art collections, not readily saleable properties, intangible assets whose value is reliant on future cash flows); and reliance placed on personal guarantees (name lending).
- *Custody.* Private banks may offer custodial services to clients for physical investment assets or valuables. The related audit risk factors are similar to those set out below under Asset Management.

Asset Management

The following risk factors are provided as considerations in planning the strategy and execution of the audit of a bank's asset management activities. Included in this area are fund management, pension management, vehicles designed to legally transfer some degree of ownership/control of assets to third parties such as trusts or other similar arrangements etc. This list is not exhaustive as the financial services industry is a rapidly changing industry.

- *When both the asset manager and the assets themselves are not both audited by the same audit firm.* The performance of an asset manager and the assets themselves generally are closely linked. It is easier to identify and understand the implications of an issue arising in one entity on the financial statements of the other if both are audited by the same firm, or if arrangements have been made to permit an appropriate exchange of information between two audit firms. Where there is no requirement for both the assets and the asset manager to be audited, or where appropriate access to the other audit firm is not possible, the auditor considers whether he is in a position to form a complete view.

- *Fiduciary responsibility to third parties.* Mismanagement of third party funds may have a financial or reputational effect on an asset manager. Matters falling into this category may include:
  - Improper record keeping;
  - Inadequate controls over the protection and valuation of assets;
  - Inadequate controls to prevent fund manager fraud;
  - Inappropriate physical and/or legal segregation of client funds from the manager's funds or other clients' funds (often a regulated aspect);
  - Inappropriate segregation of client investments from the manager's own investments (either personal or corporate or both) or other clients' investments;
  - Inappropriate segregation of bank staff engaged in asset management duties and those engaged in other operations;
  - Non-compliance with mandates from clients or the investment policy under which funds were supposed to be managed; and
  - Failure to comply with reporting requirements (contractual or regulatory) to clients.
- Consideration is given to the policies and controls over client acceptance; investment decisions; compliance with client instructions; conflicts of interest; compliance with regulations; segregation and safeguarding of funds and proper reporting of client assets and transactions.
- *Fund manager remuneration.* There is a heightened potential for fund managers to make imprudent or illegal business decisions based upon a desire for personal gain through a bonus or incentive arrangement.
- *Technology.* Technology is critical to the operation of most asset management companies therefore an examination is made of the security, completeness and accuracy of data and data input where computer controls are being relied on for audit purposes, as well as the overall computer control environment. Consideration is given as to whether appropriate controls exist to ensure transactions on behalf of clients are separately recorded from the bank's own transactions.
- *Globalization and international diversification.* These are features of many asset managers and this may give rise to additional risks due to the diversity of practice among different countries regarding matters such as pricing and custody rules, regulations, legal systems, market practices, disclosure rules and accounting standards.

Glossary of Terms

Hidden Reserves	Some financial reporting frameworks allow banks to manipulate their reported income by transferring amounts to non-disclosed reserves in years when they make large profits and transferring amounts from those reserves when they make losses or small profits. The reported income is the amount after such transfers. The practice served to make the bank appear more stable by reducing the volatility of its earnings, and would help to prevent a loss of confidence in the bank by reducing the occasions on which it would report low earnings.
Nostros	Accounts held in the bank's name with a correspondent bank.
Provision	An adjustment to the carrying value of an asset to take account of factors that might reduce the asset's worth to the entity. Sometimes called an allowance.
Prudential Ratios	Ratios used by regulators to determine the types and amounts of lending a bank can undertake.
Stress Testing	Testing a valuation model by using assumptions and initial data outside normal market circumstances and assessing whether the model's predictions are still reliable.
Vostros	Accounts held by the bank in the name of a correspondent bank.

Reference Material

The following is a list of material that auditors of banks' financial statements may find helpful.

Basel Committee on Banking Supervision:

Publication 30: Core Principles for Effective Banking Supervision. Basel, 1997.

Publication 33: Framework for Internal Control Systems in Banking Organisations. Basel, 1998.

Publication 55: Sound Practices for Loan Accounting and Disclosure. Basel, 1999.

Publication 56: Enhancing Corporate Governance in Banking Organisations. Basel, 1999.

Publication 72: Internal Audit in Banking Organisations and the Relationship of the Supervisory Authorities with Internal and External Auditors. Basel, 2000

Publication 75: Principles for the Management of Credit Risk. Basel, 2000.

Publication 77: Customer Due Diligence for Banks. Basel, 2001.

Publication 82: Risk Management Principles for Electronic Banking. Basel, 2001.

Publications of the Basel Committee on Banking Supervision can be downloaded from the website of the Bank for International Settlements: http://www.bis.org.

International Accounting Standards Board:

IAS 30: Disclosures in the Financial Statements of Banks and Similar Financial Institutions. London, 1999.

IAS 32: Financial Instruments: Disclosure and Presentation. London, 2000.

IAS 37: Provisions, Contingent Liabilities and Contingent Assets. London, 1998.

IAS 39: Financial Instruments: Recognition and Measurement. London, 2000.

In addition a number of IFAC member bodies have issued reference and guidance material on banks and the audits of the financial statements of banks.

INTERNATIONAL AUDITING PRACTICE STATEMENT 1010

THE CONSIDERATION OF ENVIRONMENTAL MATTERS IN THE AUDIT OF FINANCIAL STATEMENTS

(This Statement is effective)

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Appendix 1: Obtaining Knowledge of the Business from an Environmental Point of View—Illustrative Questions

Appendix 2: Substantive Procedures to Detect a Material Misstatement Due to Environmental Matters

International Auditing Practice Statement (IAPS) 1010, "The Consideration of Environmental Matters in the Audit of Financial Statements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of IAPSs.

This Statement was approved by the IAPC in March 1998 for publication in March 1998.

[1] ISA 310, "Knowledge of the Business" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" became effective.

[2] ISA 400, "Risk Assessments and Internal Control" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" became effective.

Introduction

The Purpose of this Statement

1. Environmental matters are becoming significant to an increasing number of entities and may, in certain circumstances, have a material impact on their financial statements. These issues are of growing interest to the users of financial statements. The recognition, measurement, and disclosure of these matters is the responsibility of management.

2. For some entities, environmental matters are not significant. However, when environmental matters are significant to an entity, there may be a risk of material misstatement (including inadequate disclosure) in the financial statements arising from such matters: in these circumstances, the auditor needs to give consideration to environmental matters in the audit of the financial statements.

3. Environmental matters can be complex and may therefore require additional consideration by auditors. This Statement provides practical assistance to auditors by describing:

   (a) The auditor's main considerations in an audit of financial statements with respect to environmental matters;

   (b) Examples of possible impacts of environmental matters on financial statements; and

   (c) Guidance that the auditor may consider when exercising professional judgment in this context to determine the nature, timing, and extent of audit procedures with respect to:

      (i) Knowledge of the business (ISA 310, "Knowledge of the Business");[3]

      (ii) Risk assessments and internal control (ISA 400, "Risk Assessments and Internal Control");[4]

      (iii) Consideration of laws and regulations (ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements"); and

      (iv) Other substantive procedures (ISA 620, "Using the Work of an Expert" and some others).

   The guidance under (c) reflects the typical sequence of the audit process. Having acquired a sufficient knowledge of the business the auditor assesses

3 See footnote 1.

4 See footnote 2.

the risk of a material misstatement in the financial statements. This assessment includes consideration of environmental laws and regulations that may pertain to the entity, and provides a basis for the auditor to decide whether there is a need to pay attention to environmental matters in the course of the audit of financial statements.

Appendix 1 provides illustrative questions that an auditor may consider when obtaining a knowledge of the business, including an understanding of the entity's control environment and control procedures from an environmental point of view. Appendix 2 provides examples of substantive procedures that an auditor may perform to detect a material misstatement in the financial statements due to environmental matters. These appendices are included for illustrative purposes only. It is not intended that all, or even any, of the questions or examples will necessarily be appropriate in any particular case.

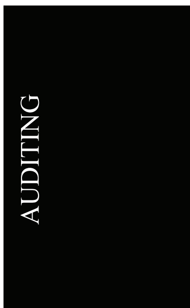
4. This Statement does not establish any new basic principles or essential procedures: its purpose is to assist auditors, and the development of good practice, by providing guidance on the application of the ISAs in cases when environmental matters are significant to the financial statements of the entity. The extent to which any of the audit procedures described in this Statement may be appropriate in a particular case requires the exercise of the auditor's judgment in the light of the requirements of the ISAs and the circumstances of the entity.

5. The Statement does not provide guidance on the audit of the financial statements of insurance companies with regard to claims incurred under insurance policies relating to environmental matters affecting policyholders.

The Auditor's Main Considerations with Respect to Environmental Matters

6. 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." (ISA 200, "Objective and General Principles Governing an Audit of Financial Statements," paragraph 2.)



7. The auditor's opinion relates to the financial statements taken as a whole and not to any specific aspect. When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. However, an audit can not be expected to detect noncompliance with all laws and regulations (ISA 250, paragraph 2). In particular, with respect to the entity's compliance with environmental laws and regulations, the auditor's purpose is not to plan the audit to detect possible breaches of environmental laws

and regulations; nor are the auditor's procedures sufficient to draw a conclusion on the entity's compliance with environmental laws and regulations or the adequacy of its controls over environmental matters.

8. In all audits, when developing the overall audit plan, the auditor assesses inherent risk at the financial statement level (ISA 400, paragraph 11[5]). The auditor uses professional judgment to evaluate the factors relevant to this assessment. In certain circumstances these factors may include the risk of material misstatement of the financial statements due to environmental matters. The need to consider, and extent of the consideration of, environmental matters in an audit of financial statements depends on the auditor's judgment as to whether environmental matters give rise to a risk of material misstatement in the financial statements. In some cases, no specific audit procedures may be judged necessary. In other cases, however, the auditor uses professional judgment to determine the nature, timing and extent of the specific procedures considered necessary in order to obtain sufficient appropriate audit evidence that the financial statements are not materially misstated. If the auditor does not have the professional competence to perform these procedures, technical advice may be sought from specialists, such as lawyers, engineers, or other environmental experts.

9. To conclude that an entity operates in compliance with existing environmental laws or regulations ordinarily requires the technical skills of environmental experts, which the auditor cannot be expected to possess. Also, whether a particular event or condition that comes to the attention of the auditor is a breach of environmental laws and regulations is a legal determination that is ordinarily beyond the auditor's professional competence. However, as with other laws and regulations:

   "the auditor's training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor's attention may constitute noncompliance with laws and regulations. The determination as to whether a particular act constitutes or is likely to constitute noncompliance is generally based on the advice of an informed expert qualified to practice law but ultimately can only be determined by a court of law." (ISA 250, paragraph 4.)

Environmental Matters and their Impact on the Financial Statements

10. For the purpose of this Statement, "environmental matters" are defined as:

    (a) Initiatives to prevent, abate, or remedy damage to the environment, or to deal with conservation of renewable and non-renewable

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5 See footnote 2.

resources (such initiatives may be required by environmental laws and regulations or by contract, or they may be undertaken voluntarily);

(b) Consequences of violating environmental laws and regulations;

(c) Consequences of environmental damage done to others or to natural resources; and

(d) Consequences of vicarious liability imposed by law (for example, liability for damages caused by previous owners).

11. Some examples of environmental matters affecting the financial statements are the following:

- The introduction of environmental laws and regulations may involve an impairment of assets and consequently a need to write down their carrying value.
- Failure to comply with legal requirements concerning environmental matters, such as emissions or waste disposal, or changes to legislation with retrospective effect, may require accrual of remediation, compensation or legal costs.
- Some entities, for example in the extraction industries (oil and gas exploration or mining), chemical manufacturers or waste management companies may incur environmental obligation as a direct by-product of their core businesses.
- Constructive obligations that stem from a voluntary initiative, for example an entity may have identified contamination of land and, although under no legal obligation, it may have decided to remedy the contamination, because of its concern for its long-term reputation and its relationship with the community.[6]
- An entity may need to disclose in the notes the existence of a contingent liability where the expense relating to environmental matters cannot be reasonably estimated.

6 The term "constructive obligations" (as opposed to "present legal obligations") has been clarified by the International Accounting Standards Committee as follows: "Sometimes the actions or representations of the enterprise's management, or changes in the economic environment, directly influence the reasonable expectations or actions of those outside the enterprise and, although they have no legal entitlement, they have other sanctions that leave the enterprise with no realistic alternative to certain expenditures. Such obligations are sometimes called "constructive obligations" (IASC: ED 59 Proposed International Accounting Standard on "Provisions, Contingent Liabilities and Contingent Assets," paragraph 16).

Subsequent to the issue of this Statement, International Accounting Standard (ISA) 37, " Provisions, Contingent Liabilities and Contingent Assets" was issued.

- In extreme situations, noncompliance with certain environmental laws and regulations may affect the continuance of an entity as a going concern and consequently may affect the disclosures and the basis of preparation of the financial statements.

12. As of the date of publication of this Statement there are few authoritative accounting standards, whether International Accounting Standards or national standards, that explicitly address the recognition, measurement, and disclosure of the consequences for the financial statements arising from environmental matters. However, existing accounting standards generally do provide appropriate general considerations that also apply to the recognition, measurement and disclosure of environmental matters in financial statements.[7]

Guidance on the Application of ISA 310, "Knowledge of the Business"[8]

13. In all audits a sufficient knowledge of the client's business is needed to enable the auditor to identify and understand matters that may have a significant effect on the financial statements, the audit process and the audit report (ISA 310, paragraph 2). In obtaining a sufficient knowledge of the business, the auditor considers important conditions affecting the entity's business and the industry in which it operates, such as environmental requirements and problems.

14. The auditor's level of knowledge with regard to environmental matters, appropriate for a particular engagement is less than that ordinarily possessed by management or by environmental experts. However, the auditor's level of knowledge needs to be sufficient to enable the auditor to identify and obtain an understanding of the events, transactions, and practices related to environmental matters that may have a material effect on the financial statements and on the audit.

15. The auditor considers the industry in which the entity operates, as it may be indicative of the possible existence of environmental liabilities and contingencies. Certain industries, by their nature, tend to be exposed to

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[7] For example, International Accounting Standard (IAS) 10, "Contingencies and Events Occurring After the Balance Sheet Date," provides the general considerations which apply to the recognition and disclosure of contingent losses, including losses as a consequence of environmental matters. IAS 10 is currently under review by IASC. ED:59 Proposed International Accounting Standard on "Provisions, Contingent Liabilities and Contingent Assets," contains some examples of environmental liabilities.

Subsequent to the issue of this Statement, IAS 10, "Events After the Balance Sheet Date" and IAS 37, "Provisions, Contingent Liabilities and Contingent Assets" were issued.

[8] See footnote 1.

significant environmental risk.[9] These include the chemical, oil and gas, pharmaceutical, metallurgical, mining, and utility industries.

16. An entity does not, however, need to operate in one of these industries to be exposed to significant environmental risk. Potential exposure to significant environmental risk may in general arise for any entity that:

    (a) Is subject to environmental laws and regulations to a substantial degree;

    (b) Owns, or holds security over, sites contaminated by previous owners ("vicarious liability"); or

    (c) Has business processes that:

        (i) May cause contamination of soil and groundwater, contamination of surface water, or air pollution;

        (ii) Use hazardous substances;

        (iii) Generate or process hazardous waste; or

        (iv) May have an adverse impact on customers, employees, or people that live in the neighborhood of the company's sites.

Guidance on the Application of ISA 400, "Risk Assessments and Internal Control"[10]

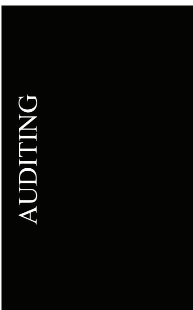
17. This section of the Statement provides additional guidance on the application of certain aspects of ISA 400 by explaining the relationship between environmental matters and the audit risk model. More specifically, it provides examples of the auditor's possible consideration of environmental matters with respect to the:

    (a) Inherent risk assessment;

    (b) Accounting and internal control systems;

    (c) Control environment; and

    (d) Control procedures.



Inherent Risk

18. The auditor uses professional judgment to evaluate the factors relevant to the assessment of inherent risk for the development of the overall audit plan. In certain circumstances these factors may include the risk of material misstatement of the financial statements due to environmental matters

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9 "Environmental risk" is defined in paragraph 18 of this Statement as a possible component of inherent risk.

10 See footnote 2.

("environmental risk"). Thus, environmental risk may be a component of inherent risk.

19. Examples of environmental risk at financial statement level are:

- The risk of compliance costs arising from legislation or from contractual requirements;
- The risk of noncompliance with environmental laws and regulations; and
- The possible effects of specific environmental requirements of customers and their possible reactions to the entity's environmental conduct.

20. If the auditor considers that environmental risk is a significant component in the inherent risk assessment, the auditor relates this assessment to material account balances and classes of transactions at the assertion level when developing the audit program (ISA 400, paragraph 11).

21. Examples of environmental risk at the level of account balances or classes of transactions are:

- The extent to which an account balance is based on complex accounting estimates with respect to environmental matters (for example, the measurement of an environmental provision for the removal of contaminated land and future site restoration). ISA 540, "Audit of Accounting Estimates" provides guidance to the auditor for these situations. Inherent risk may be high if there is a lack of data upon which to base a reasonable estimate, for example because of complex technologies for removal and site restoration; and
- The extent to which an account balance is affected by unusual or non-routine transactions involving environmental matters.

Accounting and Internal Control Systems

22. It is management's responsibility to design and operate internal controls to assist in achieving, as far as practicable, the orderly and efficient conduct of the business, including any environmental aspects. The way in which management achieves control over environmental matters differs in practice:

- Entities with low exposure to environmental risk, or smaller entities, will probably monitor and control their environmental matters as part of their normal accounting and internal control systems;
- Some entities that operate in industries with a high exposure to environmental risk may design and operate a separate internal control

sub-system for this purpose, that conforms with existing standards for Environmental Management Systems (EMS);[11] and

- Other entities design and operate all of their controls in an integrated control system, encompassing policies and procedures related to accounting, environmental and other matters (for example, quality, health and safety).

23. For the auditor's purposes it makes no difference how management actually achieves control over environmental matters. In particular, the lack of an EMS does not in itself mean that the auditor has to conclude that there is inadequate control over the environmental aspects of the business.

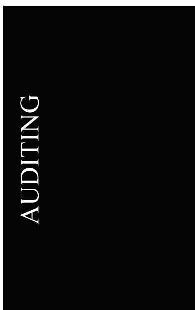
24. Only if, in the auditor's judgment, environmental matters may have a material effect on the financial statements of an entity, does the auditor need to obtain an understanding of the entity's significant policies and procedures with respect to its monitoring of, and control over these environmental matters (the entity's "environmental controls"), in order to plan the audit and develop an effective audit approach. In such cases the auditor is only concerned with those environmental controls (within or outside the accounting and internal control systems) that are considered relevant to the audit of the financial statements.

Control Environment

25. In all audits, the auditor obtains an understanding of the control environment sufficient to assess directors' and management's attitudes, awareness, and actions regarding internal controls and their importance in the entity (ISA 400, paragraph 19). Similar conditions as described in paragraph 24 of this Statement apply to the auditor's need to obtain an understanding of the control environment. Factors in obtaining an understanding of the control environment with respect to environmental matters may include:

- The functioning of the board of directors and its committees, with respect to the entity's environmental controls;

- Management's philosophy and operating style and its approach to environmental issues, such as any efforts to improve the environmental



[11] Standards for an EMS have been issued by the International Organization for Standardization (ISO 14001: "Environmental Management Systems—Specification with Guidance for Use," International Organization for Standardization, Geneva, Switzerland, First edition 1996–09–01). The specification requires participating organizations to develop and implement a systematic approach to managing significant environmental aspects. It also includes a commitment to continual improvement. When in certain countries or regions other standards for an EMS are in use, such as the standards issued by the European Commission on behalf of an entity's participation in the Eco-Management and Audit Scheme (EMAS), those national or regional standards can be used by the entity as benchmarks also.

performance of the entity, participation in certification programs for the entity's EMS, and the voluntary publication of environmental performance reports.[12] This also encompasses management's reaction to external influences such as those relating to monitoring and compliance requirements imposed by regulatory bodies and enforcement agencies;

- The entity's organizational structure and methods of assigning authority and responsibility to deal with environmental operating functions and regulatory requirements; and
- Management's control system, including the internal auditing function, the performance of "environmental audits" (see paragraph 45 of this Statement), personnel policies, and procedures and appropriate segregation of duties.

Control Procedures

26. Applying the considerations and conditions mentioned in paragraphs 18-20 the auditor may come to the conclusion that there is a need to obtain an understanding of environmental controls. Examples of environmental controls are policies and procedures:
    - To monitor compliance with the entity's environmental policy, as well as with relevant environmental laws and regulations;
    - To maintain an appropriate environmental information system, which may include recording of, for example, physical quantities of emissions and hazardous waste, environmental characteristics of products, complaints from stakeholders, results of inspections performed by enforcement agencies, occurrence and effects of incidents, etc;
    - To provide for the reconciliation of environmental information with relevant financial data, for example, physical quantities of waste production in relation to cost of waste disposal; and
    - To identify potential environmental matters and related contingencies affecting the entity.
27. If the entity has established environmental controls, the auditor also inquires of those persons overseeing such controls as to whether any environmental matters have been identified that may have a material effect on the financial statements.

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12 An "environmental performance report" is a report, separate from the financial statements, in which an entity provides third parties with qualitative information on the entity's commitments towards the environmental aspects of the business, its policies and targets in that field, its achievement in managing the relationship between its business processes and environmental risk, and quantitative information on its environmental performance.

28. One of the possibilities for the auditor to obtain an understanding of the entity's control over environmental matters may be to read the entity's environmental performance report, if available. That report often discloses the entity's environmental commitments and policies, and its major environmental controls.

Control Risk

29. After obtaining an understanding of the accounting and internal control systems, the auditor may need to consider the effect of environmental matters in the assessment of control risk and in any tests of control that may be necessary to support that assessment. (The auditor's assessment of control risk is described in paragraphs 21-39 of ISA 400.)

Guidance on the Application of ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"

30. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of noncompliance rests with management (ISA 250, paragraph 9). In this context, management has to take into account:

    - Laws and regulations that impose liability for remediation of environmental pollution arising from past events; this liability may not be limited to the entity's own actions but may also be imposed on the current owner of a property where the damage was incurred by a previous owner ("vicarious liability");
    - Pollution control and pollution prevention laws that are directed at identifying or regulating sources of pollution, or reducing emissions or discharges of pollutants;
    - Environmental licenses that, in certain jurisdictions, specify the entity's operating conditions from an environmental point of view, for example, a specification of the maximum levels of emissions; and
    - The requirements of regulatory authorities with respect to environmental matters.

31. Changes in environmental legislation could have significant consequences for the operations of the entity and may even result in liabilities that relate to past events which, at the time, were not governed by legislation. An example of the first category is a change in noise regulations that could curtail future use of plant or machinery. An example of the latter is an increase in standards that could render a waste generator liable for waste disposed of in previous years, even though disposal of the waste was in compliance with the then existing practice.

32. The auditor is not, and cannot be held responsible for preventing noncompliance with environmental laws and regulations. Also, as stated in paragraph 9, the detection of possible breaches of environmental laws and regulations is ordinarily beyond the auditor's professional competence. However, an audit carried out in accordance with ISAs is planned and performed with an attitude of professional skepticism, recognizing that the audit may reveal conditions or events that would lead to questioning whether the entity is complying with relevant environmental laws and regulations in so far as noncompliance could result in a material misstatement of the financial statements.

33. As part of the planning process of the audit, the auditor obtains a general understanding of such environmental laws and regulations which, if violated, could reasonably be expected to result in a material misstatement in the financial statements, and of the policies and procedures used by the entity to comply with those laws and regulations. In obtaining this general understanding, the auditor recognizes that noncompliance with some environmental laws and regulations may severely impact the operations of the entity.

34. To obtain a general understanding of relevant environmental laws and regulations, the auditor ordinarily:

    - Uses existing knowledge of the entity's industry and business;
    - Inquires of management (including key officers for environmental matters) concerning the entity's policies and procedures regarding compliance with relevant environmental laws and regulations;
    - Inquires of management as to the environmental laws and regulations that may be expected to have a fundamental effect on the operations of the entity. Noncompliance with these requirements might cause the entity to cease operations, or call into question the entity's continuance as a going concern; and
    - Discusses with management the policies or procedures adopted for identifying, evaluating and accounting for litigation, claims and assessments.

Substantive Procedures

35. This section of the Statement provides guidance on substantive procedures, including the application of ISA 620, "Using the Work of an Expert."

36. The auditor considers the assessed levels of inherent and control risk in determining the nature, timing and extent of substantive procedures required to reduce the risk of not detecting a material misstatement in the financial statements to an acceptable level, including any material

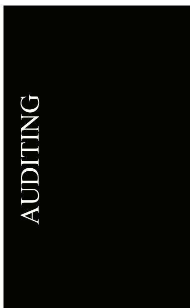
misstatements if the entity fails to properly recognize, measure or disclose the effects of environmental matters.

37. Substantive procedures include obtaining evidence through inquiry of both management responsible for the preparation of the financial statements and key officers responsible for environmental matters. The auditor considers the need to gather corroborative audit evidence for any environmental assertions from sources inside or outside the entity. In certain situations, the auditor may need to consider using the work of environmental experts.

38. Examples of substantive procedures that an auditor may perform to detect a material misstatement in the financial statements due to environmental matters, are provided in Appendix 2.

39. Most of the audit evidence available to the auditor is persuasive rather than conclusive. Therefore, the auditor needs to use professional judgment in determining whether the planned substantive procedures, either individually or in combination, are appropriate. The use of professional judgment may become even more important because of a number of difficulties with respect to the recognition and measurement of the consequences of environmental matters in the financial statements, for example:

- Often there is a considerable time delay between the activity that basically causes an environmental issue, and the identification of it by the entity or regulators;
- Accounting estimates may not have an established historical pattern or may have wide ranges of reasonableness because of the number and nature of assumptions underlying the determination of these estimates;
- Environmental laws or regulations are evolving, and interpretation may be difficult or ambiguous. Consultation of an expert may be necessary to assess the impact of these laws and regulations on the valuation of certain assets (for example, assets that contain asbestos). Making a reasonable estimate of liabilities for known obligations may also appear to be difficult in practice; or
- Liabilities may arise other than as a result of legal or contractual obligations.



40. In the course of the audit process, for example in gathering knowledge of the business, in the assessments of inherent and control risk, or in performing certain substantive procedures, evidence may come to the attention of the auditor that indicates the existence of a risk that the financial statements may be materially misstated due to environmental matters. Examples of such circumstances include:

- The existence of reports outlining material environmental problems prepared by environmental experts, internal auditors or environmental auditors;
- Violations of environmental laws and regulations cited in correspondence with, or in reports issued by, regulatory agencies;
- Inclusion of the entity's name in a publicly available register, or plan, for the restoration of soil contamination (if one exists);
- Media comment about the entity related to major environmental matters;
- Comments relating to environmental matters made in lawyers' letters;
- Evidence indicating purchases of goods and services relating to environmental matters that are unusual in relation to the nature of the entity's business;
- Increased or unusual legal or environmental consultants' fees, or payments of penalties as a result of violation of environmental laws and regulations; and
- In these circumstances the auditor considers the need to re-assess inherent and control risk and the resulting impact on detection risk. If necessary, the auditor may decide to consult an environmental expert.

Environmental Experts

41. Management is responsible for accounting estimates included in the financial statements. Management may require technical advice from specialists such as lawyers, engineers or other environmental experts to assist in developing accounting estimates and disclosures related to environmental matters. Such experts may be involved in many stages in the process of developing accounting estimates and disclosures, including assisting management in:

    - Identifying situations where the recognition of liabilities and related estimates is required (for example, an environmental engineer may make a preliminary investigation of a site to determine if contamination has occurred, or a lawyer may be used to determine the entity's legal responsibility to restore the site);
    - Gathering the necessary data on which to base estimates and providing details of information that needs to be disclosed in the financial statements (for example, an environmental expert may test a site in order to assist in quantifying the nature and extent of contamination and considering acceptable alternative methods of site restoration); and
    - Designing the appropriate remedial action plan and calculating related financial consequences.

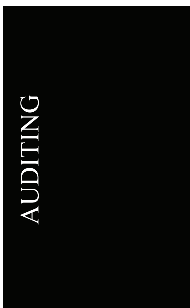
42. If the auditor intends to use the results of such work as part of the audit, the auditor considers the adequacy of the work performed by environmental experts for the purposes of the audit, as well as the expert's competence and objectivity, in accordance with ISA 620. The auditor may need to engage another expert in considering such work, to apply additional procedures, or to modify the auditor's report.

43. As the environmental area is an emerging specialty, the expert's professional competence may be more difficult to assess than is the case with some other experts, because there may be no certification or licensing by, or membership of, an appropriate professional body. In this situation, it may be necessary for the auditor to give particular consideration to the experience and reputation of the environmental expert.

44. Timely and ongoing communication with the expert may assist the auditor to understand the nature, scope, objective and limitations of the expert's report. The report might deal with only one aspect of the entity's operations. For example, the expert's report may be based on cost estimates related to only one element of a particular issue (for example, soil contamination), rather than on cost estimates of all relevant issues (for example, contamination of soil and groundwater, including vicarious liability imposed by law). It is also necessary for the auditor to discuss the assumptions, methods, procedures, and source data used by the expert.

Environmental Audit

45. "Environmental audits" are becoming increasingly common in certain industries.[13] The term "environmental audit" has a wide variety of meanings. They can be performed by external or internal experts (sometimes including internal auditors), at the discretion of the entity's management. In practice, persons from various disciplines can qualify to perform "environmental audits." Often the work is performed by a multi-disciplinary team. Normally, "environmental audits" are performed at the request of management and are for internal use. They may address various subject matters, including site contamination, or compliance with environmental laws and regulations. However, an "environmental audit" is not necessarily an equivalent to an audit of an environmental performance report.



46. The auditor of the entity's financial statements may consider using the findings of "environmental audits" as appropriate audit evidence. In that situation the auditor has to decide whether the "environmental audit" meets

[13] Guidelines for "environmental auditing" have been issued by the International Organization for Standardization (ISO), "Guidelines for Environmental Auditing—General Principles" (International Organization for Standardization, Geneva, Switzerland, First Edition 1996–10–01).

the evaluation criteria included in ISA 610, "Considering the Work of Internal Auditing" or ISA 620. Important criteria to be considered are:

(a) The impact of the results of the environmental audit on the financial statements;

(b) The competency and skill of the environmental audit team and the objectivity of the auditors, specially when chosen from the entity's staff;

(c) The scope of the environmental audit, including management's reactions to the recommendations that result from the environmental audit and how this is evidenced;

(d) The due professional care exercised by the team in the performance of the environmental audit; and

(e) The proper direction, supervision, and review of the audit.

Internal Audit

47. If the entity has an internal auditing function, the auditor considers whether the internal auditors address environmental aspects of the entity's operations as part of their internal auditing activities. If this is the case, the auditor considers the appropriateness of using such work for the purpose of the audit, applying the criteria set out in ISA 610.

Management Representations

48. ISA 580, "Management Representations" requires that the auditor obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. Much of the evidence available to the auditor with respect to the impact of environmental matters on the financial statements will be persuasive in nature rather than conclusive. The auditor may therefore wish to obtain specific representation that management:

(a) Is not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts;

(b) Is not aware of any other environmental matters that may have a material impact on the financial statements; or

(c) If aware of such matters, has disclosed them properly in the financial statements.

Reporting

49. When forming an opinion on the financial statements, the auditor considers whether the effects of environmental matters are adequately treated or disclosed in accordance with the appropriate financial reporting framework. In addition, the auditor reads any other information to be included with the

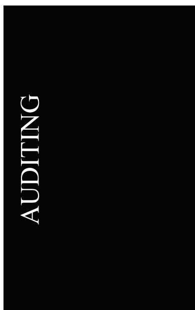
financial statements in order to identify any material inconsistencies, for example, regarding environmental matters.

50. Management's assessment of uncertainties and the extent of their disclosure in the financial statements are key issues in determining the impact on the auditor's report. The auditor may conclude that there are significant uncertainties, or inappropriate disclosures, due to environmental matters. There may even be circumstances when, in the auditor's judgment, the going concern assumption is no longer appropriate. ISA 700, "The Auditor's Report on Financial Statements"[14] and ISA 570, "Going Concern" provide detailed guidance to auditors in these circumstances.

Public Sector Perspective

1. *As stated in paragraph 3, this Statement provides practical assistance to auditors in identifying and addressing environmental matters in the context of an audit of financial statements. This guidance would generally be equally applicable to public sector auditors in their audit of the financial statements of governments and other public sector entities. However, it should be noted that the nature and scope of public sector audit engagements may be affected by legislation, regulation, ordinances and ministerial directives that impose additional audit or reporting responsibilities with respect to environmental issues.*

2. *As in the private sector, auditors of financial statements of governments and other public sector entities may need to consider the recognition, measurement and disclosure of any liabilities or contingencies for environmental damage. Liabilities or contingencies may arise through damage caused by the reporting entity or one of its agencies. However, in the public sector, liability or contingencies may also arise when the government accepts responsibility for clean-up or other costs associated with damage caused by others, if, for example, responsibility is unresolved or cannot be attributed to others.*



3. *Public sector auditors may, in some countries, be obliged to report instances of noncompliance with environmental regulations found in the course of a financial statement audit, regardless of whether or not those instances of noncompliance have a material impact on the entity's financial statements.*

4. *A government's responsibilities may also include the monitoring of compliance with laws and regulations in relation to environmental matters.*

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[14] ISA 700, "The Auditor's Report on Financial Statements" was withdrawn in December 2006 when ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" became effective.

More specifically, this monitoring role will be the responsibility of a particular public sector agency or agencies. In performing the financial statement audit of such an agency or agencies the auditor may need to consider, for example, controls covering the imposing of appropriate charges/fines and the collection of fines. For unresolved cases consideration may also need to be given to the recognition, measurement and disclosure of any liabilities or contingencies.

Appendix 1

Obtaining Knowledge of the Business from an Environmental Point of View—Illustrative Questions

The purpose of this appendix is to provide examples of questions that an auditor may consider when obtaining a knowledge of the business, including an understanding of the entity's control environment and control procedures, from an environmental point of view.

These examples are included for illustrative purposes only. It is not intended that all of the questions illustrated will be appropriate in any particular case. The questions need to be tailored to fit the particular circumstances of each engagement. In some cases, the auditor may judge it unnecessary to address any of these questions.

It may be necessary for the auditor to consult an environmental expert when evaluating the answers received from the entity's officers in response to any inquiries with regard to environmental matters.

Knowledge of the Business

1. Does the entity operate in an industry that is exposed to significant environmental risk that may adversely affect the financial statements of the entity?
2. What are the environmental issues in the entity's industry in general?
3. Which environmental laws and regulations are applicable to the entity?
4. Are there any substances used in the entity's products or production processes that are part of a phase-out scheme required by legislation, or adopted voluntarily by the industry in which the client operates?
5. Do enforcement agencies monitor the entity's compliance with the requirements of environmental laws, regulations or licenses?
6. Have any regulatory actions been taken or reports been issued by enforcement agencies that may have a material impact on the entity and its financial statements?
7. Have initiatives been scheduled to prevent, abate or remedy damage to the environment, or to deal with conservation of renewable and non-renewable resources?
8. Is there a history of penalties and legal proceedings against the entity or its directors in connection with environmental matters? If so, what were the reasons for such actions?

9. Are any legal proceedings pending with regard to compliance with environmental laws and regulations?

10. Are environmental risks covered by insurance?

Control Environment and Control Procedures

11. What is management's philosophy and operating style with respect to environmental control in general (to be assessed by the auditor, based on his knowledge of the entity in general)?

12. Does the entity's operating structure include assigning responsibility, including segregation of duties, to specified individuals for environmental control?

13. Does the entity maintain an environmental information system, based on requirements by regulators or the entity's own evaluation of environmental risks? This system may provide, for example, information about physical quantities of emissions and hazardous waste, eco-balances, environmental characteristics of the entity's products and services, results from inspections performed by enforcement agencies, information about the occurrence and effects of incidents, and the number of complaints made by stakeholders.

14. Does the entity operate an Environmental Management System (EMS)? If so, has the EMS been certified by an independent certification body? Examples of recognized standards for an EMS are the international standard ISO 14001 and the European Commission's Eco-Management and Audit Scheme (EMAS).

15. Has the entity (voluntarily) published an environmental performance report? If so, has it been verified by an independent third party?

16. Are control procedures in place to identify and assess environmental risk, to monitor compliance with environmental laws and regulations, and to monitor possible changes in environmental legislation likely to impact the entity?

17. Does the entity have control procedures to deal with complaints about environmental matters, including health problems, from employees or third parties?

18. Does the entity operate control procedures for handling and disposal of hazardous waste, in compliance with legal requirements?

19. Are control procedures in place to identify and assess environmental hazards associated with the entity's products and services and the proper communication of information to customers about required preventive measures, if necessary?

20. Is management aware of the existence, and the potential impact on the entity's financial statements, of:

    - Any risk of liabilities arising as a result of contamination of soil, groundwater, or surface water;
    - Any risk of liabilities arising as a result of air pollution; or
    - Unresolved complaints about environmental matters from employees or third parties?

Appendix 2

Substantive Procedures to Detect a Material Misstatement Due to Environmental Matters

The purpose of this appendix is to provide examples of substantive procedures that an auditor may perform to detect a material misstatement due to environmental matters.

These examples are included for illustrative purposes only. It is not intended that all of the procedures illustrated will be appropriate in any particular case. The procedures need to be tailored to fit the particular circumstances of each engagement. In some cases, the auditor may judge it unnecessary to perform any of these procedures.

It may be necessary for the auditor to consult an environmental expert when evaluating the results of substantive procedures with regard to environmental matters. The decision to involve an expert is a matter of professional judgment, governed by the circumstances and matters such as the technological situation, complexity and materiality of the items concerned.

General

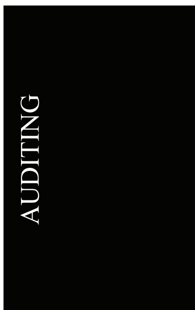
Documentary Review in General

1. Consider minutes from board of directors' meetings, audit committees, or any other subcommittees of the board specifically responsible for environmental matters.
2. Consider publicly available industry information to consider any existing or possible future environmental matters. Also consider general available media comment, if any.
3. Where available, consider:
   - Reports issued by environmental experts about the entity, such as site assessments or environmental impact studies;
   - Internal audit reports;
   - "Environmental audit" reports;
   - Reports on due diligence investigations;
   - Reports issued by and correspondence with regulatory agencies;
   - (Publicly available) registers or plans for the restoration of soil contamination;
   - Environmental performance reports issued by the entity;

- Correspondence with enforcement agencies; and
- Correspondence with the entity's lawyers.

Using the Work of Others

4. If an environmental expert is involved (for example, an expert has quantified the nature and extent of contamination, considering alternative methods of site restoration) and the outcome has been recognized or disclosed in the financial statements:
   (a) Consider the impact of the results of the expert's work on the financial statements;
   (b) Assess the professional competence and the objectivity of the environmental expert;
   (c) Obtain sufficient appropriate audit evidence that the scope of the work of the environmental expert is adequate for the purposes of the audit of the financial statements; and
   (d) Assess the appropriateness of the expert's work as audit evidence.
5. If the internal auditor has addressed certain environmental aspects of the entity's operations as part of the internal audit, consider the appropriateness of the work of the internal auditors for the purpose of the audit of the financial statements, applying the criteria set out in ISA 610, "Considering the Work of Internal Auditing."
6. If an "environmental audit" has been performed and the findings of that audit could qualify as audit evidence in the audit of the financial statements:[15]
   (a) Consider the impact of the results of the "environmental audit" on the financial statements;
   (b) Assess the professional competence and the objectivity of the "environmental auditor"/audit team;
   (c) Obtain sufficient appropriate audit evidence that the scope of "environmental audit" is adequate for the purposes of the audit of the financial statements; and
   (d) Assess the appropriateness of the work of the "environmental auditor" as audit evidence.



[15] "Environmental Audit" see paragraph 45.

Insurance

7. Inquire about existing (and earlier) insurance cover for environmental risk and discuss this with management.

Representations from Management

8. Obtain written representations from management that it has considered the effects of environmental matters on the financial statements, and that it:

   (a) Is not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts;

   (b) Is not aware of environmental matters that may result in a material impairment of assets; or

   (c) If aware of such matters, has disclosed to the auditor all facts related to them.

Subsidiaries

9. Inquire of auditors of subsidiaries as to the subsidiary's compliance with relevant local environmental laws and regulations and their possible effects on their financial statements.

Assets

Purchases of Land, Plant and Machinery

10. For purchases of land, plant, and machinery made during the period (either directly by the entity, or indirectly through the acquisition of a subsidiary), inquire about the due diligence procedures management conducted to consider the effects of environmental matters in establishing a purchase price, taking into account the findings of remedial investigations and site restoration obligations.

Long-term Investments

11. Read, and discuss with those responsible, financial statements underlying long-term investments and consider the effect of any environmental matters discussed in these statements on the valuation of the investments.

Asset Impairment

12. Inquire about any planned changes in capital assets, for example, in response to changes in environmental legislation or changes in business strategy, assess their influences on the valuation of these assets or the company as a whole.

13. Inquire about policies and procedures to assess the need to write-down the carrying amount of an asset in situations where an asset impairment has occurred due to environmental matters.

14. Inquire about data gathered on which to base estimates and assumptions developed about the most likely outcome to determine the write-down due to the asset impairment.

15. Inspect the documentation supporting the amount of possible asset impairment and discuss such documentation with management.

16. For any asset impairments related to environmental matters that existed in previous periods, consider whether the assumptions underlying a write-down of related carrying values continue to be appropriate.

Recoverability of Claims

17. Review the recoverability of claims with respect to environmental matters that are included in the financial statements.

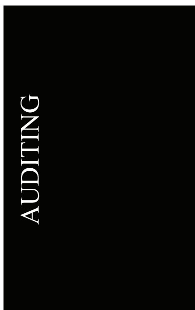
Liabilities, Provisions and Contingencies

Completeness of Liabilities, Provisions and Contingencies

18. Inquire about policies and procedures implemented to help identify liabilities, provisions or contingencies arising from environmental matters.

19. Inquire about events or conditions that may give rise to liabilities, provisions or contingencies arising from environmental matters, for example:

    - Violations of environmental laws and regulations;
    - Citations or penalties arising from violations of environmental laws and regulations; or
    - Claims and possible claims for environmental damage.



20. If site clean-up costs, future removal or site restoration costs or penalties arising from noncompliance with environmental laws and regulations have been identified, inquire about any related claims or possible claims.

21. Inquire about, read, and evaluate correspondence from regulatory authorities relating to matters dealing with environmental matters and consider whether such correspondence indicates liabilities, provisions or contingencies.

22. For property abandoned, purchased, or closed during the period, inquire about requirements for site clean-up or intentions for future removal and site restoration.

23. For property sold during the period (and in prior periods), inquire about any liabilities relating to environmental matters retained by contract or by law.

24. Perform analytical procedures and consider, as far as practicable, the relationships between financial information and quantitative information included in the entity's environmental records (for example, the relationship between raw materials consumed or energy used, and waste production or emissions, taking into account the entity's liabilities for proper waste disposal or maximum emission levels).

Accounting Estimates

25. Review and test the process used by management to develop accounting estimates and disclosures:

    (a) Consider the adequacy of the work performed by environmental experts engaged by management, if any, applying the criteria set out in ISA 620, "Using the Work of an Expert";

    (b) Review the data gathered on which estimates have been based;

    (c) Consider whether the data are relevant, reliable and sufficient for the purpose;

    (d) Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data;

    (e) Consider whether changes in the business or industry may cause other factors to become significant to the assumptions;

    (f) Consider the need to engage an environmental expert regarding the review of certain assumptions;

    (g) Test the calculations made by management to translate the assumptions into the accounting estimate; and

    (h) Consider whether top-management has reviewed and approved material accounting estimates with respect to environmental matters.

26. If management's estimates are not appropriate, obtain an independent estimate to corroborate the reasonableness of management's estimate.

27. For liabilities, provisions, or contingencies related to environmental matters consider whether the assumptions underlying the estimates continue to be appropriate.

28. Compare estimates of liabilities relating to one location (for example, estimates for site restoration or future removal and site restoration costs at a specific location) with:

    (a) Estimates of liabilities for other locations with similar environmental problems;

(b) Actual costs incurred for other similar locations; or

(c) Estimates of costs of environmental liabilities reflected in the sales price for similar locations sold during the period.

Documentary Review

29. Inspect and evaluate the documentation supporting the amount of the environmental liability, provision or contingency and discuss such documentation with those responsible for it, such as:

- Site clean-up or restoration studies;
- Quotes obtained for site clean-up or future removal and site restoration costs; and
- Correspondence with legal counsel as to the amount of a claim or the amount of penalties.

Disclosure

30. Review the adequacy of the disclosure of the effects of environmental matters on the financial statements.

INTERNATIONAL AUDITING PRACTICE STATEMENT 1012

AUDITING DERIVATIVE FINANCIAL INSTRUMENTS

(This Statement is effective)

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International Auditing Practice Statement (IAPS) 1012, "Auditing Derivative Financial Instruments" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of IAPSs.

The International Auditing Practices Committee approved this International Auditing Practice Statement for publication in March 2001.

Introduction

1. The purpose of this International Auditing Practice Statement (IAPS) is to provide guidance to the auditor in planning and performing auditing procedures for financial statement assertions related to derivative financial instruments. This IAPS focuses on auditing derivatives held by end users, including banks and other financial sector entities when they are the end users. An end user is an entity that enters into a financial transaction, through either an organized exchange or a broker, for the purpose of hedging, asset/liability management or speculating. End users consist primarily of corporations, government entities, institutional investors and financial institutions. An end user's derivative activities often are related to the entity's production or use of a commodity. The accounting systems and internal control issues associated with issuing or trading derivatives may be different from those associated with using derivatives. IAPS 1006, "Audits of the Financial Statements of Banks" provides guidance on the audits of banks and other financial-sector entities, and includes guidance on auditing international commercial banks issuing or trading derivatives.

Derivative Instruments and Activities

2. Derivative financial instruments are becoming more complex, their use is becoming more commonplace and the accounting requirements to provide fair value and other information about them in financial statement presentations and disclosures are expanding. Values of derivatives may be volatile. Large and sudden decreases in their value may increase the risk that a loss to an entity using derivatives may exceed the amount, if any, recorded on the balance sheet. Furthermore, because of the complexity of derivative activities, management may not fully understand the risks of using derivatives.

3. For many entities, the use of derivatives has reduced exposures to changes in exchange rates, interest rates and commodity prices, as well as other risks. On the other hand, the inherent characteristics of derivative activities and derivative financial instruments also may result in increased business risk in some entities, in turn increasing audit risk and presenting new challenges to the auditor.

4. "Derivatives" is a generic term used to categorize a wide variety of financial instruments whose value "depends on" or is "derived from" an underlying rate or price, such as interest rates, exchange rates, equity prices, or commodity prices. Derivative contracts can be linear or non-linear. They are contracts that either involve obligatory cash flows at a future date (linear) or have option features where one party has the right but not the obligation to demand that another party deliver the underlying item to it (non-linear). Some national financial reporting frameworks, and the International

Accounting Standards contain definitions of derivatives. For example, International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement" defines a derivative as a financial instrument:

- Whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the "underlying");
- That requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
- That is settled at a future date.

In addition, different national financial reporting frameworks and the International Accounting Standards provide for different accounting treatments of derivative financial instruments.

5. The most common linear contracts are forward contracts (for example, foreign exchange contracts and forward rate agreements), futures contracts (for example, a futures contract to purchase a commodity such as oil or power) and swaps. The most common non-linear contracts are options, caps, floors and swaptions. Derivatives that are more complex may have a combination of the characteristics of each category.

6. Derivative activities range from those whose primary objective is to:

- Manage current or anticipated risks relating to operations and financial position; or
- Take open or speculative positions to benefit from anticipated market movements.

Some entities may be involved in derivatives not only from a corporate treasury perspective but also, or alternatively, in association with the production or use of a commodity.

7. While all financial instruments have certain risks, derivatives often possess particular features that leverage the risks, such as:

- Little or no cash outflows/inflows are required until maturity of the transactions;
- No principal balance or other fixed amount is paid or received;
- Potential risks and rewards can be substantially greater than the current outlays; and
- The value of an entity's asset or liability may exceed the amount, if any, of the derivative that is recognized in the financial statements,

especially in entities whose financial reporting frameworks do not require derivatives to be recorded at fair market value in the financial statements.

Responsibilities of Management and Those Charged with Governance

8. ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" states that the entity's management is responsible for preparing and presenting financial statements. As part of the process of preparing those financial statements, management makes specific assertions related to derivatives. Those assertions include (where the financial reporting framework requires) that all derivatives recorded in the financial statements exist, that there are no unrecorded derivatives at the balance sheet date, that the derivatives recorded in the financial statements are properly valued, and presented, and that all relevant disclosures are made in the financial statements.

9. Those charged with governance of an entity, through oversight of management, are responsible for:

   - The design and implementation of a system of internal control to:
     - Monitor risk and financial control;
     - Provide reasonable assurance that the entity's use of derivatives is within its risk management policies; and
     - Ensure that the entity is in compliance with applicable laws and regulations; and
   - The integrity of the entity's accounting and financial reporting systems to ensure the reliability of management's financial reporting of derivative activities.

10. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

The Auditor's Responsibility

11. ISA 200 states that the objective of the audit is to enable the auditor to express an opinion on whether the financial statements are prepared in all material respects, in accordance with the applicable financial reporting framework. The auditor's responsibility related to derivative financial instruments, in the context of the audit of the financial statements taken as a whole, is to consider whether management's assertions related to derivatives result in financial statements prepared in all material respects in accordance with the applicable financial reporting framework.

12. The auditor establishes an understanding with the entity that the purpose of the audit work is to be able to express an opinion on the financial statements. The purpose of an audit of financial statements is not to provide assurance on the adequacy of the entity's risk management related to derivative activities, or the controls over those activities. To avoid any misunderstanding the auditor may discuss with management the nature and extent of the audit work related to derivative activities. ISA 210, "Terms of Audit Engagements" provides guidance on agreeing upon the terms of the engagement with an entity.

The Need for Special Skill and Knowledge

13. ISA 200 requires that the auditor comply with the *Code of Ethics for Professional Accountants* (the Code) issued by the International Federation of Accountants. Among other things, the Code requires that the professional accountant perform professional services with competence and diligence. The Code further requires that the auditor maintain sufficient professional knowledge and skill to fulfill responsibilities with due care.

14. To comply with the requirements of ISA 200, the auditor may need special skills or knowledge to plan and perform auditing procedures for certain assertions about derivatives. Special skills and knowledge include obtaining an understanding of:

    - The operating characteristics and risk profile of the industry in which an entity operates;
    - The derivative financial instruments used by the entity, and their characteristics;
    - The entity's information system for derivatives, including services provided by a service organization. This may require the auditor to have special skills or knowledge about computer applications when significant information about those derivatives is transmitted, processed, maintained or accessed electronically;
    - The methods of valuation of the derivative, for example, whether fair value is determined by quoted market price, or a pricing model; and
    - The requirements of the financial reporting framework for financial statement assertions related to derivatives. Derivatives may have complex features that require the auditor to have special knowledge to evaluate their measurement, recognition and disclosure in conformity with the financial reporting framework. For example, features embedded in contracts or agreements may require separate accounting, and complex pricing structures may increase the complexity of the assumptions used in measuring the instrument at fair value. In addition, the requirements of the financial reporting framework may vary

depending on the type of derivative, the nature of the transaction, and the type of entity.

15. Members of the engagement team may have the necessary skill and knowledge to plan and perform auditing procedures related to derivatives transactions. Alternatively, the auditor may decide to seek the assistance of an expert outside the firm, with the necessary skills or knowledge to plan and perform the auditing procedures, especially when the derivatives are very complex, or when simple derivatives are used in complex situations, the entity is engaged in active trading of derivatives, or the valuation of the derivatives are based on complex pricing models. ISA 220, "Quality Control for Audits of Historical Financial Information"[1] provides guidance on the supervision of individuals who serve as members of the engagement team and assist the auditor in planning and performing auditing procedures. ISA 620, "Using the Work of an Expert" provides guidance on the use of an expert's work as audit evidence.

Knowledge of the Business

16. ISA 310, "Knowledge of the Business"[2] requires the auditor, in performing an audit of financial statements, to have or obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements, the examination or the audit report. For example, the auditor uses such knowledge to assess inherent and control risks and to determine the nature, timing and extent of audit procedures.

17. Because derivative activities generally support the entity's business activities, factors affecting its day-to-day operations also will have implications for its derivative activities. For example, because of the economic conditions that affect the price of an entity's primary raw materials, an entity may enter into a futures contract to hedge the cost of its inventory. Similarly, derivative activities can have a major effect on the entity's operations and viability.

AUDITING

General Economic Factors

18. General economic factors are likely to have an influence on the nature and extent of an entity's derivative activities. For example, when interest rates appear likely to rise, an entity may try to fix the effective level of interest

[1] ISA 220, "Quality Control for Audit Work" was withdrawn in June 2005 when ISA 220, "Quality Control for Audits of Historical Financial Information" became effective.

[2] ISA 310, "Knowledge of the Business" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" became effective.

rates on its floating rate borrowings through the use of interest rate swaps, forward rate agreements and caps. General economic factors that may be relevant include:

- The general level of economic activity;
- Interest rates, including the term structure of interest rates, and availability of financing;
- Inflation and currency revaluation;
- Foreign currency rates and controls; and
- The characteristics of the markets that are relevant to the derivatives used by the entity, including the liquidity or volatility of those markets.

The Industry

19. Economic conditions in the entity's industry also are likely to influence the entity's derivative activities. If the industry is seasonal or cyclical, it may be inherently more difficult to accurately forecast interest rate, foreign exchange or liquidity exposures. A high growth rate or sharp rate of decline in an entity's business also may make it difficult to predict activity levels in general and, thus, its level of derivative activity. Economic conditions in a particular industry that may be relevant include:

    - The price risk in the industry;
    - The market and competition;
    - Cyclical or seasonal activity;
    - Declining or expanding operations;
    - Adverse conditions (for example, declining demand, excess capacity, serious price competition); and
    - Foreign currency transactions, translation or economic exposure.

The Entity

20. To obtain a sufficient understanding of an entity's derivative activities, to be able to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or auditor's report, the auditor considers:

    - *Knowledge and experience of management and those charged with governance*. Derivative activities can be complicated and often, only a few individuals within an entity fully understand these activities. In entities that engage in few derivative activities, management may lack experience with even relatively simple derivative transactions.

Furthermore, the complexity of various contracts or agreements makes it possible for an entity to inadvertently enter into a derivative transaction. Significant use of derivatives, particularly complex derivatives, without relevant expertise within the entity increases inherent risk. This may prompt the auditor to question whether there is adequate management control, and may affect the auditor's risk assessment and the nature, extent and timing of audit testing considered necessary;

- *Availability of timely and reliable management information*. The control risk associated with derivative activities may increase with greater decentralization of those activities. This especially may be true where an entity is based in different locations, some perhaps in other countries. Derivative activities may be run on either a centralized or a decentralized basis. Derivative activities and related decision making depend heavily on the flow of accurate, reliable, and timely management information. The difficulty of collecting and aggregating such information increases with the number of locations and businesses in which an entity is involved; and
- *Objectives for the use of derivatives*. Derivative activities range from those whose primary objective is to reduce or eliminate risk (hedging) to those whose primary objective is to maximize profits (speculating). All other things being equal, risk increases as maximizing profits becomes the focus of derivative activity. The auditor gains an understanding of the strategy behind the entity's use of derivatives and identifies where the entity's derivative activities lie on the hedging-speculating continuum.

Key Financial Risks

21. The auditor obtains an understanding of the principal types of financial risk, related to derivative activities, to which entities may be exposed. Those key financial risks are:

    (a) *Market risk*, which relates broadly to economic losses due to adverse changes in the fair value of the derivative. Related risks include:

    - Price risk, which relates to changes in the level of prices due to changes in interest rates, foreign exchange rates, or other factors related to market volatilities of the underlying rate, index, or price. Price risk includes interest rate risk and foreign exchange risk;
    - Liquidity risk, which relates to changes in the ability to sell or dispose of the derivative instrument. Derivative activities bear the additional risk that a lack of available contracts or

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counterparties may make it difficult to close out the derivative transaction or enter into an offsetting contract. For example, liquidity risk may increase if an entity encounters difficulties obtaining the required security or commodity or other deliverable should the derivative call for physical delivery,

- Economic losses also may occur if the entity makes inappropriate trades based on information obtained using poor valuation models, and
- Derivatives used in hedging transactions bear additional risk, known as basis risk. Basis is the difference between the price of the hedged item and the price of the related hedging instrument. Basis risk is the risk that the basis will change while the hedging contract is open, and thus, the price correlation between the hedged item and the hedging instrument will not be perfect. For example, basis risk may be affected by a lack of liquidity in either the hedged item, or the hedging instrument;

(b) *Credit risk*, which relates to the risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter. For certain derivatives, market values are volatile, so the credit risk exposure also is volatile. Generally, a derivative has credit exposure only when the derivative has positive market value. That value represents an obligation of the counterparty and, therefore, an economic benefit that can be lost if the counterparty fails to fulfill its obligation. Furthermore, the market value of a derivative may fluctuate quickly, alternating between positive and negative values. The potential for rapid changes in prices, coupled with the structure of certain derivatives, also can affect credit risk exposure. For example, highly leveraged derivatives or derivatives with extended time periods can result in credit risk exposure increasing quickly after a derivative transaction has been undertaken. Many derivatives are traded under uniform rules through an organized exchange (exchange-traded derivatives). Exchange traded derivatives generally remove individual counterparty risk and substitute the clearing organization as the settling counterparty. Typically, the participants in an exchange-traded derivative settle changes in the value of their positions daily, which further mitigates credit risk. Other methods for minimizing credit risk include requiring the counterparty to offer collateral, or assigning a credit limit to each counterparty based on its credit rating;

(c) *Settlement risk* is the related risk that one side of a transaction will be settled without value being received from the customer or counterparty. One method for minimizing settlement risk is to enter

into a master netting agreement, which allows the parties to set off all their related payable and receivable positions at settlement;

(d) *Solvency risk*, which relates to the risk that the entity would not have the funds available to honor cash outflow commitments as they fall due. For example, an adverse price movement on a futures contract may result in a margin call that the entity may not have the liquidity to meet; and

(e) *Legal risk*, which relates to losses resulting from a legal or regulatory action that invalidates or otherwise precludes performance by the end user or its counterparty under the terms of the contract or related netting arrangements. For example, legal risk could arise from insufficient documentation for the contract, an inability to enforce a netting arrangement in bankruptcy, adverse changes in tax laws, or statutes that prohibit entities from investing in certain types of derivatives.

Although other classifications of risk exist, they are normally combinations of these principal risks. There is also a further risk for commodities in that their quality may not meet expectations.

Assertions to Address

22. Financial statement assertions are assertions by management, explicit or otherwise, embodied in the financial statements prepared in accordance with the applicable financial reporting framework. They can be categorized as follows:

- *Existence*: An asset or liability exists at a given date. For example, the derivatives reported in the financial statements through measurement or disclosure exist at the date of the balance sheet;
- *Rights and obligations*: An asset or a liability pertains to the entity at a given date. For example, an entity has the rights and obligations associated with the derivatives reported in the financial statements;
- *Occurrence*: A transaction or event took place that pertains to the entity during the period. For example, the transaction that gave rise to the derivative occurred within the financial reporting period;
- *Completeness*: There are no unrecorded assets, liabilities, transactions or events, or undisclosed items. For example, all of the entity's derivatives are reported in the financial statements through measurement or disclosure;
- *Valuation*: An asset or liability is recorded at an appropriate carrying value. For example, the values of the derivatives reported in the

financial statements through measurement or disclosure were determined in accordance with the financial reporting framework;

- *Measurement*: A transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period. For example, the amounts associated with the derivatives reported in the financial statements through measurement or disclosure were determined in accordance with the financial reporting framework, and the revenues or expenses associated with the derivatives reported in the financial statements were allocated to the correct financial reporting periods; and
- *Presentation and disclosure*: An item is disclosed, classified and described in accordance with the applicable financial reporting framework. For example, the classification, description and disclosure of derivatives in the financial statements are in accordance with the financial reporting framework.

Risk Assessment and Internal Control

23. Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk. The auditor considers knowledge obtained about the business and about the key financial risks in assessing the components of audit risk.

24. ISA 400, "Risk Assessments and Internal Control"[3] provides guidance on the auditor's consideration of audit risk and internal control when planning and performing an audit of financial statements in accordance with ISAs. The ISA requires that the auditor use professional judgment to assess audit risk and to design audit procedures to ensure that risk is reduced to an acceptably low level. It also requires the auditor to obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach.

Inherent Risk

25. Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal control.

26. ISA 400[4] requires that, in developing the overall audit plan, the auditor assess the inherent risk at the financial statement level. ISA 400 requires the

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[3] ISA 400, "Risk Assessments and Internal Control" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" became effective.

[4] See footnote 3.

auditor to relate that assessment to material account balances and classes of transactions at the assertion level, or assume that inherent risk is high for the assertion.

27. ISA 400 provides guidance to the auditor in using professional judgment to evaluate numerous factors that may affect the assessment of inherent risk. Examples of factors that might affect the auditor's assessment of the inherent risk for assertions about derivatives include:

- *Economics and business purpose of the entity's derivative activities*. The auditor understands the nature of the entity's business and the economics and business purpose of its derivative activities, all of which may influence the entity's decision to buy, sell or hold derivatives.

- *Derivative activities range from positions where the primary aim is to reduce or eliminate risk (hedging), to positions where the primary aim is to maximize profits (speculating).* The inherent risks associated with risk management differ significantly from those associated with speculative investing.

- *The complexity of a derivative's features*. Generally, the more complex a derivative, the more difficult it is to determine its fair value. The fair values of certain derivatives, such as exchange-traded options, are available from independent pricing sources such as financial publications and broker-dealers not affiliated with the entity. Determining fair value can be particularly difficult, however, if a transaction has been customized to meet individual user needs. When derivatives are not traded regularly, or are traded only in markets without published or quoted market prices, management may use a valuation model to determine fair value. Valuation risk is the risk that the fair value of the derivative is determined incorrectly. Model risk, which is a component of valuation risk, exists whenever models (as opposed to quoted market prices) are used to determine the fair value of a derivative. Model risk is the risk associated with the imperfections and subjectivity of these models and their related assumptions. Both valuation risk and model risk contribute to the inherent risk for the valuation assertion about those derivatives.

- *Whether the transaction giving rise to the derivative involved the exchange of cash*. Many derivatives do not involve an exchange of cash at the inception of the transaction, or may involve contracts that have irregular or end of term cash flows. There is an increased risk that such contracts will not be identified, or will be only partially identified and recorded in the financial statements, increasing the inherent risk for the completeness assertion about those derivatives.

- *An entity's experience with the derivative*. Significant use of complex derivatives without relevant expertise within the entity increases

inherent risk. Relevant expertise should reside with the personnel involved with the entity's derivative activities, including those charged with governance, those committing the entity to the derivative transactions (hereinafter referred to as "dealers"), those involved with risk control and the accounting and operations personnel responsible for recording and settling the transactions. In addition, management may be more likely to overlook infrequent transactions for relevant accounting and disclosure issues.

- *Whether the derivative is an embedded feature of an agreement*. Management may be less likely to identify embedded derivatives, which increases the inherent risk for the completeness assertion about those derivatives.
- *Whether external factors affect the assertion*. For example, the increase in credit risk associated with entities operating in declining industries increases the inherent risk for the valuation assertion about those derivatives. In addition, significant changes in, or volatility of, interest rates increase the inherent risk for the valuation of derivatives whose value is significantly affected by interest rates.
- *Whether the derivative is traded on national exchanges or across borders*. Derivatives traded in cross-border exchanges may be subject to increased inherent risk because of differing laws and regulations, exchange rate risk, or differing economic conditions. These conditions may contribute to the inherent risk for the rights and obligations assertion or the valuation assertion.

28. Many derivatives have the associated risk that a loss might exceed the amount, if any, of the value of the derivative recognized on the balance sheet (off-balance-sheet risk). For example, a sudden fall in the market price of a commodity may force an entity to realize losses to close a forward position in that commodity. In some cases, the potential losses may be enough to cast significant doubt on the entity's ability to continue as a going concern. ISA 570, "Going Concern" establishes standards and provides guidance on the auditor's responsibility in the audit of financial statements with respect to the going concern assumption used in the preparation of the financial statements. The entity may perform sensitivity analyses or value-at-risk analyses to assess the hypothetical effects on derivative instruments subject to market risks. The auditor may consider these analyses in evaluating management's assessment of the entity's ability to continue as a going concern.

Accounting Considerations

29. An entity's accounting method affects specific audit procedures and is, therefore, significant. The accounting for derivatives may depend whether

the derivative has been classified as a hedging instrument, and if the hedging relationship is a highly effective one. For example, IAS 39 requires the entity to recognize the changes in fair value of a derivative instrument as net profit or loss in the current period. If a derivative is part of a hedging relationship that meets certain criteria, the hedging relationship qualifies for special hedge accounting, which recognizes the offsetting effects of the hedged item on net profit or loss. Because the derivatives and hedged item are economically connected, it is appropriate to recognize derivative gains or losses in the same accounting period that the gains or losses on the hedged item are recognized. For some transactions, changes in fair value will appear as a component of current net profit or loss. For other transactions, changes in fair value will appear currently in changes in equity, and ultimately, when the final transactions occurs, in net profit or loss.

30. Derivatives used as hedges are subject to the risk that market conditions will change so that the hedge is no longer effective and, thus, no longer meets the conditions of a hedging relationship. For example, IAS 39 requires that periodic gains and losses on a futures contract used to hedge the future purchase of inventory be recognized as changes in stockholders' equity, with the cumulative gains or losses appearing in net profit or loss in the same period(s) that the hedged forecasted transaction affects net profit or loss. Any discrepancies between changes in the spot price of the futures contract and the corollary changes in the cost of the related inventory purchase would reduce the effectiveness of the hedge. Discrepancies may be caused by differing delivery sites for an inventory purchase and futures contract used to hedge the inventory purchase. For example, the cost of physical delivery may vary depending on site. Other discrepancies may be caused by differing time parameters between the execution of the hedged item and the hedging instrument, or differing quality or quantity measures involving the hedged item and those specified in the hedging instrument. IAS 39 requires the ineffective portion of a change in the value of a hedging instrument to be reported immediately in net profit or loss. If the hedge is assessed and determined not to be highly effective, the hedging relationship would no longer meet the criteria for hedge accounting. Continued hedge accounting would exclude gains and losses improperly from net profit or loss for the period. The complexities of the accounting for derivatives increase the inherent risk for the presentation and disclosure assertion about those derivatives.

Accounting System Considerations

31. ISA 400[5] requires that the auditor obtain an understanding of the accounting system. To achieve this understanding, the auditor obtains knowledge of the design of the accounting system, changes to that system and its operation. The extent of an entity's use of derivatives and the relative complexity of the instruments are important determinants of the necessary level of sophistication of both the entity's information systems (including the accounting system) and control procedures.

32. Certain instruments may require a large number of accounting entries. Although the accounting system used to post derivative transactions likely will need some manual intervention, ideally, the accounting system is able to post such entries accurately with minimal manual intervention. As the sophistication of the derivative activities increases, so should the sophistication of the accounting system. Because this is not always the case, the auditor remains alert to the possible need to modify the audit approach if the quality of the accounting system, or aspects of it, appears weak.

Control Environment

33. The control environment influences the tone of an entity and the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. The control environment has a pervasive influence on the way business activities are structured, objectives established and risks assessed.

34. ISA 400[6] requires the auditor to obtain an understanding of the control environment sufficient to assess the attitudes of management and those charged with governance, their awareness and actions regarding internal control and its importance in the entity.

35. The auditor considers management's overall attitude toward, and awareness of, derivative activities as a part of obtaining an understanding of the control environment, including any changes to it. It is the role of those charged with governance to determine an appropriate attitude towards the risks. It is management's role to monitor and manage the entity's exposures to those risks. The auditor obtains an understanding of how the control environment for derivatives responds to management's assessment of risk. To effectively monitor and manage its exposure to risk, an entity implements a structure that:

    - Is appropriate and consistent with the entity's attitude toward risk as determined by those charged with governance;

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5 See footnote 3.

6 See footnote 3.

- Specifies the approval levels for the authorization of different types of instruments and transactions that may be entered into and for what purposes. The permitted instruments and approval levels should reflect the expertise of those involved in derivative activities;
- Sets appropriate limits for the maximum allowable exposure to each type of risk (including approved counterparties). Levels of allowable exposure may vary depending on the type of risk, or counterparty;
- Provides for the independent and timely monitoring of the financial risks and control procedures; and
- Provides for the independent and timely reporting of exposures, risks and the results of derivative activities in managing risk.

36. Management should establish suitable guidelines to ensure that derivative activities fulfill the entity's needs. In setting suitable guidelines, management should include clear rules on the extent to which those responsible for derivative activities are permitted to participate in the derivative markets. Once this has been done, management can implement suitable systems to manage and control those risks. Three elements of the control environment deserve special mention for their potential effect on controls over derivative activities:

- *Direction from management or those charged with governance.* Management is responsible for providing direction, through clearly stated policies, for the purchase, sale and holding of derivatives. These policies should begin with management clearly stating its objectives with regard to its risk management activities and an analysis of the investment and hedging alternatives available to meet those objectives. Policies and procedures should then be developed that consider the:
    - Level of the entity's management expertise;
    - Sophistication of the entity's internal control and monitoring systems;
    - Entity's asset/liability structure;
    - Entity's capacity to maintain liquidity and absorb losses of capital;
    - Types of derivative financial instruments that management believes will meet its objectives; and
    - Uses of derivative financial instruments that management believes will meet its objectives, for example, whether derivatives may be used for speculative purposes or hedging purposes.

  An entity's policies for the purchase, sale and holding of derivatives should be appropriate and consistent with its attitude toward risk and the expertise of those involved in derivative activities.

- *Segregation of duties and the assignment of personnel.* Derivative activities may be categorized into three functions:

    - Committing the entity to the transaction (dealing);
    - Initiating cash payments and accepting cash receipts (settlements); and
    - Recording of all transactions correctly in the accounting records, including the valuation of derivatives.

    Segregation of duties should exist among these three functions. Where an entity is too small to achieve proper segregation of duties, management should take a more active role to monitor derivative activities.

    Some entities have established a fourth function, *risk control*, which is responsible for reporting on and monitoring derivative activities. Examples of key responsibilities in this area may include:

    - Setting and monitoring risk management policy;
    - Designing risk limit structures;
    - Developing disaster scenarios and subjecting open position portfolios to sensitivity analysis, including reviews of unusual movements in positions; and
    - Reviewing and analyzing new derivative instrument products.

    In entities that have not established a separate risk control function, reporting on and monitoring derivative activities may be a component of the accounting function's responsibility or management's overall responsibility.

- *Whether or not the general control environment has been extended to those responsible for derivative activities.* An entity may have a control culture that is generally focused on maintaining a high level of internal control. Because of the complexity of some treasury or derivative activities, this culture may not pervade the group responsible for derivative activities. Alternatively, because of the risks associated with derivative activities, management may enforce a more strict control environment than it does elsewhere within the entity.

37. Some entities may operate an incentive compensation system for those involved in derivative transactions. In such situations, the auditor considers the extent to which proper guidelines, limits and controls have been established to ascertain if the operation of that system could result in transactions that are inconsistent with the overall objectives of the entity's risk management strategy.

38. When an entity uses electronic commerce for derivative transactions, it should address the security and control considerations relevant to the use of an electronic network.

Control Objectives and Procedures

39. Internal controls over derivative transactions should prevent or detect problems that hinder an entity from achieving its objectives. These objectives may be either operational, financial reporting, or compliance in nature, and internal control is necessary to prevent or detect problems in each area.

40. ISA 400[7] requires the auditor to obtain an understanding of the control procedures sufficient to plan the audit. Effective control procedures over derivatives generally will include adequate segregation of duties, risk management monitoring, management oversight, and other policies and procedures designed to ensure that the entity's control objectives are met. Those control objectives include the following:

- *Authorized execution*. Derivative transactions are executed in accordance with the entity's approved policies.
- *Complete and accurate information*. Information relating to derivatives, including fair value information, is recorded on a timely basis, is complete and accurate when entered into the accounting system, and has been properly classified, described and disclosed.
- *Prevention or detection of errors*. Misstatements in the processing of accounting information for derivatives are prevented or detected in a timely manner.
- *Ongoing monitoring*. Activities involving derivatives are monitored on an ongoing basis to recognize and measure events affecting related financial statement assertions.
- *Valuation*. Changes in the value of derivatives are appropriately accounted for and disclosed to the right people from both an operational and a control viewpoint. Valuation may be a part of ongoing monitoring activities.

In addition, for derivatives designated as hedges, internal controls should assure that those derivatives meet the criteria for hedge accounting, both at the inception of the hedge, and on an ongoing basis.

41. As it relates to the purchase, sale and holding of derivatives, the level of sophistication of an entity's internal control will vary according to:

[7] See footnote 3.

- The complexity of the derivative and the related inherent risk–more complex derivative activities will require more sophisticated systems;
- The risk exposure of derivative transactions in relation to the capital employed by the entity; and
- The volume of transactions–entities that do not have a significant volume of derivative transactions will require less sophisticated accounting systems and internal control.

42. As the sophistication of derivative activity increases, so should internal control. In some instances, an entity will expand the types of financial activities it enters into without making corresponding adjustments to its internal control.

43. In larger entities, sophisticated computer information systems generally keep track of derivative activities, and to ensure that settlements occur when due. More complex computer systems may generate automatic postings to clearing accounts to monitor cash movements. Proper controls over processing will help to ensure that derivative activities are correctly reflected in the entity's records. Computer systems may be designed to produce exception reports to alert management to situations where derivatives have not been used within authorized limits or where transactions undertaken were not within the limits established for the chosen counterparties. Even a sophisticated computer system may not ensure the completeness of derivative transactions.

44. Derivatives, by their very nature, can involve the transfer of sizable amounts of money both to and from the entity. Often, these transfers take place at maturity. In many instances, a bank is only provided with appropriate payment instructions or receipt notifications. Some entities may use electronic fund transfer systems. Such systems may involve complex password and verification controls, standard payment templates and cash pooling/sweeping facilities. ISA 401, "Auditing in a Computer Information Systems Environment"[8] requires the auditor to consider how computer information systems (CIS) environments affect the audit and to obtain an understanding of the significance and complexity of the CIS activities and the availability of data for use in the audit. The auditor gains an understanding of the methods used to transfer funds, along with their strengths and weaknesses, as this will affect the risks the business is faced with and accordingly, the audit risk assessment.

[8] ISA 401, "Auditing in a Computer Information Systems Environment" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" became effective.

45. Regular reconciliations are an important aspect of controlling derivative activities. Formal reconciliations should be performed on a regular basis to ensure that the financial records are properly controlled, all entries are promptly made and the dealers have adequate and accurate position information before formally committing the entity to a legally binding transaction. Reconciliations should be properly documented and independently reviewed. The following are some of the more significant types of reconciliation procedures associated with derivative activities:

- Reconciliation of dealers' records to records used for the ongoing monitoring process and the position or profit and loss shown in the general ledger.
- Reconciliation of subsidiary ledgers, including those maintained on computerized data bases, to the general ledger.
- Reconciliation of all clearing and bank accounts and broker statements to ensure all outstanding items are promptly identified and cleared.
- Reconciliation of entity's accounting records to records maintained by service organizations, where applicable.

46. An entity's deal initiation records should clearly identify the nature and purpose of individual transactions, and the rights and obligations arising under each derivative contract. In addition to the basic financial information, such as a notional amount, these records should include:

- The identity of the dealer;
- The identity of the person recording the transaction, if that person is not the dealer;
- The date and time of the transaction;
- The nature and purpose of the transaction, including whether or not it is intended to hedge an underlying commercial exposure; and
- Information on compliance with accounting requirements related to hedging, if applicable, such as:
    - Designation as a hedge, including the type of hedge;
    - Identification of the criteria used for assessing effectiveness of the hedge; and
    - Identification of the hedged item in a hedging relationship.

47. Transaction records for derivatives may be maintained in a database, register or subsidiary ledger, which are then checked for accuracy with independent confirmations received from the counterparties to the transactions. Often, the transaction records will be used to provide accounting information, including information for disclosures in the

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financial statements, together with other information to manage risk, such as exposure reports against policy limits. Therefore, it is essential to have appropriate controls over input, processing and maintenance of the transaction records, whether they are in a database, a register or a subsidiary ledger.

48. The main control over the completeness of the derivative transaction records is the independent matching of counterparty confirmations against the entity's own records. Counterparties should be asked to send the confirmations back directly to employees of the entity that are independent from the dealers, to guard against dealers suppressing confirmations and "hiding" transactions, and all details should be checked off against the entity's records. Employees independent of the dealer should resolve any exceptions contained in the confirmations, and fully investigate any confirmation that is not received.

The Role of Internal Auditing

49. As part of the assessment of internal control, the auditor considers the role of internal auditing. The knowledge and skills required to understand and audit an entity's use of derivatives are generally quite different from those needed in auditing other parts of the business. The external auditor considers the extent to which the internal audit function has the knowledge and skill to cover, and has in fact covered, the entity's derivatives activities.

50. In many entities, internal auditing forms an essential part of the risk control function that enables senior management to review and evaluate the control procedures covering the use of derivatives. The work performed by internal auditing may assist the external auditor in assessing the accounting systems and internal controls and therefore control risk. Areas where the work performed by internal auditing may be particularly relevant are:

- Developing a general overview of the extent of derivative use;
- Reviewing the appropriateness of policies and procedures and management's compliance with them;
- Reviewing the effectiveness of control procedures;
- Reviewing the accounting systems used to process derivative transactions;
- Reviewing systems relevant to derivative activities;
- Ensuring that objectives for derivative management are fully understood across the entity, particularly where there are operating divisions where the risk exposures are most likely to arise;
- Assessing whether new risks relating to derivatives, are being identified, assessed and managed;

- Evaluating whether the accounting for derivatives is in accordance with the financial reporting framework including, if applicable, whether derivatives accounted for using hedge accounting specified by the financial reporting framework meet the conditions of a hedging relationship; and
- Conducting regular reviews to:
    - Provide management with assurance that derivative activities are being properly controlled; and
    - Ensure that new risks and the use of derivatives to manage these risks are being identified, assessed and managed.

51. Certain aspects of internal auditing may be useful in determining the nature, timing and extent of external audit procedures. When it appears that this might be the case, the external auditor, during the course of planning the audit, obtains a sufficient understanding of internal audit activities and performs a preliminary assessment of the internal audit function When the external auditor intends to use specific internal audit work, the external auditor evaluates and tests that work to confirm its adequacy for the external auditor's purposes. ISA 610, "Considering the Work of Internal Auditing" provides guidance to the external auditor in considering the work of internal auditing.

Service Organizations

52. Entities may use service organizations to initiate the purchase or sale of derivatives or maintain records of derivative transactions for the entity.

53. The use of service organizations may strengthen controls over derivatives. For example, a service organization's personnel may have more experience with derivatives than the entity's management. The use of the service organization also may allow for greater segregation of duties. On the other hand, the use of a service organization may increase risk because it may have a different control culture or process transactions at some distance from the entity.

54. ISA 402 provides guidance to the auditor when the entity being audited uses a service organization. ISA 402 requires the auditor to consider, when planning the audit and developing an effective audit approach, how using a service organization affects the entity's accounting and internal control systems. ISA 402 provides further guidance in auditing entities using service organizations. When applying ISA 402 to a service organization engaged in derivative transactions, the auditor considers how a service organization affects the entity's accounting and internal control systems.

55. Because service organizations often act as investment advisors, the auditor may consider risks associated with service organizations when acting as investment advisors, including:

    - How their services are monitored;
    - The procedures in place to protect the integrity and confidentiality of the information;
    - Contingency arrangements; and
    - Any related party issues that may arise because the service organization can enter into its own derivative transactions with the entity while, at the same time, being a related party.

Control Risk

56. Control risk is the risk that an entity's accounting and internal control systems will not prevent or detect and correct, on a timely basis, any misstatements in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes.

57. ISA 400[9] requires the auditor, after obtaining an understanding of the accounting and internal control systems, to make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions. ISA 400 requires the preliminary assessment of control risk for a financial statement assertion to be high unless the auditor:

    (a) Is able to identify internal controls relevant to the assertion that are likely to prevent or detect and correct a material misstatement; and

    (b) Plans to perform tests of control to support the assessment.

58. When developing the audit approach, the auditor considers the preliminary assessment of control risk (in conjunction with the assessment of inherent risk) to determine the nature, timing and extent of substantive procedures for the financial statement assertions.

59. Examples of considerations that might affect the auditor's assessment of control risk include:

    - Whether policies and procedures that govern derivative activities reflect management's objectives;
    - How management informs its personnel of controls;
    - How management captures information about derivatives; and

[9] See footnote 3.

- How management assures itself that controls over derivatives are operating as designed.

60. ISA 400 requires the auditor, before the conclusion of the audit, and based on the results of substantive procedures and other audit evidence obtained, to consider whether the assessment of control risk is confirmed.

61. The assessment of control risk depends on the auditor's judgment as to the quality of the control environment and the control procedures in place. In reaching a decision on the nature, timing and extent of testing of controls, the auditor considers factors such as:

    - The importance of the derivative activities to the entity;
    - The nature, frequency and volume of derivatives transactions;
    - The potential effect of any identified weaknesses in control procedures;
    - The types of controls being tested;
    - The frequency of performance of these controls; and
    - The evidence of performance.

Tests of Controls

62. Where the assessment of control risk is less than high, the auditor performs tests of controls to obtain evidence as to whether or not the preliminary assessment of control risk is supported. Notwithstanding the auditor's assessment of control risk, it may be that the entity undertakes only a limited number of derivative transactions, or that the magnitude of these instruments is especially significant to the entity as a whole. In such instances, a substantive approach, sometimes in combination with tests of control, may be more appropriate.

63. The population from which items are selected for detailed testing is not limited to the accounting records. Tested items may be drawn from other sources, for example counterparty confirmations and trader tickets, so that the possibility of overlooking transactions in the recording procedure can be tested.

64. Tests of controls are performed to obtain audit evidence about the effectiveness of the: (a) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements and (b) operation of the internal controls throughout the period. Key procedures may include evaluating, for a suitably sized sample of transactions, whether:

    - Derivatives have been used in accordance with the agreed policies, guidelines and within authority limits;

- Appropriate decision-making processes have been applied and the reasons behind entering into selected transactions are clearly understandable;
- The transactions undertaken were within the policies for derivative transactions, including terms and limits and transactions with foreign or related parties;
- The transactions were undertaken with counterparties with appropriate credit risk;
- Derivatives are subject to appropriate timely measurement, and reporting of risk exposure, independent of the dealer;
- Counterparty confirmations have been sent;
- Incoming confirmations from counterparties have been properly matched and reconciled;
- Early termination and extension of derivatives are subject to the same controls as new derivative transactions;
- Designations, including any subsequent changes in designations, as hedging or speculative transactions, are properly authorized;
- Transactions have been properly recorded and are entered completely and accurately in the accounting records, and correctly processed in any subsidiary ledger through to the financial statements; and
- Adequate security has been maintained over passwords necessary for electronic fund transfers.

65. Examples of tests of controls to consider include:

- Reading minutes of meetings of those charged with governance of the entity (or, where the entity has established one, the Asset/Liability Risk Management Committee or similar group) for evidence of that body's periodic review of derivative activities, adherence to established policies, and periodic review of hedging effectiveness; and
- Comparing derivative transactions, including those that have been settled to the entity's policies to determine whether the entity is following those policies. For example, the auditor might:
    - Test that transactions have been executed in accordance with authorizations specified in the entity's policy;
    - Test that any pre-acquisition sensitivity analysis dictated by the investment policy is being performed;

- Test transactions to determine whether the entity obtained required approvals for the transactions and used only authorized brokers or counterparties;
- Inquire of management about whether derivatives and related transactions are being monitored and reported upon on a timely basis and read any supporting documentation;
- Test recorded purchases of derivatives, including their classification and prices, and the entries used to record related amounts;
- Test the reconciliation process. The auditor might test whether reconciling differences are investigated and resolved on a timely basis, and whether the reconciliations are reviewed and approved by supervisory personnel. For example, organizations that have a large number of derivative transactions may require reconciliation and review on a daily basis;
- Test the controls for unrecorded transactions. The auditor might examine the entity's third-party confirmations and the resolution of any exceptions contained in the confirmations; and
- Test the controls over the adequate security and back-up of data to ensure adequate recovery in case of disaster. In addition, the auditor may consider the procedures the entity adopts for annual testing and maintenance of the computerized records site.

Substantive Procedures

66. ISA 400[10] requires the auditor to consider the assessed levels of inherent and control risk in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level. The higher the assessment of inherent and control risk, the more audit evidence the auditor obtains from the performance of substantive procedures.

67. The assessed levels of inherent and control risk cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. The auditor performs some substantive procedures for material account balances and classes of transactions. Nevertheless, the auditor may not be able to obtain sufficient appropriate audit evidence to reduce detection risk, and therefore reduce audit risk to an acceptably low level by performing substantive tests alone. If the auditor is unable to reduce audit risk to an acceptably low level, ISA 700, "The Auditor's Report on Financial

[10] See footnote 3.

Statements"[11] requires the auditor to qualify or disclaim an opinion. Furthermore, ISA 400 requires the auditor to make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems that have come to the auditor's attention.

Materiality

68. ISA 320, "Audit Materiality" states that the auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. The auditor's judgment may include assessments of what constitutes materiality for significant captions in the balance sheet, income statement, and statement of cash flows both individually, and for the financial statements as a whole.

69. ISA 320 requires the auditor to consider materiality when determining the nature, timing and extent of audit procedures. While planning the audit, materiality may be difficult to assess in relation to derivative transactions, particularly given some of their characteristics. Materiality cannot be based on balance sheet values alone, as derivatives may have little effect on the balance sheet, even though significant risks may arise from them. When assessing materiality, the auditor also may consider the potential effect on the account balance or class of transactions on the financial statements. A highly leveraged, or a more complex, derivative may be more likely to have a significant effect on the financial statements than a less highly leveraged or simpler derivative might. Greater potential for effect on the financial statements also exists when the exposure limits for entering into derivative transactions are high.

Types of Substantive Procedures

70. Substantive audit procedures are performed to obtain audit evidence to detect material misstatements in the financial statements, and are of two types: (a) tests of details of transactions and balances; and (b) analytical procedures.

71. In designing substantive tests, the auditor considers:

    - *Appropriateness of accounting*. A primary audit objective often addressed through substantive procedures is determining the appropriateness of an entity's accounting for derivatives.

    - *Involvement of an outside organization*. When planning the substantive procedures for derivatives, the auditor considers whether another

[11] ISA 700, "The Auditor's Report on Financial Statements" was withdrawn in December 2006 when ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" became effective.

organization holds, services or both holds and services the entity's derivatives.

- *Interim audit procedures*. When performing substantive procedures before the balance sheet date, the auditor considers market movement in the period between the interim testing date and year-end. The value of some derivatives can fluctuate greatly in a relatively short period. As the amount, relative significance, or composition of an account balance becomes less predictable, the value of testing at an interim date becomes less valuable.
- *Routine vs. non-routine transactions*. Many financial transactions are negotiated contracts between an entity and its counterparty. To the extent that derivative transactions are not routine and outside an entity's normal activities, a substantive audit approach may be the most effective means of achieving the planned audit objectives.
- *Procedures performed in other audit areas*. Procedures performed in other financial statement areas may provide evidence about the completeness of derivative transactions. These procedures may include tests of subsequent cash receipts and payments, and the search for unrecorded liabilities.

Analytical Procedures

72. ISA 520, "Analytical Procedures" requires the auditor to apply analytical procedures at the planning and overall review stages of the audit. Analytical procedures also may be applied at other stages of the audit. Analytical procedures as a substantive procedure in the audit of derivative activities may give information about an entity's business but, by themselves, are generally unlikely to provide sufficient evidence with respect to assertions related to derivatives. The complex interplay of the factors from which the values of these instruments are derived often masks any unusual trends that might arise.

73. Some personnel responsible for derivative activities compile detailed analytical reviews of the results of all derivatives activity. They are able to capture the effect of derivatives trading volumes and market price movements on the financial results of the entity and compile such an analysis because of their detailed day-to-day involvement in the activities. Similarly, some entities may use analytical techniques in their reporting and monitoring activities. Where such analysis is available, the auditor may use it to further understand the entity's derivative activity. In doing so, the auditor seeks satisfaction that the information is reliable and has been correctly extracted from the underlying accounting records by persons sufficiently objective to be confident that the information fairly reflects the

entity's operations. When appropriate, the auditor may use computer software for facilitating analytical procedures.

74. Analytical procedures may be useful in evaluating certain risk management policies over derivatives, for example, credit limits. Analytical procedures also may be useful in evaluating the effectiveness of hedging activities. For example, if an entity uses derivatives in a hedging strategy, and large gains or losses are noted as a result of analytical procedures, the effectiveness of the hedge may become questionable and accounting for the transaction as a hedge may not be appropriate.

75. Where no such analysis is compiled and the auditor wants to do one, the effectiveness of the analytical review often depends upon the degree to which management can provide detailed and disaggregated information about the activities undertaken. Where such information is available, the auditor may be able to undertake a useful analytical review. If the information is not available, analytical procedures will be effective only as a means of identifying financial trends and relationships in simple, low volume environments. This is because, as volume and complexity of operations increase, unless detailed information is available, the factors affecting revenues and costs are such that meaningful analysis by the auditor often proves difficult, and the value of analytical procedures as an audit tool decreases. In such situations, analytical procedures are not likely to identify inappropriate accounting treatments.

Evaluating Audit Evidence

76. Evaluating audit evidence for assertions about derivatives requires considerable judgment because the assertions, especially those about valuation, are based on highly subjective assumptions or are particularly sensitive to changes in the underlying assumptions. For example, valuation assertions may be based on assumptions about the occurrence of future events for which expectations are difficult to develop or about conditions expected to exist a long time. Accordingly, competent persons could reach different conclusions about estimates of fair values or estimates of ranges of fair values. Considerable judgment also may be required in evaluating audit evidence for assertions based on features of the derivative and applicable accounting principles, including underlying criteria, that are both extremely complex. ISA 540, "Audit of Accounting Estimates" provides guidance to the auditor on obtaining and evaluating sufficient competent audit evidence to support significant accounting estimates. ISA 620 provides guidance on the use of the work of an expert in performing substantive tests.

Substantive Procedures Related to Assertions

Existence and Occurrence

77. Substantive tests for existence and occurrence assertions about derivatives may include:

    - Confirmation with the holder of or the counterparty to the derivative;
    - Inspecting the underlying agreements and other forms of supporting documentation, including confirmations received by an entity, in paper or electronic form, for amounts reported;
    - Inspecting supporting documentation for subsequent realization or settlement after the end of the reporting period; and
    - Inquiry and observation.

Rights and Obligations

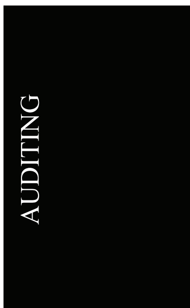
78. Substantive tests for rights and obligations assertions about derivatives may include:

    - Confirming significant terms with the holder of, or counterparty to, the derivative; and
    - Inspecting underlying agreements and other forms of supporting documentation, in paper or electronic form.

Completeness

79. Substantive tests for completeness assertions about derivatives may include:

    - Asking the holder of or counterparty to the derivative to provide details of all derivatives and transactions with the entity. In sending confirmation requests, the auditor determines which part of the counterparty's organization is responding, and whether the respondent is responding on behalf of all aspects of its operations;
    - Sending zero-balance confirmations to potential holders or counterparties to derivatives to test the completeness of derivatives recorded in the financial records;
    - Reviewing brokers' statements for the existence of derivative transactions and positions held;
    - Reviewing counterparty confirmations received but not matched to transaction records;
    - Reviewing unresolved reconciliation items;



- Inspecting agreements, such as loan or equity agreements or sales contracts, for embedded derivatives (the accounting treatment of such embedded derivatives may differ among financial reporting frameworks);
- Inspecting documentation for activity subsequent to the end of the reporting period;
- Inquiry and observation; and
- Reading other information, such as minutes of those charged with governance, and related papers and reports on derivative activities received by the governance body.

Valuation and Measurement

80. Tests of valuation assertions are designed according to the valuation method used for the measurement or disclosure. The financial reporting framework may require that a financial instrument be valued based on cost, the amount due under a contract, or fair value. It also may require disclosures about the value of a derivative and specify that impairment losses be recognized in net profit or loss before their realization. Substantive procedures to obtain evidence about the valuation of derivative financial instruments may include:

    - Inspecting of documentation of the purchase price;
    - Confirming with the holder of or counterparty to the derivative;
    - Reviewing the creditworthiness of counterparties to the derivative transaction; and
    - Obtaining evidence corroborating the fair value of derivatives measured or disclosed at fair value.

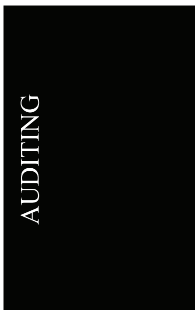
81. The auditor obtains evidence corroborating the fair value of derivatives measured or disclosed at fair value. The method for determining fair value may vary depending on the industry in which the entity operates, including any specific financial reporting framework that may be in effect for that industry, or the nature of the entity. Such differences may relate to the consideration of price quotations from inactive markets and significant liquidity discounts, control premiums, and commissions and other costs that would be incurred when disposing of a derivative. The method for determining fair value also may vary depending on the type of asset or liability. ISA 540 provides guidance on the audit of accounting estimates contained in financial statements.

82. Quoted market prices for certain derivatives that are listed on exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges or pricing services based on sources such as

these. Quoted market prices for other derivatives may be obtained from broker-dealers who are market makers in those instruments. If quoted market prices are not available for a derivative, estimates of fair value may be obtained from third-party sources based on proprietary models or from an entity's internally developed or acquired models. If information about the fair value is provided by a counterparty to the derivative, the auditor considers whether such information is objective. In some instances, it may be necessary to obtain fair value estimates from additional independent sources.

83. Quoted market prices obtained from publications or from exchanges are generally considered to provide sufficient evidence of the value of derivative financial instruments. Nevertheless, using a price quote to test valuation assertions may require a special understanding of the circumstances in which the quote was developed. For example, quotations provided by the counterparty to an option to enter into a derivative financial instrument may not be based on recent trades and may be only an indication of interest. In some situations, the auditor may determine that it is necessary to obtain fair value estimates from broker-dealers or other third-party sources. The auditor also may determine that it is necessary to obtain estimates from more than one pricing source. This may be appropriate if the pricing source has a relationship with an entity that might impair its objectivity.

84. It is management's responsibility to estimate the value of the derivative instrument. If an entity values the derivative using a valuation model, the auditor does not function as an appraiser and the auditor's judgment is not substituted for that of the entity's management. The auditor may test assertions about the fair value determined using a model by procedures such as:



- Assessing the reasonableness and appropriateness of the model. The auditor determines whether the market variables and assumptions used are reasonable and appropriately supported. Furthermore, the auditor assesses whether market variables and assumptions are used consistently, and whether new conditions justify a change in the market variables or assumptions used. The evaluation of the appropriateness of valuation models and each of the variables and assumptions used in the models may require considerable judgment and knowledge of valuation techniques, market factors that affect value, and market conditions, particularly in relation to similar financial instruments. Accordingly, the auditor may consider it necessary to involve a specialist in assessing the model.

- Calculating the value, for example, using a model developed by the auditor or by a specialist engaged by the auditor. The re-performance of valuations using the auditor's own models and data enables the auditor

to develop an independent expectation to use in corroborating the reasonableness of the value calculated by the entity.

- Comparing the fair value with recent transactions.
- Considering the sensitivity of the valuation to changes in the variables and assumptions, including market conditions that may affect the value.
- Inspecting supporting documentation for subsequent realization or settlement of the derivative transaction after the end of the reporting period to obtain further evidence about its valuation at the balance sheet date.

85. Some financial reporting frameworks, for example IAS 39, presume that fair value can be reliably determined for most financial assets, including derivatives. That presumption can be overcome for an investment in an equity instrument (including an investment that is in substance an equity instrument) that does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. The presumption can also be overcome for a derivative that is linked to and that must be settled by delivery of such an unquoted equity instrument. Derivatives, for which the presumption that the fair value of the derivative can be reliably determined has been overcome, and that have a fixed maturity, are measured at amortized cost using the effective interest rate method. Those that do not have a fixed maturity are measured at cost.

86. The auditor gathers audit evidence to determine whether the presumption that the fair value of the derivative can be reliably determined has been overcome, and whether the derivative is properly accounted for under the financial reporting framework. If management cannot support that it has overcome the presumption that the fair value of the derivative can be reliably determined, ISA 700[12] requires that the auditor express a qualified opinion or an adverse opinion. If the auditor is unable to obtain sufficient audit evidence to determine whether the presumption has been overcome, there is a limitation on the scope of the auditor's work. In this case, ISA 700 requires that the auditor express a qualified opinion or a disclaimer of opinion.

Presentation and Disclosure

87. Management is responsible for preparing and presenting the financial statements in accordance with the financial reporting framework, including fairly and completely presenting and disclosing the results of derivative transactions and relevant accounting policies.

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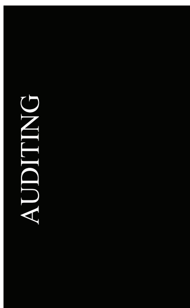
[12] See footnote 11.

88. The auditor assesses whether the presentation and disclosure of derivatives is in conformity with the financial reporting framework. The auditor's conclusion as to whether derivatives are presented in conformity with the financial reporting framework is based on the auditor's judgment as to whether:

- The accounting principles selected and applied are in conformity with the financial reporting framework;
- The accounting principles are appropriate in the circumstances;
- The financial statements, including the related notes, provide information on matters that may affect their use, understanding, and interpretation;
- Disclosure is adequate to ensure that the entity is in full compliance with the current disclosure requirements of the financial reporting framework under which the financial statements are being reported, for example, IAS 39;
- The information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed; and
- The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.

89. The financial reporting framework may prescribe presentation and disclosure requirements for derivative instruments. For example, some financial reporting frameworks may require users of derivative financial instruments to provide extensive disclosure of the market risk management policies, market risk measurement methodologies and market price information. Other frameworks may not require disclosure of this information as part of the financial statements, but encourage entities to disclose such information outside of the financial statements. ISA 720, "Other Information in Documents Containing Audited Financial Statements" provides guidance on the consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.



Additional Considerations About Hedging Activities

90. To account for a derivative transaction as a hedge, some financial reporting frameworks, for example, IAS 39, require that management, at the inception of the transaction, designate the derivative instrument as a hedge and contemporaneously formally document: (a) the hedging relationship, (b) the entity's risk management objective and strategy for undertaking the

hedge, and (c) how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or the hedged transaction's cash flow that is attributable to the hedged risk. IAS 39 also requires that management have an expectation that the hedge will be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistent with the originally documented risk management strategy for that particular hedging relationship.

91. The auditor gathers audit evidence to determine whether management complied with the applicable hedge accounting requirements of the financial reporting framework, including designation and documentation requirements. In addition, the auditor gathers audit evidence to support management's expectation, both at the inception of the hedge transaction, and on an ongoing basis, that the hedging relationship will be highly effective. If management has not prepared the documentation required by the financial reporting framework, the financial statements may not be in conformity with the applicable financial reporting framework, and ISA 700[13] would require the auditor to express a qualified opinion or an adverse opinion. Regardless of the financial reporting framework, the auditor is required to obtain sufficient appropriate audit evidence. Therefore, the auditor may obtain documentation prepared by the entity that may be similar to that described in paragraph 90, and may consider obtaining management representations regarding the entity's use and effectiveness of hedge accounting. The nature and extent of the documentation prepared by the entity will vary depending on the nature of the hedged items and the hedging instruments. If sufficient audit evidence to support management's use of hedge accounting is not available, the auditor may have a scope limitation, and may be required by ISA 700 to issue a qualified or disclaimer of opinion.

Management Representations

92. ISA 580, "Management Representations" requires the auditor to obtain appropriate representations from management, including written representations on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. Although management representation letters ordinarily are signed by personnel with primary responsibility for the entity and its financial aspects (ordinarily the senior executive officer and the senior financial officer), the auditor may wish to obtain representations about derivative activities from those responsible for derivative activities within the entity. Depending on the volume and complexity of derivative activities, management

[13] See footnote 11.

representations about derivative financial instruments may include representations about:

- Management's objectives with respect to derivative financial instruments, for example, whether derivatives are used for hedging or speculative purposes;
- The financial statement assertions concerning derivative financial instruments, for example:
  - The records reflect all derivative transactions;
  - All embedded derivative instruments have been identified;
  - The assumptions and methodologies used in the derivative valuation models are reasonable;
- Whether all transactions have been conducted at arm's length and at fair market value;
- The terms of derivative transactions;
- Whether there are any side agreements associated with any derivative instruments;
- Whether the entity has entered into any written options; and
- Whether the entity complies with the documentation requirements of the financial reporting framework for derivatives that are conditions precedent to specified hedge accounting treatments.

93. Sometimes, with respect to certain aspects of derivatives, management representations may be the only audit evidence that reasonably can be expected to be available; however, ISA 580 states that representations from management cannot be a substitute for other audit evidence that the auditor's also expects to be available. If the audit evidence the auditor expects to be available cannot be obtained, this may constitute a limitation on the scope of the audit and the auditor considers the implications for the auditor's report. In this case, ISA 700[14] requires that the auditor express a qualified opinion or a disclaimer of opinion.

Communications with Management and Those Charged with Governance

94. As a result of obtaining an understanding of an entity's accounting and internal control systems and, if applicable, tests of controls, the auditor may become aware of matters to be communicated to management or those

[14] See footnote 11.

charged with governance. ISA 400[15] requires that the auditor make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems that have come to the auditor's attention. ISA 260, "Communication of Audit Matters with Those Charged with Governance" requires the auditor to consider audit matters of governance interest that arise from the audit of financial statements and communicate them on a timely basis to those charged with governance. With respect to derivatives, those matters may include:

- Material weaknesses in the design or operation of the accounting and internal control systems;
- A lack of management understanding of the nature or extent of the derivative activities or the risks associated with such activities;
- A lack of a comprehensive policy on strategy and objectives for using derivatives, including operational controls, definition of "effectiveness" for derivatives designated as hedges, monitoring exposures and financial reporting; or
- A lack of segregation of duties.

[15] See footnote 3.

Glossary of Terms

Asset/Liability Management—A planning and control process, the key concept of which is matching the mix and maturities of assets and liabilities.

Basis—The difference between the price of the hedged item and the price of the related hedging instrument.

Basis Risk—The risk that the basis will change while the hedging contract is open and, thus, the price correlation between the hedged item and hedging instrument will not be perfect.

Cap—A series of call options based on a notional amount. The strike price of these options defines an upper limit to interest rates.

Close Out—The consummation or settlement of a financial transaction.

Collateral—Assets pledged by a borrower to secure a loan or other credit; these are subject to seizure in the event of default.

Commodity—A physical substance, such as food, grains and metals that is interchangeable with other product of the same type.

Correlation—The degree to which contract prices of hedging instruments reflect price movements in the cash-market position. The correlation factor represents the potential effectiveness of hedging a cash-market instrument with a contract where the deliverable financial instrument differs from the cash-market instrument. Generally, the correlation factor is determined by regression analysis or some other method of technical analysis of market behavior.

Counterparty—The other party to a derivative transaction.

Credit Risk—The risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter.

Dealer (for the purposes of this IAPS)—The person who commits the entity to a derivative transaction.

Derivative—A generic term used to categorize a wide variety of financial instruments whose value "depends on" or is "derived from" an underlying rate or price, such as interest rates, exchange rates, equity prices, or commodity prices. Many national financial reporting frameworks, and the International Accounting Standards contain definitions of derivatives. For example, International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement" defines a derivative as a financial instrument:

- Whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the "underlying");

- That requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
- That is settled at a future date.

Embedded Derivative Instruments—Implicit or explicit terms in a contract or agreement that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative.

End User—An entity that enters into a financial transaction, either through an organized exchange or a broker, for the purpose of hedging, asset/liability management or speculating. End users consist primarily of corporations, government entities, institutional investors and financial institutions. The derivative activities of end users are often related the production or use of a commodity by the entity.

Exchange-Traded Derivatives—Derivatives traded under uniform rules through an organized exchange.

Fair Value—The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Floor—A series of put options based on a notional amount. The strike price of these options defines a lower limit to the interest rate.

Foreign Exchange Contracts—Contracts that provide an option for, or require a future exchange of foreign currency assets or liabilities.

Foreign Exchange Risk—The risk of losses arising through repricing of foreign currency instruments because of exchange rate fluctuations.

Forward Contracts—A contract negotiated between two parties to purchase and sell a specified quantity of a financial instrument, foreign currency, or commodity at a price specified at the origination of the contract, with delivery and settlement at a specified future date.

Forward Rate Agreements—An agreement between two parties to exchange an amount determined by an interest rate differential at a given future date based on the difference between an agreed interest rate and a reference rate (LIBOR, Treasury bills, *etc*.) on a notional principal amount.

Futures Contracts—Exchange-traded contracts to buy or sell a specified financial instrument, foreign currency or commodity at a specified future date or during a specified period at a specified price or yield.

Hedge—A strategy that protects an entity against the risk of adverse price or interest-rate movements on certain of its assets, liabilities or anticipated transactions. A hedge is used to avoid or reduce risks by creating a relationship by which losses on certain positions are expected to be counterbalanced in whole or in part by gains on separate positions in another market.

Hedging (for accounting purposes)—Designating one or more hedging instruments so that their change in fair value is an offset, completely or in part, to the change in fair value or cash flows of a hedged item.

Hedged Item—An asset, liability, firm commitment, or forecasted future transaction that (a) exposes an entity to risk of changes in fair value or changes in future cash flows and (b) for hedge accounting purposes, is designated as being hedged.

Hedging Instrument (for hedge accounting purposes)—A designated derivative or (in limited circumstances) another financial asset or liability whose value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

Hedge Effectiveness—The degree to which offsetting changes in fair value or cash flows attributable to a hedged risk are achieved by the hedging instrument.

Interest Rate Risk—The risk that a movement in interest rates would have an adverse effect on the value of assets and liabilities or would affect interest cash flows.

Interest Rate Swap—A contract between two parties to exchange periodic interest payments on a notional amount (referred to as the notional principal) for a specified period. In the most common instance, an interest rate swap involves the exchange of streams of variable and fixed-rate interest payments.

Legal Risk—The risk that a legal or regulatory action could invalidate or otherwise preclude performance by the end user or its counterparty under the terms of the contract.

LIBOR (London Interbank Offered Rate)—An international interest rate benchmark. It is commonly used as a repricing benchmark for financial instruments such as adjustable rate mortgages, collateralized mortgage obligations and interest rate swaps.

Linear Contracts—Contracts that involve obligatory cash flows at a future date.

Liquidity—The capability of a financial instrument to be readily convertible into cash.

Liquidity Risk—Changes in the ability to sell or dispose of the derivative. Derivatives bear the additional risk that a lack of sufficient contracts or willing counterparties may make it difficult to close out the derivative or enter into an offsetting contract.

Margin—(a) The amount of deposit money a securities broker requires from an investor to purchase securities on behalf of the investor on credit. (b) An amount of money or securities deposited by both buyers and sellers of futures contracts and short options to ensure performance of the terms of the contract, i.e., the delivery or taking of delivery of the commodity, or the cancellation of the position by a subsequent offsetting trade. Margin in commodities is not a payment of equity or

down payment on the commodity itself, but rather a performance bond or security deposit.

Margin Call—A call from a broker to a customer (called a maintenance margin call) or from a clearinghouse to a clearing member (called a variation margin call) demanding the deposit of cash or marketable securities to maintain a requirement for the purchase or short sale of securities or to cover an adverse price movement.

Market Risk—The risk of losses arising because of adverse changes in the value of derivatives due to changes in equity prices, interest rates, foreign exchange rates, commodity prices or other market factors. Interest rate risk and foreign exchange risk are sub-sets of market risk.

Model Risk—The risk associated with the imperfections and subjectivity of valuation models used to determine the fair value of a derivative.

Non-Linear Contracts—Contracts that have option features where one party has the right, but not the obligation to demand that another party deliver the underlying item to it.

Notional Amount—A number of currency units, shares, bushels, pounds or other units specified in a derivative instrument.

Off-Balance Sheet Instrument—A derivative financial instrument that is not recorded on the balance sheet, although it may be disclosed.

Off-Balance Sheet Risk—The risk of loss to the entity in excess of the amount, if any, of the asset or liability that is recognized on the balance sheet.

Option—A contract that gives the holder (or purchaser) the right, but not the obligation to buy (call) or sell (put) a specific or standard commodity, or financial instrument, at a specified price during a specified period (the American option) or at a specified date (the European option).

Policy—Management's dictate of what should be done to effect control. A policy serves as the basis for procedures and their implementation.

Position—The status of the net of claims and obligations in financial instruments of an entity.

Price Risk—The risk of changes in the level of prices due to changes in interest rates, foreign exchange rates or other factors that relate to market volatility of the underlying rate, index or price.

Risk Management—Using derivatives and other financial instruments to increase or decrease risks associated with existing or anticipated transactions.

Sensitivity Analysis—A general class of models designed to assess the risk of loss in market-risk-sensitive instruments based upon hypothetical changes in market rates or prices.

Settlement Date—The date on which derivative transactions are to be settled by delivery or receipt of the underlying product or instrument in return for payment of cash.

Settlement Risk—The risk that one side of a transaction will be settled without value being received from the counterparty.

Solvency Risk—The risk that an entity would not have funds available to honor cash outflow commitments as they fall due.

Speculation—Entering into an exposed position to maximize profits, that is, assuming risk in exchange for the opportunity to profit on anticipate market movements.

Swaption—A combination of a swap and an option.

Term Structure of Interest Rates—The relationship between interest rates of different terms. When interest rates of bonds are plotted graphically according to their interest rate terms, this is called the "yield curve." Economists and investors believe that the shape of the yield curve reflects the market's future expectation for interest rates and thereby provide predictive information concerning the conditions for monetary policy.

Trading—The buying and selling of financial instruments for short-term profit.

Underlying—A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability, but it is not the asset or liability itself.

Valuation Risk—The risk that the fair value of the derivative is determined incorrectly.

Value at Risk—A general class of models that provides a probabilistic assessment of the risk of loss in market-risk-sensitive instruments over a period of time, with a selected likelihood of occurrences based upon selected confidence intervals.

Volatility—A measure of the variability of the price of an asset or index.

Written Option—The writing, or sale, of an option contract that obligates the writer to fulfill the contract should the holder choose to exercise the option.

INTERNATIONAL AUDITING PRACTICE STATEMENT 1013

ELECTRONIC COMMERCE—EFFECT ON THE AUDIT OF FINANCIAL STATEMENTS

(This Statement is effective)

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International Auditing Practice Statement (IAPS) 1013, "Electronic Commerce—Effect on the Audit of Financial Statements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of IAPSs.

This Statement provides:

(a) Guidance on the application of the ISAs where an entity uses a public network such as the Internet, for electronic commerce; and

(b) Material to enhance awareness of financial statement audit issues in this rapidly developing area.

This Statement was approved by the IAPC for publication in March 2002.

Introduction

1. The purpose of this International Auditing Practice Statement (IAPS) is to provide guidance to assist auditors of financial statements where an entity engages in commercial activity that takes place by means of connected computers over a public network, such as the Internet (e-commerce[1]). The guidance in this Statement is particularly relevant to the application of ISA 300, "Planning,"[2] ISA 310, "Knowledge of the Business"[3] and ISA 400, "Risk Assessments and Internal Control."[4]

2. This Statement identifies specific matters to assist the auditor when considering the significance of e-commerce to the entity's business activities and the effect of e-commerce on the auditor's assessments of risk for the purpose of forming an opinion on the financial statements. The purpose of the auditor's consideration is not to form an opinion or provide consulting advice concerning the entity's e-commerce systems or activities in their own right.

3. Communications and transactions over networks and through computers are not new features of the business environment. For example, business processes frequently involve interaction with a remote computer, the use of computer networks, or electronic data interchange (EDI). However the increasing use of the Internet for business to consumer, business to business, business to government and business to employee e-commerce is introducing new elements of risk to be addressed by the entity and considered by the auditor when planning and performing the audit of the financial statements.

4. The Internet refers to the worldwide network of computer networks, it is a shared public network that enables communication with other entities and individuals around the world. It is interoperable, which means that any computer connected to the Internet can communicate with any other

AUDITING

[1] The term e-commerce is used in this IAPS. E-business is also commonly used in a similar context. There are no generally accepted definitions of these terms, and e-commerce and e-business are often used interchangeably. Where a distinction is made, e-commerce is sometimes used to refer solely to transactional activities (such as the buying and selling of goods and services) and e-business is used to refer to all business activities, both transactional and non-transactional, such as customer relations and communications.

[2] ISA 300, "Planning" was withdrawn in December 2004 when ISA 300, "Planning an Audit of Financial Statements" became effective.

[3] ISA 310, "Knowledge of the Business" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" became effective.

[4] ISA 400, "Risk Assessments and Internal Control" was withdrawn in December 2004 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" became effective.

computer connected to the Internet. The Internet is a public network, in contrast to a private network that only allows access to authorized persons or entities. The use of a public network introduces special risks to be addressed by the entity. Growth of Internet activity without due attention by the entity to those risks may affect the auditor's assessment of risk.

5. While this Statement has been written for situations where the entity engages in commercial activity over a public network such as the Internet, much of the guidance it contains can also be applied when the entity uses a private network. Similarly, while much of this guidance will be helpful when auditing entities formed primarily for e-commerce activities (often called "dot coms") it is not intended to deal with all audit issues that would be addressed in the audit of such entities.

Skills and Knowledge

6. The level of skills and knowledge required to understand the effect of e-commerce on the audit will vary with the complexity of the entity's e-commerce activities. The auditor considers whether the personnel assigned to the engagement have appropriate IT[5] and Internet business knowledge to perform the audit. When e-commerce has a significant effect on the entity's business, appropriate levels of both information technology (IT) and Internet business knowledge may be required to:

   - Understand, so far as they may affect the financial statements:
     - The entity's e-commerce strategy and activities;
     - The technology used to facilitate the entity's e-commerce activities and the IT skills and knowledge of entity personnel; and
     - The risks involved in the entity's use of e-commerce and the entity's approach to managing those risks, particularly the adequacy of the internal control system, including the security infrastructure and related controls, as it affects the financial reporting process;
   - Determine the nature, timing and extent of audit procedures and evaluate audit evidence; and
   - Consider the effect of the entity's dependence on e-commerce activities on its ability to continue as a going concern.

[5] International Education Guideline (IEG) 11, "Information Technology for Professional Accountants" issued by the Education Committee of IFAC (now referred to as the International Accounting Education Standards Board), which defines the broad content areas and specific skills and knowledge required by all professional accountants in connection with IT applied in a business context, may assist the auditor in identifying appropriate skills and knowledge.

7. In some circumstances, the auditor may decide to use the work of an expert, for example if the auditor considers it appropriate to test controls by attempting to break through the security layers of the entity's system (vulnerability or penetration testing). When the work of an expert is used, the auditor obtains sufficient appropriate audit evidence that such work is adequate for the purposes of the audit, in accordance with ISA 620, "Using the Work of an Expert." The auditor also considers how the work of the expert is integrated with the work of others on the audit, and what procedures are undertaken regarding risks identified through the expert's work.

Knowledge of the Business

8. ISA 310[6] requires that the auditor obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that may have a significant effect on the financial statements or on the audit report. Knowledge of the business includes a general knowledge of the economy and the industry within which the entity operates. The growth of e-commerce may have a significant effect on the entity's traditional business environment.

9. The auditor's knowledge of the business is fundamental to assessing the significance of e-commerce to the entity's business activities and any effect on audit risk. The auditor considers changes in the entity's business environment attributable to e-commerce, and e-commerce business risks as identified so far as they affect the financial statements. Although the auditor obtains much information from inquiries of those responsible for financial reporting, making inquiries of personnel directly involved with the entity's e-commerce activities, such as the chief information officer or equivalent, may also be useful. In obtaining or updating knowledge of the entity's business, the auditor considers, so far as they affect the financial statements:

   - The entity's business activities and industry (paragraphs 10-12);
   - The entity's e-commerce strategy (paragraph 13);
   - The extent of the entity's e-commerce activities (paragraphs 14-16); and
   - The entity's outsourcing arrangements (paragraphs 17-18).

   Each of these is discussed below.

AUDITING

[6] See footnote 3.

The Entity's Business Activities and Industry

10. E-commerce activities may be complementary to an entity's traditional business activity. For example, the entity may use the Internet to sell conventional products (such as books or CDs), delivered by conventional methods from a contract executed on the Internet. In contrast, e-commerce may represent a new line of business and the entity may use its website to both sell and deliver digital products via the Internet.

11. The Internet lacks the clear, fixed geographic lines of transit that traditionally have characterized the physical trade of many goods and services. In many cases, particularly where goods or services can be delivered via the Internet, e-commerce has been able to reduce or eliminate many of the limitations imposed by time and distance.

12. Certain industries are more conducive to the use of e-commerce, therefore e-commerce in these industries is in a more mature phase of development. When an entity's industry has been significantly influenced by e-commerce over the Internet, business risks that may affect the financial statements may be greater. Examples of industries that are being transformed by e-commerce include:

    - Computer software;
    - Securities trading;
    - Banking;
    - Travel services;
    - Books and magazines;
    - Recorded music;
    - Advertising;
    - News media; and
    - Education.

    In addition many other industries, in all business sectors, have been significantly affected by e-commerce.

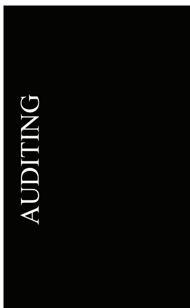
The Entity's E-commerce Strategy

13. The entity's e-commerce strategy, including the way it uses IT for e-commerce and its assessment of acceptable risk levels, may affect the security of the financial records and the completeness and reliability of the financial information produced. Matters that may be relevant to the auditor when considering the entity's e-commerce strategy in the context of the auditor's understanding of the control environment, include:

- Involvement of those charged with governance in considering the alignment of e-commerce activities with the entity's overall business strategy;
- Whether e-commerce supports a new activity for the entity, or whether it is intended to make existing activities more efficient or reach new markets for existing activities;
- Sources of revenue for the entity and how these are changing (for example, whether the entity will be acting as a principal or agent for goods or services sold);
- Management's evaluation of how e-commerce affects the earnings of the entity and its financial requirements;
- Management's attitude to risk and how this may affect the risk profile of the entity;
- The extent to which management has identified e-commerce opportunities and risks in a documented strategy that is supported by appropriate controls, or whether e-commerce is subject to ad hoc development responding to opportunities and risks as they arise; and
- Management's commitment to relevant codes of best practice or web seal programs.

The Extent of the Entity's E-commerce Activities

14. Different entities use e-commerce in different ways. For example, e-commerce might be used to:
    - Provide only information about the entity and its activities, which can be accessed by third parties such as investors, customers, suppliers, finance providers, and employees;
    - Facilitate transactions with established customers whereby transactions are entered via the Internet;
    - Gain access to new markets and new customers by providing information and transaction processing via the Internet;
    - Access Application Service Providers (ASPs); and
    - Create an entirely new business model.



15. The extent of e-commerce use affects the nature of risks to be addressed by the entity. Security issues may arise whenever the entity has a website. Even if there is no third party interactive access, information-only pages can provide an access point to the entity's financial records. The security infrastructure and related controls can be expected to be more extensive

where the website is used for transacting with business partners, or where systems are highly integrated (see paragraphs 32-34).

16. As an entity becomes more involved with e-commerce, and as its internal systems become more integrated and complex, it becomes more likely that new ways of transacting business will differ from traditional forms of business activity and will introduce new types of risks.

The Entity's Outsourcing Arrangements

17. Many entities do not have the technical expertise to establish and operate in-house systems needed to undertake e-commerce. These entities may depend on service organizations such as Internet Service Providers (ISPs), Application Service Providers (ASPs) and data hosting companies to provide many or all of the IT requirements of e-commerce. The entity may also use service organizations for various other functions in relation to its e-commerce activities such as order fulfillment, delivery of goods, operation of call centers and certain accounting functions.

18. When the entity uses a service organization, certain policies, procedures and records maintained by the service organization may be relevant to the audit of the entity's financial statements. The auditor considers the outsourcing arrangements used by the entity to identify how the entity responds to risks arising from the outsourced activities. ISA 402, "Audit Considerations Relating to Entities Using Service Organizations" provides guidance on assessing the effect that the service entity has on control risk.

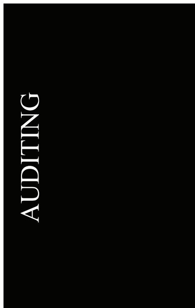
Risk Identification

19. Management faces many business risks relating to the entity's e-commerce activities, including:

    - Loss of transaction integrity, the effects of which may be compounded by the lack of an adequate audit trail in either paper or electronic form;
    - Pervasive e-commerce security risks, including virus attacks and the potential for the entity to suffer fraud by customers, employees and others through unauthorized access;
    - Improper accounting policies related to, for example, capitalization of expenditures such as website development costs, misunderstanding of complex contractual arrangements, title transfer risks, translation of foreign currencies, allowances for warranties or returns, and revenue recognition issues such as:
        - Whether the entity is acting as principal or agent and whether gross sales or commission only are to be recognized;

    - If other entities are given advertising space on the entity's website, how revenues are determined and settled (for example, by the use of barter transactions);
    - The treatment of volume discounts and introductory offers (for example, free goods worth a certain amount); and
    - Cut off (for example, whether sales are only recognized when goods and services have been supplied);
- Noncompliance with taxation and other legal and regulatory requirements, particularly when Internet e-commerce transactions are conducted across international boundaries;
- Failure to ensure that contracts evidenced only by electronic means are binding;
- Over reliance on e-commerce when placing significant business systems or other business transactions on the Internet; and
- Systems and infrastructure failures or "crashes."

20. The entity addresses certain business risks arising in e-commerce through the implementation of an appropriate security infrastructure and related controls, which generally include measures to:
    - Verify the identity of customers and suppliers;
    - Ensure the integrity of transactions;
    - Obtain agreement on terms of trade, including agreement of delivery and credit terms and dispute resolution processes, which may address tracking of transactions and procedures to ensure a party to a transaction cannot later deny having agreed to specified terms (non-repudiation procedures);
    - Obtain payment from, or secure credit facilities for, customers; and
    - Establish privacy and information protection protocols.



21. The auditor uses the knowledge of the business obtained to identify those events, transactions and practices related to business risks arising from the entity's e-commerce activities that, in the auditor's judgment, may result in a material misstatement of the financial statements or have a significant effect on the auditor's procedures or the auditor's report.

Legal and Regulatory Issues

22. A comprehensive international legal framework for e-commerce and an efficient infrastructure to support such a framework (electronic signatures, document registries, dispute mechanisms, consumer protection, etc.) does not yet exist. Legal frameworks in different jurisdictions vary in their

recognition of e-commerce. Nonetheless, management needs to consider legal and regulatory issues related to the entity's e-commerce activities, for example, whether the entity has adequate mechanisms for recognition of taxation liabilities, particularly sales or value-added taxes, in various jurisdictions. Factors that may give rise to taxes on e-commerce transactions include the place where:

- The entity is legally registered;
- Its physical operations are based;
- Its web server is located;
- Goods and services are supplied from; and
- Its customers are located or goods and services are delivered.

These may all be in different jurisdictions. This may give rise to a risk that taxes due on cross-jurisdictional transactions are not appropriately recognized.

23. Legal or regulatory issues that may be particularly relevant in an e-commerce environment include:

- Adherence to national and international privacy requirements;
- Adherence to national and international requirements for regulated industries;
- The enforceability of contracts;
- The legality of particular activities, for example Internet gambling;
- The risk of money laundering; and
- Violation of intellectual property rights.

24. ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" requires that when planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. ISA 250 also requires that, in order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework. That framework may, in the particular circumstances of the entity, include certain legal and regulatory issues related to its e-commerce activities. While ISA 250 recognizes that an audit cannot be expected to detect noncompliance with all laws and regulations, the auditor is specifically required to perform procedures to help identify instances of noncompliance with those laws and regulations where noncompliance should be considered when preparing financial statements. When a legal or regulatory issue arises that, in the auditor's

judgment, may result in a material misstatement of the financial statements or have a significant effect on the auditor's procedures or the auditor's report, the auditor considers management's response to the issue. In some cases, the advice of a lawyer with particular expertise in e-commerce issues may be necessary when considering legal and regulatory issues arising from an entity's e-commerce activity.

Internal Control Considerations

25. Internal controls can be used to mitigate many of the risks associated with e-commerce activities. In accordance with ISA 400[7] the auditor considers the control environment and control procedures the entity has applied to its e-commerce activities to the extent they are relevant to the financial statement assertions. In some circumstances, for example when electronic commerce systems are highly automated, when transaction volumes are high, or when electronic evidence comprising the audit trail is not retained, the auditor may determine that it is not possible to reduce audit risk to an acceptably low level by using only substantive procedures. CAATs are often used in such circumstances (refer to IAPS 1009, "Computer-Assisted Audit Techniques"[8]).

26. As well as addressing security, transaction integrity and process alignment, as discussed below, the following aspects of internal control are particularly relevant when the entity engages in e-commerce:

    - Maintaining the integrity of control procedures in the quickly changing e-commerce environment; and
    - Ensuring access to relevant records for the entity's needs and for audit purposes.

Security

27. The entity's security infrastructure and related controls are a particularly important feature of its internal control system when external parties are able to access the entity's information system using a public network such as the Internet. Information is secure to the extent that the requirements for its authorization, authenticity, confidentiality, integrity, non-repudiation and availability have been satisfied.

28. The entity will ordinarily address security risks related to the recording and processing of e-commerce transactions through its security infrastructure and related controls. The security infrastructure and related controls may include an information security policy, an information security risk

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[7] See footnote 4.

[8] IAPS 1009, "Computer-Assisted Audit Techniques" was withdrawn in December 2004.

assessment, and standards, measures, practices, and procedures within which individual systems are introduced and maintained, including both physical measures and logical and other technical safeguards such as user identifiers, passwords and firewalls. To the extent they are relevant to the financial statement assertions the auditor considers such matters as:

- The effective use of firewalls and virus protection software to protect its systems from the introduction of unauthorized or harmful software, data or other material in electronic form;
- The effective use of encryption, including both:
  - Maintaining the privacy and security of transmissions through, for example, authorization of decryption keys; and
  - Preventing the misuse of encryption technology through, for example, controlling and safeguarding private decryption keys;
- Controls over the development and implementation of systems used to support e-commerce activities;
- Whether security controls in place continue to be effective as new technologies that can be used to attack Internet security become available; and
- Whether the control environment supports the control procedures implemented. For example, while some control procedures, such as digital certificate-based encryption systems, can be technically advanced, they may not be effective if they operate within an inadequate control environment.

Transaction Integrity

29. The auditor considers the completeness, accuracy, timeliness and authorization of information provided for recording and processing in the entity's financial records (transaction integrity). The nature and the level of sophistication of an entity's e-commerce activities influence the nature and extent of risks related to the recording and processing of e-commerce transactions.

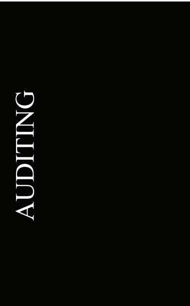
30. Audit procedures regarding the integrity of information in the accounting system relating to e-commerce transactions are largely concerned with evaluating the reliability of the systems in use for capturing and processing such information. In a sophisticated system, the originating action, for example receipt of a customer order over the Internet, will automatically initiate all other steps in processing the transaction. Therefore, in contrast to audit procedures for traditional business activities, which ordinarily focus separately on control processes relating to each stage of transaction capture and processing, audit procedures for sophisticated e-commerce often focus

on automated controls that relate to the integrity of transactions as they are captured and then immediately and automatically processed.

31. In an e-commerce environment, controls relating to transaction integrity are often designed to, for example:

- Validate input;
- Prevent duplication or omission of transactions;
- Ensure the terms of trade have been agreed before an order is processed, including delivery and credit terms, which may require, for example, that payment is obtained when an order is placed;
- Distinguish between customer browsing and orders placed, ensure a party to a transaction cannot later deny having agreed to specified terms (non-repudiation), and ensure transactions are with approved parties when appropriate;
- Prevent incomplete processing by ensuring all steps are completed and recorded (for example, for a business to consumer transaction: order accepted, payment received, goods/services delivered and accounting system updated) or if all steps are not completed and recorded, by rejecting the order;
- Ensure the proper distribution of transaction details across multiple systems in a network (for example, when data is collected centrally and is communicated to various resource managers to execute the transaction); and
- Ensure records are properly retained, backed-up and secured.

Process Alignment



32. Process alignment refers to the way various IT systems are integrated with one another and thus operate, in effect, as one system. In the e-commerce environment, it is important that transactions generated from an entity's website are processed properly by the entity's internal systems, such as the accounting system, customer relationship management systems and inventory management systems (often known as "back office" systems). Many websites are not automatically integrated with internal systems.

33. The way e-commerce transactions are captured and transferred to the entity's accounting system may affect such matters as:

- The completeness and accuracy of transaction processing and information storage;
- The timing of the recognition of sales revenues, purchases and other transactions; and

- Identification and recording of disputed transactions.

34. When it is relevant to the financial statement assertions, the auditor considers the controls governing the integration of e-commerce transactions with internal systems, and the controls over systems changes and data conversion to automate process alignment.

The Effect of Electronic Records on Audit Evidence

35. There may not be any paper records for e-commerce transactions, and electronic records may be more easily destroyed or altered than paper records without leaving evidence of such destruction or alteration. The auditor considers whether the entity's security of information policies, and security controls as implemented, are adequate to prevent unauthorized changes to the accounting system or records, or to systems that provide data to the accounting system.

36. The auditor may test automated controls, such as record integrity checks, electronic date stamps, digital signatures, and version controls when considering the integrity of electronic evidence. Depending on the auditor's assessment of these controls, the auditor may also consider the need to perform additional procedures such as confirming transaction details or account balances with third parties (refer to ISA 505, "External Confirmations").

INTERNATIONAL AUDITING PRACTICE STATEMENT 1014

REPORTING BY AUDITORS ON COMPLIANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS

(This Statement is effective)

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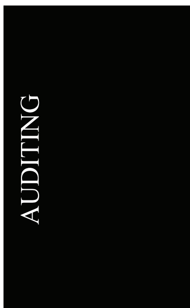
International Auditing Practice Statement (IAPS) 1014, "Reporting by Auditors on Compliance with Financial Reporting Standards" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of IAPSs.

This IAPS is issued as a supplement to ISA 700, "The Auditor's Report on Financial Statements."[1] It does not establish any new basic principles or essential procedures. Its purpose is to assist auditors, and the development of good practice, by providing guidance on the application of ISA 700 in cases when financial statements are prepared using International Financial Reporting Standards (IFRSs) or include a reference to IFRSs. The extent to which any of the guidance described in this IAPS may be appropriate in a particular case requires the exercise of the auditor's judgment in the light of the requirements of ISA 700 and the circumstances of the entity.

The IAASB approved this IAPS in March 2003 for publication on June 1, 2003.



[1] ISA 700, "The Auditor's Report on Financial Statements" was withdrawn in December 2006 when ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" and ISA 701, "Modifications to the Independent Auditor's Report" became effective.

Introduction

1. ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" states that 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. ISA 700, "The Auditor's Report on Financial Statements"[2] establishes standards and provides guidance on the form and content of the auditor's report. In particular, paragraph 17 of ISA 700 requires that the auditor's report clearly indicate the financial reporting framework used to prepare the financial statements. The purpose of this International Auditing Practice Statement (IAPS) is to provide additional guidance when the auditor expresses an opinion on financial statements that are asserted by management to be prepared:

   (a) Solely in accordance with International Financial Reporting Standards (IFRSs);

   (b) In accordance with IFRSs and a national financial reporting framework; or

   (c) In accordance with a national financial reporting framework with disclosure of the extent of compliance with IFRSs.

   The guidance provided in this IAPS may be applied, adapted as necessary, to reporting on whether financial statements have been prepared in accordance with financial reporting frameworks other than IFRSs (for example, financial statements that are asserted by management to be prepared in accordance with two different national financial reporting frameworks). This IAPS does not establish any new requirements for the audit of financial statements, nor does it establish any exemptions from the requirements of ISA 700.

Financial Statements Prepared Solely in Accordance with International Financial Reporting Standards

2. Examples have arisen of entities stating that their financial statements have been prepared in accordance with IFRSs when, in fact, they have not complied with all the requirements that IFRSs impose. International Accounting Standard (IAS) 1, "Presentation of Financial Statements" sets out the requirements to be met before an entity's financial statements can be regarded as having been prepared in accordance with IFRSs. In particular, it makes clear that financial statements should not be described as complying with IFRSs unless they comply with all the requirements of IFRSs. Examples such as the following descriptions of the basis on which the

[2] See footnote 1.

financial statements have been prepared illustrate financial statements that have not been prepared in accordance with IFRSs:

- The financial statements indicate that they have been prepared in accordance with IFRSs but then go on to specify certain material departures. For example, a note describing the accounting polices used states that the financial statements are prepared in accordance with IFRSs except for the non-disclosure of sales for geographical segments.
- The financial statements identify specific IFRS requirements that the entity uses to prepare the financial statements, but these do not include all the requirements that are applicable to an entity fully complying with IFRSs.
- The financial statements indicate partial compliance with IFRSs without reference to specific departures. For example, a note describing the accounting policies used states that the financial statements are "based on," or "comply with the significant requirements of" or "are in compliance with the accounting requirements of" IFRSs.

3. An unqualified opinion may be expressed only when the auditor is able to conclude that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework. In all other circumstances, the auditor is required to disclaim an opinion or to issue a qualified or adverse opinion depending on the nature of the circumstances. Accordingly, the auditor does not express an unqualified opinion that indicates that financial statements have been prepared in accordance with IFRSs if the financial statements contain any departure from IFRSs and the departure has a material effect on the financial statements.[3] When the auditor reports on whether the financial statements have been prepared in accordance with IFRSs and the financial statements contain a material departure from IFRSs, such a departure results in a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. Paragraphs 36-40 of ISA 700[4] provide guidance for deciding whether a qualified opinion or an

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[3] International Accounting Standards (IAS) 1, "Presentation of Financial Statements" states that in the extremely rare circumstances in which management concludes that compliance with a requirement in a Standard or an Interpretation would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, the entity shall depart from that requirement in the manner set out in IAS 1 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure. A departure from the requirements of a particular International Financial Reporting Standard (IFRS) made under the provisions of IAS 1 does not constitute a departure from IFRSs for this purpose.

[4] See footnote 1.

adverse opinion is necessary and on the information to be included in the auditor's report.

4. If the auditor's report contains any qualifying or limiting language when describing the financial reporting framework, it does not meet the requirement in paragraph 17 of ISA 700 that the auditor's report clearly indicate the financial reporting framework used to prepare the financial statements. For example, an opinion paragraph that indicates "the financial statements give a true and fair view and are in substantial compliance with International Financial Reporting Standards" does not meet the requirements of ISA 700.

Financial Statements Prepared in Accordance with International Financial Reporting Standards and a National Financial Reporting Framework

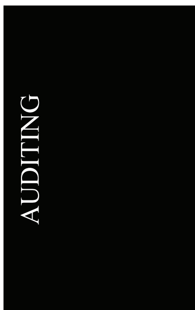
5. A note describing the accounting polices used may state that the financial statements have been prepared in accordance with both IFRSs and a national financial reporting framework. For financial statements to have been prepared in accordance with more than one financial reporting framework, they must comply with each of the indicated frameworks individually. A set of financial statements that has been prepared in accordance with one financial reporting framework and that contains a note or supplementary statement reconciling the results to those that would be shown under another financial reporting framework has not been prepared in accordance with that other framework. This is because the financial statements do not include all the information in the manner required by that other framework. The financial statements must comply with both financial reporting frameworks simultaneously and without any need for reconciling statements if they are to be regarded as having been prepared in accordance with both. In practice, simultaneous compliance with both IFRSs and a national financial reporting framework is unlikely unless the country has adopted IFRSs as its national financial reporting framework or has eliminated all barriers for compliance with IFRSs.

6. It is helpful for the auditor to discuss financial statements that state they have been prepared in accordance with IFRSs and a national financial reporting framework with management and those charged with governance. The purpose of the discussion is to advise management and those charged with governance of the possibility of a qualified opinion or adverse opinion on compliance with one or both of the financial reporting frameworks, given that the ability to simultaneously comply fully with IFRSs and a national financial reporting framework is unlikely. In these situations, the auditor encourages management to prepare the financial statements in accordance with only one financial reporting framework, taking into consideration any requirements of relevant laws and regulations. The

auditor's report is then worded in terms of whether the financial statements have been prepared in accordance with that financial reporting framework.

7. If management insists on indicating that the financial statements have been prepared in accordance with both IFRSs and a national financial reporting framework, the auditor's report refers to both frameworks. However, the auditor considers each financial reporting framework separately. If a matter results in failure to comply with one of the frameworks, but does not cause a failure to comply with the other framework, then the auditor expresses an unqualified opinion on compliance with that framework and a qualified opinion or an adverse opinion on compliance with the one framework. If the auditor is of the opinion that the failure to comply with one of the financial reporting frameworks causes the financial statements to fail to comply with the other financial reporting framework, the auditor issues a qualified opinion or adverse opinion on compliance with both frameworks. An illustration of an auditor's report where the auditor is of the opinion that the financial statements comply, in all material respects, with the national financial reporting framework, but judges a qualified opinion is appropriate for compliance with IFRSs follows:

> "Note X to the financial statements indicates that the financial statements have been prepared in accordance with [relevant national financial reporting framework] and International Financial Reporting Standards. As discussed in Note Y to the financial statements, the Company has investment properties in the amount of $X that are carried at cost less accumulated depreciation. This accounting is required by [relevant national financial reporting framework] and permitted by International Financial Reporting Standards. The fair value of these investment properties of $X has not been disclosed. Such disclosure is not required by [relevant national financial reporting framework], but is required by International Financial Reporting Standards.
>
> In our opinion, the financial statements give a true and fair view of (or 'present fairly, in all material respects') the financial position of the Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with [title of national financial reporting framework with reference to the country of origin] (and comply with [refer to relevant statutes or law]), and, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view of (or 'present fairly, in all material respects') the financial position of the Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards."



Financial Statements Prepared in Accordance with a National Financial Reporting Framework with Disclosure of the Extent of Compliance with International Financial Reporting Standards

8. Entities that prepare their financial statements in accordance with a national financial reporting framework may disclose additionally, in the notes to those financial statements, the extent to which they comply with IFRSs. Management may, for example, consider such additional disclosures to be desirable when the entity is required to comply with IFRSs at a future date and management wishes to provide readers of the financial statements with an indication of progress towards that compliance. In these circumstances, the auditor considers whether assertions made in the notes to the financial statements with respect to the extent of such compliance are accurate and not misleading. The auditor then considers the effect of that disclosure on the auditor's report.

9. A note to the financial statements containing disclosure about compliance with IFRSs is treated no differently from any other note to the financial statements. All such notes contain management assertions and the auditor obtains sufficient appropriate audit evidence to support the assertions. If the note contains a reference to compliance with IFRSs, the auditor considers whether the note is appropriate. In some cases, the auditor may conclude that the note contains misleading information such that the financial statements fail to comply with the national financial reporting framework. This is likely to be the case in circumstances where the reference to compliance with IFRSs misleads readers of the financial statements because it contains materially inaccurate information or incomplete information that is material and pervasive to the financial statements (for example, the lack of compliance with a particular IFRS that is material and pervasive to the financial statements may result in the disclosure being misleading, unless there is adequate disclosure, including quantification of the effects on the financial statements).

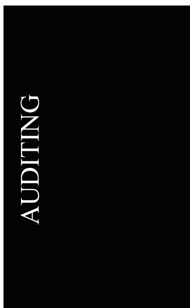
10. If the financial statements fail to comply with the national financial reporting framework because the disclosures as to the compliance with IFRSs are misleading, the auditor's report expresses a qualified or an adverse opinion. An illustration of a qualified opinion that may be given in such circumstances follows:

    > "Note X to the financial statements indicates that the financial statements have been prepared in accordance with [relevant national financial reporting framework] and are in accordance with International Financial Reporting Standards (IFRSs) except that they do not comply with IAS 39, 'Financial Instruments: Recognition and Measurement.' Because the effect on the Company's financial statements of noncompliance with IAS 39 is

material and pervasive, the reference to compliance with IFRSs is considered misleading.

In our opinion, except for the inclusion of the reference to compliance with IFRSs, the financial statements give a true and fair view of (or 'present fairly, in all material respects') the financial position of the Company as of December 31, 20X1, and of it financial performance and its cash flows for the year then ended in accordance with [title of national financial reporting framework with reference to the country of origin] (and comply with [refer to relevant statutes or law])."

11. A note to the financial statements containing disclosure about compliance with IFRSs may not contain misleading information such that the financial statements fail to comply with the national financial reporting framework. If the auditor is of the opinion that a reference to compliance with IFRSs is not misleading, the auditor may express an unqualified opinion on compliance with the national financial reporting framework. In certain circumstances, the auditor may decide to modify the auditor's report by adding an emphasis of matter paragraph to highlight the note that references compliance with IFRSs.[5] The use of an emphasis of matter paragraph is not a substitute for issuing a qualified opinion or adverse opinion on compliance with the national financial reporting framework when disclosures as to compliance with IFRSs are misleading such that the financial statements fail to comply with the national financial reporting framework.



[5] ISA 701, "Modifications to the Independent Auditor's Report" provides additional guidance on the use of an emphasis of matter paragraph.

INTERNATIONAL STANDARD ON REVIEW ENGAGEMENTS 2400

(Previously ISA 910)

ENGAGEMENTS TO REVIEW FINANCIAL STATEMENTS

(Effective for reviews of financial statements for periods beginning on or after December 15, 2006)*

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* ISRE 2410, "Review of Interim Financial Information Performed by the Independent Practitioner of the Entity" gave rise to conforming amendments to ISRE 2400. These amendments are effective for reviews of financial statements for periods beginning on or after December 15, 2006 and have been incorporated in the text of this ISRE.

Paragraph 2 of this ISRE was amended in December 2007 to clarify the application of the ISRE.

International Standard on Review Engagements (ISRE) 2400, "Engagements to Review Financial Statements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISREs.

Introduction

1. The purpose of this International Standard on Review Engagements (ISRE) is to establish standards and provide guidance on the practitioner's professional responsibilities when a practitioner, who is not the auditor of an entity, undertakes an engagement to review financial statements and on the form and content of the report that the practitioner issues in connection with such a review. A practitioner, who is the auditor of the entity, engaged to perform a review of interim financial information performs such a review in accordance with ISRE 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity."

2. This ISRE is directed towards the review of financial statements. However, it is to be applied, adapted as necessary in the circumstances, to engagements to review other historical financial information. Guidance in the International Standard on Auditing (ISAs) may be useful to the practitioner in applying this ISRE.

Objective of a Review Engagement

3. **The objective of a review of financial statements is to enable a practitioner to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework (negative assurance).**

General Principles of a Review Engagement

4. **The practitioner should comply with the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants.** Ethical principles governing the practitioner's professional responsibilities are:

   (a) Independence;

   (b) Integrity;

   (c) Objectivity;

   (d) Professional competence and due care;

   (e) Confidentiality;

   (f) Professional behavior; and

   (g) Technical standards.

5. **The practitioner should conduct a review in accordance with this ISRE.**

6. **The practitioner should plan and perform the review with an attitude of professional skepticism recognizing that circumstances may exist which cause the financial statements to be materially misstated.**

7. **For the purpose of expressing negative assurance in the review report, the practitioner should obtain sufficient appropriate evidence primarily through inquiry and analytical procedures to be able to draw conclusions.**

Scope of a Review

8. The term "scope of a review" refers to the review procedures deemed necessary in the circumstances to achieve the objective of the review. **The procedures required to conduct a review of financial statements should be determined by the practitioner having regard to the requirements of this ISRE, relevant professional bodies, legislation, regulation and, where appropriate, the terms of the review engagement and reporting requirements.**

Moderate Assurance

9. A review engagement provides a moderate level of assurance that the information subject to review is free of material misstatement, this is expressed in the form of negative assurance.

Terms of Engagement

10. **The practitioner and the client should agree on the terms of the engagement.** The agreed terms would be recorded in an engagement letter or other suitable form such as a contract.

11. An engagement letter will be of assistance in planning the review work. It is in the interests of both the practitioner and the client that the practitioner sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the practitioner's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the practitioner's responsibilities and the form of reports to be issued.

12. Matters that would be included in the engagement letter include the following:
    - The objective of the service being performed.
    - Management's responsibility for the financial statements.
    - The scope of the review, including reference to this ISRE (or relevant national standards or practices).

- Unrestricted access to whatever records, documentation and other information requested in connection with the review.
- A sample of the report expected to be rendered.
- The fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist.
- A statement that an audit is not being performed and that an audit opinion will not be expressed. To emphasize this point and to avoid confusion, the practitioner may also consider pointing out that a review engagement will not satisfy any statutory or third party requirements for an audit.

An example of an engagement letter for a review of financial statements appears in Appendix 1 to this ISRE.

Planning

13. **The practitioner should plan the work so that an effective engagement will be performed.**

14. **In planning a review of financial statements, the practitioner should obtain or update the knowledge of the business including consideration of the entity's organization, accounting systems, operating characteristics and the nature of its assets, liabilities, revenues and expenses.**

15. The practitioner needs to possess an understanding of such matters and other matters relevant to the financial statements, for example, a knowledge of the entity's production and distribution methods, product lines, operating locations and related parties. The practitioner requires this understanding to be able to make relevant inquiries and to design appropriate procedures, as well as to assess the responses and other information obtained.

Work Performed by Others

16. **When using work performed by another practitioner or an expert, the practitioner should be satisfied that such work is adequate for the purposes of the review.**

Documentation

17. **The practitioner should document matters which are important in providing evidence to support the review report, and evidence that the review was carried out in accordance with this ISRE.**

Procedures and Evidence

18. **The practitioner should apply judgment in determining the specific nature, timing and extent of review procedures**. The practitioner will be guided by such matters as the following:

    - Any knowledge acquired by carrying out audits or reviews of the financial statements for prior periods.
    - The practitioner's knowledge of the business including knowledge of the accounting principles and practices of the industry in which the entity operates.
    - The entity's accounting systems.
    - The extent to which a particular item is affected by management judgment.
    - The materiality of transactions and account balances.

19. **The practitioner should apply the same materiality considerations as would be applied if an audit opinion on the financial statements were being given.** Although there is a greater risk that misstatements will not be detected in a review than in an audit, the judgment as to what is material is made by reference to the information on which the practitioner is reporting and the needs of those relying on that information, not to the level of assurance provided.

20. Procedures for the review of financial statements will ordinarily include the following:

    - Obtaining an understanding of the entity's business and the industry in which it operates.
    - Inquiries concerning the entity's accounting principles and practices.
    - Inquiries concerning the entity's procedures for recording, classifying and summarizing transactions, accumulating information for disclosure in the financial statements and preparing financial statements.
    - Inquiries concerning all material assertions in the financial statements.
    - Analytical procedures designed to identify relationships and individual items that appear unusual. Such procedures would include:
        - Comparison of the financial statements with statements for prior periods.
        - Comparison of the financial statements with anticipated results and financial position.

    - Study of the relationships of the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience or industry norm.

  In applying these procedures, the practitioner would consider the types of matters that required accounting adjustments in prior periods.

- Inquiries concerning actions taken at meetings of shareholders, the board of directors, committees of the board of directors and other meetings that may affect the financial statements.
- Reading the financial statements to consider, on the basis of information coming to the practitioner's attention, whether the financial statements appear to conform with the basis of accounting indicated.
- Obtaining reports from other practitioners, if any and if considered necessary, who have been engaged to audit or review the financial statements of components of the entity.
- Inquiries of persons having responsibility for financial and accounting matters concerning, for example:
    - Whether all transactions have been recorded.
    - Whether the financial statements have been prepared in accordance with the basis of accounting indicated.
    - Changes in the entity's business activities and accounting principles and practices.
    - Matters as to which questions have arisen in the course of applying the foregoing procedures.
    - Obtaining written representations from management when considered appropriate.

Appendix 2 to this ISRE provides an illustrative list of procedures which are often used. The list is not exhaustive, nor is it intended that all the procedures suggested apply to every review engagement.

21. **The practitioner should inquire about events subsequent to the date of the financial statements that may require adjustment of or disclosure in the financial statements.** The practitioner does not have any responsibility to perform procedures to identify events occurring after the date of the review report.

22. **If the practitioner has reason to believe that the information subject to review may be materially misstated, the practitioner should carry out additional or more extensive procedures as are necessary to be able to express negative assurance or to confirm that a modified report is required.**

Conclusions and Reporting

23. **The review report should contain a clear written expression of negative assurance. The practitioner should review and assess the conclusions drawn from the evidence obtained as the basis for the expression of negative assurance.**

24. **Based on the work performed, the practitioner should assess whether any information obtained during the review indicates that the financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with the applicable financial reporting framework.**

25. The report on a review of financial statements describes the scope of the engagement to enable the reader to understand the nature of the work performed and make it clear that an audit was not performed and, therefore, that an audit opinion is not expressed.

26. **The report on a review of financial statements should contain the following basic elements, ordinarily in the following layout:**

    (a) **Title;** [2]

    (b) **Addressee;**

    (c) **Opening or introductory paragraph including:**

    - (i) **Identification of the financial statements on which the review has been performed; and**
    - (ii) **A statement of the responsibility of the entity's management and the responsibility of the practitioner;**

    (d) **Scope paragraph, describing the nature of a review, including:**

    - (i) **A reference to this ISRE applicable to review engagements, or to relevant national standards or practices;**
    - (ii) **A statement that a review is limited primarily to inquiries and analytical procedures; and**
    - (iii) **A statement that an audit has not been performed, that the procedures undertaken provide less assurance than an audit and that an audit opinion is not expressed;**

    (e) **Statement of negative assurance;**

    (f) **Date of the report;**

REVIEW

[2] It may be appropriate to use the term "independent" in the title to distinguish the practitioner's report from reports that might be issued by others, such as officers of the entity, or from the reports of other practitioners who may not have to abide by the same ethical requirements as an independent practitioner.

(g) **Practitioner's address; and**

(h) **Practitioner's signature.**

Appendices 3 and 4 to this ISRE contain illustrations of review reports.

27. **The review report should:**

(a) **State that nothing has come to the practitioner's attention based on the review that causes the practitioner to believe the financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with the applicable financial reporting framework (negative assurance); or**

(b) **If matters have come to the practitioner's attention, describe those matters that impair a true and fair view (or a fair presentation, in all material respects) in accordance with the applicable financial reporting framework, including, unless impracticable, a quantification of the possible effect(s) on the financial statements, and either:**

(i) **Express a qualification of the negative assurance provided; or**

(ii) **When the effect of the matter is so material and pervasive to the financial statements that the practitioner concludes that a qualification is not adequate to disclose the misleading or incomplete nature of the financial statements, give an adverse statement that the financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with the applicable financial reporting framework; or**

(c) **If there has been a material scope limitation, describe the limitation and either:**

(i) **Express a qualification of the negative assurance provided regarding the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed; or**

(ii) **When the possible effect of the limitation is so significant and pervasive that the practitioner concludes that no level of assurance can be provided, not provide any assurance.**

28. **The practitioner should date the review report as of the date the review is completed, which includes performing procedures relating to events occurring up to the date of the report. However, since the practitioner's responsibility is to report on the financial statements as prepared and presented by management, the practitioner should not date the review**

report earlier than the date on which the financial statements were approved by management.

Appendix 1

Example of an Engagement Letter for a Review of Financial Statements

The following letter is for use as a guide in conjunction with the consideration outlined in paragraph 10 of this ISRE and will need to be varied according to individual requirements and circumstances.

To the Board of Directors (or the appropriate representative of senior management):

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will review the balance sheet of ABC Company as of December 31, 19XX, and the related statements of income and cash flows for the year then ended, in accordance with the International Standard on Review Engagements (ISRE) 2400 (or refer to relevant national standards or practices applicable to reviews). We will not perform an audit of such financial statements and, accordingly, we will not express an audit opinion on them. Accordingly, we expect to report on the financial statements as follows:

(see Appendix 3 to this ISRE)

Responsibility for the financial statements, including adequate disclosure, is that of the management of the company. This includes the maintenance of adequate accounting records and internal controls and the selection and application of accounting policies. (As part of our review process, we will request written representations from management concerning assertions made in connection with the review.[3])

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

Our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we will inform you of any material matters that come to our attention.

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

XYZ & Co

Acknowledged on behalf of ABC Company by

(signed)
....

Name and Title
Date

[3] This sentence should be used at the discretion of the practitioner.

Appendix 2

Illustrative Detailed Procedures that may be Performed in an Engagement to Review Financial Statements

1. The inquiry and analytical review procedures carried out in a review of financial statements are determined by the practitioner's judgment. The procedures listed below are for illustrative purposes only. It is not intended that all the procedures suggested apply to every review engagement. This Appendix is not intended to serve as a program or checklist in the conduct of a review.

General

2. Discuss terms and scope of the engagement with the client and the engagement team.
3. Prepare an engagement letter setting forth the terms and scope of the engagement.
4. Obtain an understanding of the entity's business activities and the system for recording financial information and preparing financial statements.
5. Inquire whether all financial information is recorded:
   (a) Completely;
   (b) Promptly; and
   (c) After the necessary authorization.
6. Obtain the trial balance and determine whether it agrees with the general ledger and the financial statements.
7. Consider the results of previous audits and review engagements, including accounting adjustments required.
8. Inquire whether there have been any significant changes in the entity from the previous year (e.g., changes in ownership or changes in capital structure).
9. Inquire about the accounting policies and consider whether:
   (a) They comply with local or international standards;
   (b) They have been applied appropriately; and
   (c) They have been applied consistently and, if not, consider whether disclosure has been made of any changes in the accounting policies.
10. Read the minutes of meetings of shareholders, the board of directors and other appropriate committees in order to identify matters that could be important to the review.

11. Inquire if actions taken at shareholder, board of directors or comparable meetings that affect the financial statements have been appropriately reflected therein.

12. Inquire about the existence of transactions with related parties, how such transactions have been accounted for and whether related parties have been properly disclosed.

13. Inquire about contingencies and commitments.

14. Inquire about plans to dispose of major assets or business segments.

15. Obtain the financial statements and discuss them with management.

16. Consider the adequacy of disclosure in the financial statements and their suitability as to classification and presentation.

17. Compare the results shown in the current period financial statements with those shown in financial statements for comparable prior periods and, if available, with budgets and forecasts.

18. Obtain explanations from management for any unusual fluctuations or inconsistencies in the financial statements.

19. Consider the effect of any unadjusted errors – individually and in aggregate. Bring the errors to the attention of management and determine how the unadjusted errors will influence the report on the review.

20. Consider obtaining a representation letter from management.

Cash

21. Obtain the bank reconciliations. Inquire about any old or unusual reconciling items with client personnel.

22. Inquire about transfers between cash accounts for the period before and after the review date.

23. Inquire whether there are any restrictions on cash accounts.

Receivables

24. Inquire about the accounting policies for initially recording trade receivables and determine whether any allowances are given on such transactions.

25. Obtain a schedule of receivables and determine whether the total agrees with the trial balance.

26. Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.

27. Obtain an aged analysis of the trade receivables. Inquire about the reason for unusually large accounts, credit balances on accounts or any other unusual balances and inquire about the collectibility of receivables.

28. Discuss with management the classification of receivables, including noncurrent balances, net credit balances and amounts due from shareholders, directors and other related parties in the financial statements.

29. Inquire about the method for identifying "slow payment" accounts and setting allowances for doubtful accounts and consider it for reasonableness.

30. Inquire whether receivables have been pledged, factored or discounted.

31. Inquire about procedures applied to ensure that a proper cutoff of sales transactions and sales returns has been achieved.

32. Inquire whether accounts represent goods shipped on consignment and, if so, whether adjustments have been made to reverse these transactions and include the goods in inventory.

33. Inquire whether any large credits relating to revenue recorded have been issued after the balance sheet date and whether provision has been made for such amounts.

Inventories

34. Obtain the inventory list and determine whether:

    (a) The total agrees with the balance in the trial balance; and

    (b) The list is based on a physical count of inventory.

35. Inquire about the method for counting inventory.

36. Where a physical count was not carried out on the balance sheet date, inquire whether:

    (a) A perpetual inventory system is used and whether periodic comparisons are made with actual quantities on hand; and

    (b) An integrated cost system is used and whether it has produced reliable information in the past.

37. Discuss adjustments made resulting from the last physical inventory count.

38. Inquire about procedures applied to control cutoff and any inventory movements.

39. Inquire about the basis used in valuing each category of the inventory and, in particular, regarding the elimination of inter-branch profits. Inquire whether inventory is valued at the lower of cost and net realizable value.

40. Consider the consistency with which inventory valuation methods have been applied, including factors such as material, labor and overhead.

41. Compare amounts of major inventory categories with those of prior periods and with those anticipated for the current period. Inquire about major fluctuations and differences.

42. Compare inventory turnover with that in previous periods.

43. Inquire about the method used for identifying slow moving and obsolete inventory and whether such inventory has been accounted for at net realizable value.

44. Inquire whether any of the inventory has been consigned to the entity and, if so, whether adjustments have been made to exclude such goods from inventory.

45. Inquire whether any inventory is pledged, stored at other locations or on consignment to others and consider whether such transactions have been accounted for appropriately.

Investments (Including Associated Companies and Marketable Securities)

46. Obtain a schedule of the investments at the balance sheet date and determine whether it agrees with the trial balance.

47. Inquire about the accounting policy applied to investments.

48. Inquire from management about the carrying values of investments. Consider whether there are any realization problems.

49. Consider whether there has been proper accounting for gains and losses and investment income.

50. Inquire about the classification of long-term and short-term investments.

Property and Depreciation

51. Obtain a schedule of the property indicating the cost and accumulated depreciation and determine whether it agrees with the trial balance.

52. Inquire about the accounting policy applied regarding the provision for depreciation and distinguishing between capital and maintenance items. Consider whether the property has suffered a material, permanent impairment in value.

53. Discuss with management the additions and deletions to property accounts and accounting for gains and losses on sales or retirements. Inquire whether all such transactions have been accounted for.

54. Inquire about the consistency with which the depreciation method and rates have been applied and compare depreciation provisions with prior years.

55. Inquire whether there are any liens on the property.

56. Discuss whether lease agreements have been properly reflected in the financial statements in conformity with current accounting pronouncements.

Prepaid Expenses, Intangibles and Other Assets

57. Obtain schedules identifying the nature of these accounts and discuss with management the recoverability thereof.

58. Inquire about the basis for recording these accounts and the amortization methods used.

59. Compare balances of related expense accounts with those of prior periods and discuss significant variations with management.

60. Discuss the classification between long-term and short-term accounts with management.

Loans Payable

61. Obtain from management a schedule of loans payable and determine whether the total agrees with the trial balance.

62. Inquire whether there are any loans where management has not complied with the provisions of the loan agreement and, if so, inquire as to management's actions and whether appropriate adjustments have been made in the financial statements.

63. Consider the reasonableness of interest expense in relation to loan balances.

64. Inquire whether loans payable are secured.

65. Inquire whether loans payable have been classified between noncurrent and current.

Trade Payables

66. Inquire about the accounting policies for initially recording trade payables and whether the entity is entitled to any allowances given on such transactions.

67. Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.

68. Obtain a schedule of trade payables and determine whether the total agrees with the trial balance.

69. Inquire whether balances are reconciled with the creditors' statements and compare with prior period balances. Compare turnover with prior periods.

70. Consider whether there could be material unrecorded liabilities.

71. Inquire whether payables to shareholders, directors and other related parties are separately disclosed.

Accrued and Contingent Liabilities

72. Obtain a schedule of the accrued liabilities and determine whether the total agrees with the trial balance.

73. Compare major balances of related expense accounts with similar accounts for prior periods.

74. Inquire about approvals for such accruals, terms of payment, compliance with terms, collateral and classification.

75. Inquire about the method for determining accrued liabilities.

76. Inquire as to the nature of amounts included in contingent liabilities and commitments.

77. Inquire whether any actual or contingent liabilities exist which have not been recorded in the accounts. If so, discuss with management whether provisions need to be made in the accounts or whether disclosure should be made in the notes to the financial statements.

Income and Other Taxes

78. Inquire from management if there were any events, including disputes with taxation authorities, which could have a significant effect on the taxes payable by the entity.

79. Consider the tax expense in relation to the entity's income for the period.

80. Inquire from management as to the adequacy of the recorded deferred and current tax liabilities including provisions in respect of prior periods.

Subsequent Events

81. Obtain from management the latest interim financial statements and compare them with the financial statements being reviewed or with those for comparable periods from the preceding year.

82. Inquire about events after the balance sheet date that would have a material effect on the financial statements under review and, in particular, inquire whether:

    (a) Any substantial commitments or uncertainties have arisen subsequent to the balance sheet date;

    (b) Any significant changes in the share capital, long-term debt or working capital have occurred up to the date of inquiry; and

(c) Any unusual adjustments have been made during the period between the balance sheet date and the date of inquiry.

Consider the need for adjustments or disclosure in the financial statements.

83. Obtain and read the minutes of meetings of shareholders, directors and appropriate committees subsequent to the balance sheet date.

Litigation

84. Inquire from management whether the entity is the subject of any legal actions-threatened, pending or in process. Consider the effect thereof on the financial statements.

Equity

85. Obtain and consider a schedule of the transactions in the equity accounts, including new issues, retirements and dividends.

86. Inquire whether there are any restrictions on retained earnings or other equity accounts.

Operations

87. Compare results with those of prior periods and those expected for the current period. Discuss significant variations with management.

88. Discuss whether the recognition of major sales and expenses have taken place in the appropriate periods.

89. Consider extraordinary and unusual items.

90. Consider and discuss with management the relationship between related items in the revenue account and assess the reasonableness thereof in the context of similar relationships for prior periods and other information available to the practitioner.

Appendix 3

Form of Unqualified Review Report

REVIEW REPORT TO ...

We have reviewed the accompanying balance sheet of ABC Company at December 31, 19XX, and the income statement, statement of changes in equity and cash flow statement for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Review Engagements 2400 (or refer to relevant national standards or practices applicable to review engagements). This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with International Accounting Standards.[4]

PRACTITIONER

Date
Address

---

4 Or indicate the relevant national accounting standards.

Appendix 4

Examples of Review Reports Other than Unqualified

Qualification for a Departure from International Accounting Standards

REVIEW REPORT TO …

We have reviewed the accompanying balance sheet of ABC Company at December 31, 19XX, and the income statement, statement of changes in equity and cash flow statement for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Review Engagements 2400 (or refer to relevant national standards or practices applicable to review engagements). This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit, and, accordingly, we do not express an audit opinion.

Management has informed us that inventory has been stated at its cost which is in excess of its net realizable value. Management's computation, which we have reviewed, shows that inventory, if valued at the lower of cost and net realizable value as required by International Accounting Standards,[5] would have been decreased by $X, and net income and shareholders' equity would have been decreased by $Y.

Based on our review, except for the effects of the overstatement of inventory described in the previous paragraph, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with International Accounting Standards.[5]

PRACTITIONER

Date
Address

[5] See footnote 4.

Adverse Report for a Departure from International Accounting Standards

REVIEW REPORT TO …..

We have reviewed the balance sheet of ABC Company at December 31, 19XX, and the income statement, statement of changes in equity and cash flow statement for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Review Engagements 2400 (or refer to relevant national standards or practices applicable to review engagements). This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

As noted in footnote X, these financial statements do not reflect the consolidation of the financial statements of subsidiary companies, the investment in which is accounted for on a cost basis. Under International Accounting Standards,[6] the financial statements of the subsidiaries are required to be consolidated.

Based on our review, because of the pervasive effect on the financial statements of the matter discussed in the preceding paragraph, the accompanying financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with International Accounting Standards.[6]

PRACTITIONER

Date
Address

---

[6] See footnote 4.

INTERNATIONAL STANDARD ON REVIEW ENGAGEMENTS 2410

REVIEW OF INTERIM FINANCIAL INFORMATION PERFORMED BY THE INDEPENDENT AUDITOR OF THE ENTITY

(Effective for reviews of interim financial information for periods beginning on or after December 15, 2006. Earlier adoption is permissible.)*

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* ISRE 2410 gave rise to a conforming amendment to ISA 210, "Terms of Audit Engagements" that is effective for audits of financial statements for periods beginning on or after December 15, 2006. It also gave rise to conforming amendments to ISRE 2400, "Engagement to Review Financial Statements" that are effective for reviews of financial statements for periods beginning on or after December 15, 2006. These amendments have been incorporated in the text of ISA 210 and ISRE 2400.

Paragraph 3a and footnote 4 were inserted in this ISRE in December 2007 to clarify the application of the ISRE.

Appendix 2: Analytical Procedures the Auditor May Consider When Performing a Review of Interim Financial Information

Appendix 3: Example of a Management Representation Letter

Appendix 4: Examples of Review Reports on Interim Financial Information

Appendix 5: Examples of Review Reports with a Qualified Conclusion for a Departure from the Applicable Financial Reporting Framework

Appendix 6: Examples of Review Reports with a Qualified Conclusion for a Limitation on Scope Not Imposed by Management

Appendix 7: Examples of Review Reports with an Adverse Conclusion for a Departure from the Applicable Financial Reporting Framework

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International Standard on Review Engagements (ISRE) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISREs.

Introduction

1. The purpose of this International Standard on Review Engagements (ISRE) is to establish standards and provide guidance on the auditor's professional responsibilities when the auditor undertakes an engagement to review interim financial information of an audit client, and on the form and content of the report. The term "auditor" is used throughout this ISRE, not because the auditor is performing an audit function but because the scope of this ISRE is limited to a review of interim financial information performed by the independent auditor of the financial statements of the entity.

2. For purposes of this ISRE, interim financial information is financial information that is prepared and presented in accordance with an applicable financial reporting framework[1] and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year.

3. **The auditor who is engaged to perform a review of interim financial information should perform the review in accordance with this ISRE.** Through performing the audit of the annual financial statements, the auditor obtains an understanding of the entity and its environment, including its internal control. When the auditor is engaged to review the interim financial information, this understanding is updated through inquiries made in the course of the review, and assists the auditor in focusing the inquiries to be made and the analytical and other review procedures to be applied. A practitioner who is engaged to perform a review of interim financial information, and who is not the auditor of the entity, performs the review in accordance with ISRE 2400, "Engagements to Review Financial Statements." As the practitioner does not ordinarily have the same understanding of the entity and its environment, including its internal control, as the auditor of the entity, the practitioner needs to carry out different inquiries and procedures to meet the objective of the review.

3a. This ISRE is directed towards a review of interim financial information by an entity's auditor. However, it is to be applied, adapted as necessary in the circumstances, when an entity's auditor undertakes an engagement to review historical financial information other than interim financial information of an audit client.

General Principles of a Review of Interim Financial Information

4. **The auditor should comply with the ethical requirements relevant to the audit of the annual financial statements of the entity.** These ethical requirements govern the auditor's professional responsibilities in the following

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[1] For example, International Financial Reporting Standards as issued by the International Accounting Standards Board.

areas: independence, integrity, objectivity, professional competence and due care, confidentiality, professional behavior, and technical standards.

5. **The auditor should implement quality control procedures that are applicable to the individual engagement.** The elements of quality control that are relevant to an individual engagement include leadership responsibilities for quality on the engagement, ethical requirements, acceptance and continuance of client relationships and specific engagements, assignment of engagement teams, engagement performance, and monitoring.

6. **The auditor should plan and perform the review with an attitude of professional skepticism, recognizing that circumstances may exist that cause the interim financial information to require a material adjustment for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework.** An attitude of professional skepticism means that the auditor makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by management of the entity.

Objective of an Engagement to Review Interim Financial Information

7. The objective of an engagement to review interim financial information is to enable the auditor to express a conclusion whether, on the basis of the review, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with an applicable financial reporting framework. The auditor makes inquiries, and performs analytical and other review procedures in order to reduce to a moderate level the risk of expressing an inappropriate conclusion when the interim financial information is materially misstated.

8. The objective of a review of interim financial information differs significantly from that of an audit conducted in accordance with International Standards on Auditing (ISAs). A review of interim financial information does not provide a basis for expressing an opinion whether the financial information gives a true and fair view, or is presented fairly, in all material respects, in accordance with an applicable financial reporting framework.

9. A review, in contrast to an audit, is not designed to obtain reasonable assurance that the interim financial information is free from material misstatement. A review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review may bring significant matters affecting the interim financial information to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

Agreeing the Terms of the Engagement

10. **The auditor and the client should agree on the terms of the engagement.**

11. The agreed terms of the engagement are ordinarily recorded in an engagement letter. Such a communication helps to avoid misunderstandings regarding the nature of the engagement and, in particular, the objective and scope of the review, management's responsibilities, the extent of the auditor's responsibilities, the assurance obtained, and the nature and form of the report. The communication ordinarily covers the following matters:

    - The objective of a review of interim financial information.
    - The scope of the review.
    - Management's responsibility for the interim financial information.
    - Management's responsibility for establishing and maintaining effective internal control relevant to the preparation of interim financial information.
    - Management's responsibility for making all financial records and related information available to the auditor.
    - Management's agreement to provide written representations to the auditor to confirm representations made orally during the review, as well as representations that are implicit in the entity's records.
    - The anticipated form and content of the report to be issued, including the identity of the addressee of the report.
    - Management's agreement that where any document containing interim financial information indicates that the interim financial information has been reviewed by the entity's auditor, the review report will also be included in the document.

    An illustrative engagement letter is set out in Appendix 1 to this ISRE. The terms of engagement to review interim financial information can also be combined with the terms of engagement to audit the annual financial statements.

Procedures for a Review of Interim Financial Information

Understanding the Entity and its Environment, Including its Internal Control

12. **The auditor should have an understanding of the entity and its environment, including its internal control, as it relates to the preparation of both annual and interim financial information, sufficient to plan and conduct the engagement so as to be able to:**

    (a) **Identify the types of potential material misstatement and consider the likelihood of their occurrence; and**

REVIEW

(b) **Select the inquiries, analytical and other review procedures that will provide the auditor with a basis for reporting whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.**

13. As required by ISA 315, "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement," the auditor who has audited the entity's financial statements for one or more annual periods has obtained an understanding of the entity and its environment, including its internal control, as it relates to the preparation of annual financial information that was sufficient to conduct the audit. In planning a review of interim financial information, the auditor updates this understanding. The auditor also obtains a sufficient understanding of internal control as it relates to the preparation of interim financial information as it may differ from internal control as it relates to annual financial information.

14. The auditor uses the understanding of the entity and its environment, including its internal control, to determine the inquiries to be made and the analytical and other review procedures to be applied, and to identify the particular events, transactions or assertions to which inquiries may be directed or analytical or other review procedures applied.

15. The procedures performed by the auditor to update the understanding of the entity and its environment, including its internal control, ordinarily include the following:

- Reading the documentation, to the extent necessary, of the preceding year's audit and reviews of prior interim period(s) of the current year and corresponding interim period(s) of the prior year, to enable the auditor to identify matters that may affect the current-period interim financial information.
- Considering any significant risks, including the risk of management override of controls, that were identified in the audit of the prior year's financial statements.
- Reading the most recent annual and comparable prior period interim financial information.
- Considering materiality with reference to the applicable financial reporting framework as it relates to interim financial information to assist in determining the nature and extent of the procedures to be performed and evaluating the effect of misstatements.

- Considering the nature of any corrected material misstatements and any identified uncorrected immaterial misstatements in the prior year's financial statements.
- Considering significant financial accounting and reporting matters that may be of continuing significance such as material weaknesses in internal control.
- Considering the results of any audit procedures performed with respect to the current year's financial statements.
- Considering the results of any internal audit performed and the subsequent actions taken by management.
- Inquiring of management about the results of management's assessment of the risk that the interim financial information may be materially misstated as a result of fraud.
- Inquiring of management about the effect of changes in the entity's business activities.
- Inquiring of management about any significant changes in internal control and the potential effect of any such changes on the preparation of interim financial information.
- Inquiring of management of the process by which the interim financial information has been prepared and the reliability of the underlying accounting records to which the interim financial information is agreed or reconciled.

16. The auditor determines the nature of the review procedures, if any, to be performed for components and, where applicable, communicates these matters to other auditors involved in the review. Factors to be considered include the materiality of, and risk of misstatement in, the interim financial information of components, and the auditor's understanding of the extent to which internal control over the preparation of such information is centralized or decentralized.

17. **In order to plan and conduct a review of interim financial information, a recently appointed auditor, who has not yet performed an audit of the annual financial statements in accordance with ISAs, should obtain an understanding of the entity and its environment, including its internal control, as it relates to the preparation of both annual and interim financial information.**

18. This understanding enables the auditor to focus the inquiries made, and the analytical and other review procedures applied in performing a review of interim financial information in accordance with this ISRE. As part of obtaining this understanding, the auditor ordinarily makes inquiries of the predecessor auditor and, where practicable, reviews the predecessor auditor's documentation

for the preceding annual audit, and for any prior interim periods in the current year that have been reviewed by the predecessor auditor. In doing so, the auditor considers the nature of any corrected misstatements, and any uncorrected misstatements aggregated by the predecessor auditor, any significant risks, including the risk of management override of controls, and significant accounting and any reporting matters that may be of continuing significance, such as material weaknesses in internal control.

Inquiries, Analytical and Other Review Procedures

19. **The auditor should make inquiries, primarily of persons responsible for financial and accounting matters, and perform analytical and other review procedures to enable the auditor to conclude whether, on the basis of the procedures performed, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.**

20. A review ordinarily does not require tests of the accounting records through inspection, observation or confirmation. Procedures for performing a review of interim financial information are ordinarily limited to making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures, rather than corroborating information obtained concerning significant accounting matters relating to the interim financial information. The auditor's understanding of the entity and its environment, including its internal control, the results of the risk assessments relating to the preceding audit and the auditor's consideration of materiality as it relates to the interim financial information, affects the nature and extent of the inquiries made, and analytical and other review procedures applied.

21. The auditor ordinarily performs the following procedures:

    - Reading the minutes of the meetings of shareholders, those charged with governance, and other appropriate committees to identify matters that may affect the interim financial information, and inquiring about matters dealt with at meetings for which minutes are not available that may affect the interim financial information.

    - Considering the effect, if any, of matters giving rise to a modification of the audit or review report, accounting adjustments or unadjusted misstatements, at the time of the previous audit or reviews.

    - Communicating, where appropriate, with other auditors who are performing a review of the interim financial information of the reporting entity's significant components.

    - Inquiring of members of management responsible for financial and accounting matters, and others as appropriate about the following:

- Whether the interim financial information has been prepared and presented in accordance with the applicable financial reporting framework.
- Whether there have been any changes in accounting principles or in the methods of applying them.
- Whether any new transactions have necessitated the application of a new accounting principle.
- Whether the interim financial information contains any known uncorrected misstatements.
- Unusual or complex situations that may have affected the interim financial information, such as a business combination or disposal of a segment of the business.
- Significant assumptions that are relevant to the fair value measurement or disclosures and management's intention and ability to carry out specific courses of action on behalf of the entity.
- Whether related party transactions have been appropriately accounted for and disclosed in the interim financial information.
- Significant changes in commitments and contractual obligations.
- Significant changes in contingent liabilities including litigation or claims.
- Compliance with debt covenants.
- Matters about which questions have arisen in the course of applying the review procedures.
- Significant transactions occurring in the last several days of the interim period or the first several days of the next interim period.
- Knowledge of any fraud or suspected fraud affecting the entity involving:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the interim financial information.
- Knowledge of any allegations of fraud, or suspected fraud, affecting the entity's interim financial information communicated by employees, former employees, analysts, regulators, or others.

  - ° Knowledge of any actual or possible noncompliance with laws and regulations that could have a material effect on the interim financial information.

- Applying analytical procedures to the interim financial information designed to identify relationships and individual items that appear to be unusual and that may reflect a material misstatement in the interim financial information. Analytical procedures may include ratio analysis and statistical techniques such as trend analysis or regression analysis and may be performed manually or with the use of computer-assisted techniques. Appendix 2 to this ISRE contains examples of analytical procedures the auditor may consider when performing a review of interim financial information.

- Reading the interim financial information, and considering whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.

22. The auditor may perform many of the review procedures before or simultaneously with the entity's preparation of the interim financial information. For example, it may be practicable to update the understanding of the entity and its environment, including its internal control, and begin reading applicable minutes before the end of the interim period. Performing some of the review procedures earlier in the interim period also permits early identification and consideration of significant accounting matters affecting the interim financial information.

23. The auditor performing the review of interim financial information is also engaged to perform an audit of the annual financial statements of the entity. For convenience and efficiency, the auditor may decide to perform certain audit procedures concurrently with the review of interim financial information. For example, information gained from reading the minutes of meetings of the board of directors in connection with the review of the interim financial information also may be used for the annual audit. The auditor may also decide to perform, at the time of the interim review, auditing procedures that would need to be performed for the purpose of the audit of the annual financial statements, for example, performing audit procedures on significant or unusual transactions that occurred during the period, such as business combinations, restructurings, or significant revenue transactions.

24. A review of interim financial information ordinarily does not require corroborating the inquiries about litigation or claims. It is, therefore, ordinarily not necessary to send an inquiry letter to the entity's lawyer. Direct communication with the entity's lawyer with respect to litigation or claims may, however, be appropriate if a matter comes to the auditor's attention that causes

the auditor to question whether the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework, and the auditor believes the entity's lawyer may have pertinent information.

25. **The auditor should obtain evidence that the interim financial information agrees or reconciles with the underlying accounting records**. The auditor may obtain evidence that the interim financial information agrees or reconciles with the underlying accounting records by tracing the interim financial information to:

    (a) The accounting records, such as the general ledger, or a consolidating schedule that agrees or reconciles with the accounting records; and

    (b) Other supporting data in the entity's records as necessary.

26. **The auditor should inquire whether management has identified all events up to the date of the review report that may require adjustment to or disclosure in the interim financial information.** It is not necessary for the auditor to perform other procedures to identify events occurring after the date of the review report.

27. **The auditor should inquire whether management has changed its assessment of the entity's ability to continue as a going concern. When, as a result of this inquiry or other review procedures, the auditor becomes aware of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:**

    (a) **Inquire of management as to its plans for future actions based on its going concern assessment, the feasibility of these plans, and whether management believes that the outcome of these plans will improve the situation; and**

    (b) **Consider the adequacy of the disclosure about such matters in the interim financial information.**

28. Events or conditions which may cast significant doubt on the entity's ability to continue as a going concern may have existed at the date of the annual financial statements or may be identified as a result of inquiries of management or in the course of performing other review procedures. When such events or conditions come to the auditor's attention, the auditor inquires of management as to its plans for future action, such as its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital. The auditor also inquires as to the feasibility of management's plans and whether management believes that the outcome of these plans will improve the situation. However, it is not ordinarily necessary for the auditor to corroborate the feasibility of management's plans and whether the outcome of these plans will improve the situation.

29. **When a matter comes to the auditor's attention that leads the auditor to question whether a material adjustment should be made for the interim financial information to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor should make additional inquiries or perform other procedures to enable the auditor to express a conclusion in the review report.** For example, if the auditor's review procedures lead the auditor to question whether a significant sales transaction is recorded in accordance with the applicable financial reporting framework, the auditor performs additional procedures sufficient to resolve the auditor's questions, such as discussing the terms of the transaction with senior marketing and accounting personnel, or reading the sales contract.

Evaluation of Misstatements

30. **The auditor should evaluate, individually and in the aggregate, whether uncorrected misstatements that have come to the auditor's attention are material to the interim financial information.**

31. A review of interim financial information, in contrast to an audit engagement, is not designed to obtain reasonable assurance that the interim financial information is free from material misstatement. However, misstatements which come to the auditor's attention, including inadequate disclosures, are evaluated individually and in the aggregate to determine whether a material adjustment is required to be made to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework.

32. The auditor exercises professional judgment in evaluating the materiality of any misstatements that the entity has not corrected. The auditor considers matters such as the nature, cause and amount of the misstatements, whether the misstatements originated in the preceding year or interim period of the current year, and the potential effect of the misstatements on future interim or annual periods.

33. The auditor may designate an amount below which misstatements need not be aggregated, because the auditor expects that the aggregation of such amounts clearly would not have a material effect on the interim financial information. In so doing, the auditor considers the fact that the determination of materiality involves quantitative as well as qualitative considerations, and that misstatements of a relatively small amount could nevertheless have a material effect on the interim financial information.

Management Representations

34. **The auditor should obtain written representation from management that:**

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

(b) **The interim financial information is prepared and presented in accordance with the applicable financial reporting framework;**

(c) **It believes the effect of those uncorrected misstatements aggregated by the auditor during the review are immaterial, both individually and in the aggregate, to the interim financial information taken as a whole. A summary of such items is included in or attached to the written representations;**

(d) **It has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity;**

(e) **It has disclosed to the auditor the results of its assessment of the risks that the interim financial information may be materially misstated as a result of fraud;**[2]

(f) **It has disclosed to the auditor all known actual or possible noncompliance with laws and regulations whose effects are to be considered when preparing the interim financial information; and**

(g) **It has disclosed to the auditor all significant events that have occurred subsequent to the balance sheet date and through to the date of the review report that may require adjustment to or disclosure in the interim financial information.**

35. The auditor obtains additional representations as are appropriate related to matters specific to the entity's business or industry. An illustrative management representation letter is set out in Appendix 3 to this ISRE.

Auditor's Responsibility for Accompanying Information

36. **The auditor should read the other information that accompanies the interim financial information to consider whether any such information is materially inconsistent with the interim financial information.** If the auditor identifies a material inconsistency, the auditor considers whether the interim financial information or the other information needs to be amended. If an amendment is necessary in the interim financial information and management refuses to make the amendment, the auditor considers the implications for the review report. If an amendment is necessary in the other information and management refuses to make the amendment, the auditor considers including in

[2] Paragraph 35 of ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" explains that the nature, extent and frequency of such an assessment vary from entity to entity and that management may make a detailed assessment on an annual basis or as part of continuous monitoring. Accordingly, this representation, insofar as it relates to the interim financial information, is tailored to the entity's specific circumstances.

the review report an additional paragraph describing the material inconsistency, or taking other actions, such as withholding the issuance of the review report or withdrawing from the engagement. For example, management may present alternative measures of earnings that more positively portray financial performance than the interim financial information, and such alternative measures are given excessive prominence, are not clearly defined, or not clearly reconciled to the interim financial information such that they are confusing and potentially misleading.

37. **If a matter comes to the auditor's attention that causes the auditor to believe that the other information appears to include a material misstatement of fact, the auditor should discuss the matter with the entity's management.** While reading the other information for the purpose of identifying material inconsistencies, an apparent material misstatement of fact may come to the auditor's attention (i.e., information, not related to matters appearing in the interim financial information, that is incorrectly stated or presented). When discussing the matter with the entity's management, the auditor considers the validity of the other information and management's responses to the auditor's inquiries, whether valid differences of judgment or opinion exist and whether to request management to consult with a qualified third party to resolve the apparent misstatement of fact. If an amendment is necessary to correct a material misstatement of fact and management refuses to make the amendment, the auditor considers taking further action as appropriate, such as notifying those charged with governance and obtaining legal advice.

Communication

38. **When, as a result of performing the review of interim financial information, a matter comes to the auditor's attention that causes the auditor to believe that it is necessary to make a material adjustment to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor should communicate this matter as soon as practicable to the appropriate level of management.**

39. **When, in the auditor's judgment, management does not respond appropriately within a reasonable period of time, the auditor should inform those charged with governance.** The communication is made as soon as practicable, either orally or in writing. The auditor's decision whether to communicate orally or in writing is affected by factors such as the nature, sensitivity and significance of the matter to be communicated and the timing of such communications. If the information is communicated orally, the auditor documents the communication.

40. **When, in the auditor's judgment, those charged with governance do not respond appropriately within a reasonable period of time, the auditor should consider:**

(a) **Whether to modify the report; or**

(b) **The possibility of withdrawing from the engagement; and**

(c) **The possibility of resigning from the appointment to audit the annual financial statements.**

41. **When, as a result of performing the review of interim financial information, a matter comes to the auditor's attention that causes the auditor to believe in the existence of fraud or noncompliance by the entity with laws and regulations the auditor should communicate the matter as soon as practicable to the appropriate level of management.** The determination of which level of management is the appropriate one is affected by the likelihood of collusion or the involvement of a member of management. The auditor also considers the need to report such matters to those charged with governance and considers the implication for the review.

42. **The auditor should communicate relevant matters of governance interest arising from the review of interim financial information to those charged with governance.** As a result of performing the review of the interim financial information, the auditor may become aware of matters that in the opinion of the auditor are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. The auditor communicates such matters to those charged with governance.

Reporting the Nature, Extent and Results of the Review of Interim Financial Information

43. **The auditor should issue a written report that contains the following:**

(a) **An appropriate title.**

(b) **An addressee, as required by the circumstances of the engagement.**

(c) **Identification of the interim financial information reviewed, including identification of the title of each of the statements contained in the complete or condensed set of financial statements and the date and period covered by the interim financial information.**

(d) **If the interim financial information comprises a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, a statement that management is responsible for the preparation and fair presentation of the interim financial information in accordance with the applicable financial reporting framework.**

(e) **In other circumstances, a statement that management is responsible for the preparation and presentation of the interim financial**

information in accordance with the applicable financial reporting framework.

(f) **A statement that the auditor is responsible for expressing a conclusion on the interim financial information based on the review.**

(g) **A statement that the review of the interim financial information was conducted in accordance with International Standard on Review Engagements (ISRE) 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity," and a statement that that such a review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.**

(h) **A statement that a review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable the auditor to obtain assurance that the auditor would become aware of all significant matters that might be identified in an audit and that accordingly no audit opinion is expressed.**

(i) **If the interim financial information comprises a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information does not give a true and fair view, or does not present fairly, in all material respects, in accordance with the applicable financial reporting framework (including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards).**

(j) **In other circumstances, a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework (including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards).**

(k) **The date of the report.**

(l) **The location in the country or jurisdiction where the auditor practices.**

(m) **The auditor's signature.**

Illustrative review reports are set out in Appendix 4 to this ISRE.

44. In some jurisdictions, law or regulation governing the review of interim financial information may prescribe wording for the auditor's conclusion that is different from the wording described in paragraph 43(i) or (j). Although the auditor may be obliged to use the prescribed wording, the auditor's responsibilities as described in this ISRE for coming to the conclusion remain the same.

Departure from the Applicable Financial Reporting Framework

45. **The auditor should express a qualified or adverse conclusion when a matter has come to the auditor's attention that causes the auditor to believe that a material adjustment should be made to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework.**

46. If matters have come to the auditor's attention that cause the auditor to believe that the interim financial information is or may be materially affected by a departure from the applicable financial reporting framework, and management does not correct the interim financial information, the auditor modifies the review report. The modification describes the nature of the departure and, if practicable, states the effects on the interim financial information. If the information that the auditor believes is necessary for adequate disclosure is not included in the interim financial information, the auditor modifies the review report and, if practicable, includes the necessary information in the review report. The modification to the review report is ordinarily accomplished by adding an explanatory paragraph to the review report, and qualifying the conclusion. Illustrative review reports with a qualified conclusion are set out in Appendix 5 to this ISRE.

47. When the effect of the departure is so material and pervasive to the interim financial information that the auditor concludes a qualified conclusion is not adequate to disclose the misleading or incomplete nature of the interim financial information, the auditor expresses an adverse conclusion. Illustrative review reports with an adverse conclusion are set out in Appendix 7 to this ISRE.

Limitation on Scope

48. A limitation on scope ordinarily prevents the auditor from completing the review.

49. **When the auditor is unable to complete the review, the auditor should communicate, in writing, to the appropriate level of management and to those charged with governance the reason why the review cannot be completed, and consider whether it is appropriate to issue a report.**

Limitation on Scope Imposed by Management

50. The auditor does not accept an engagement to review the interim financial information if the auditor's preliminary knowledge of the engagement circumstances indicates that the auditor would be unable to complete the review because there will be a limitation on the scope of the auditor's review imposed by management of the entity.

51. If, after accepting the engagement, management imposes a limitation on the scope of the review, the auditor requests the removal of that limitation. If management refuses to do so, the auditor is unable to complete the review and express a conclusion. In such cases, the auditor communicates, in writing, to the appropriate level of management and those charged with governance the reason why the review cannot be completed. Nevertheless, if a matter comes to the auditor's attention that causes the auditor to believe that a material adjustment to the interim financial information is necessary for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor communicates such matters in accordance with the guidance in paragraphs 38-40.

52. The auditor also considers the legal and regulatory responsibilities, including whether there is a requirement for the auditor to issue a report. If there is such a requirement, the auditor disclaims a conclusion, and provides in the review report the reason why the review cannot be completed. However, if a matter comes to the auditor's attention that causes the auditor to believe that a material adjustment to the interim financial information is necessary for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor also communicates such a matter in the report.

Other Limitations on Scope

53. A limitation on scope may occur due to circumstances other than a limitation on scope imposed by management. In such circumstances, the auditor is ordinarily unable to complete the review and express a conclusion and is guided by paragraphs 51-52. There may be, however, some rare circumstances where the limitation on the scope of the auditor's work is clearly confined to one or more specific matters that, while material, are not in the auditor's judgment pervasive to the interim financial information. In such circumstances, the auditor modifies the review report by indicating that, except for the matter which is described in an explanatory paragraph to the review report, the review was conducted in accordance with this ISRE, and by qualifying the conclusion. Illustrative review reports with a qualified conclusion are set out in Appendix 6 to this ISRE.

54. The auditor may have expressed a qualified opinion on the audit of the latest annual financial statements because of a limitation on the scope of that audit. The auditor considers whether that limitation on scope still exists and, if so, the implications for the review report.

Going Concern and Significant Uncertainties

55. In certain circumstances, an emphasis of matter paragraph may be added to a review report, without affecting the auditor's conclusion, to highlight a matter that is included in a note to the interim financial information that more extensively discusses the matter. The paragraph would preferably be included after the conclusion paragraph and ordinarily refers to the fact that the conclusion is not qualified in this respect.

56. **If adequate disclosure is made in the interim financial information, the auditor should add an emphasis of matter paragraph to the review report to highlight a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern.**

57. The auditor may have modified a prior audit or review report by adding an emphasis of matter paragraph to highlight a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern. If the material uncertainty still exists and adequate disclosure is made in the interim financial information, the auditor modifies the review report on the current interim financial information by adding a paragraph to highlight the continued material uncertainty.

58. If, as a result of inquiries or other review procedures, a material uncertainty relating to an event or condition comes to the auditor's attention that may cast significant doubt on the entity's ability to continue as a going concern, and adequate disclosure is made in the interim financial information the auditor modifies the review report by adding an emphasis of matter paragraph.

59. **If a material uncertainty that casts significant doubt about the entity's ability to continue as a going concern is not adequately disclosed in the interim financial information, the auditor should express a qualified or adverse conclusion, as appropriate. The report should include specific reference to the fact that there is such a material uncertainty.**

60. **The auditor should consider modifying the review report by adding a paragraph to highlight a significant uncertainty (other than a going concern problem) that came to the auditor's attention, the resolution of which is dependent upon future events and which may affect the interim financial information.**

Other Considerations

61. The terms of the engagement include management's agreement that where any document containing interim financial information indicates that such information has been reviewed by the entity's auditor, the review report will also be included in the document. If management has not included the review

report in the document, the auditor considers seeking legal advice to assist in determining the appropriate course of action in the circumstances.

62. If the auditor has issued a modified review report and management issues the interim financial information without including the modified review report in the document containing the interim financial information, the auditor considers seeking legal advice to assist in determining the appropriate course of action in the circumstances, and the possibility of resigning from the appointment to audit the annual financial statements.

63. Interim financial information consisting of a condensed set of financial statements does not necessarily include all the information that would be included in a complete set of financial statements, but may rather present an explanation of the events and changes that are significant to an understanding of the changes in the financial position and performance of the entity since the annual reporting date. This is because it is presumed that the users of the interim financial information will have access to the latest audited financial statements, such as is the case with listed entities. In other circumstances, the auditor discusses with management the need for such interim financial information to include a statement that it is to be read in conjunction with the latest audited financial statements. In the absence of such a statement, the auditor considers whether, without a reference to the latest audited financial statements, the interim financial information is misleading in the circumstances, and the implications for the review report.

Documentation

64. **The auditor should prepare review documentation that is sufficient and appropriate to provide a basis for the auditor's conclusion and to provide evidence that the review was performed in accordance with this ISRE and applicable legal and regulatory requirements.** The documentation enables an experienced auditor having no previous connection with the engagement to understand the nature, timing and extent of the inquiries made, and analytical and other review procedures applied, information obtained, and any significant matters considered during the performance of the review, including the disposition of such matters.

Effective Date

65. This ISRE is effective for reviews of interim financial information for periods beginning on or after December 15, 2006. Earlier adoption of the ISRE is permissible.

Public Sector Perspective

1. *Paragraph 10 requires that the auditor and the client agree on the terms of engagement. Paragraph 11 explains that an engagement letter helps to avoid misunderstandings regarding the nature of the engagement and, in particular, the objective and scope of the review, management's responsibilities, the extent of the auditor's responsibilities, the assurance obtained, and the nature and form of the report. Law or regulation governing review engagements in the public sector ordinarily mandates the appointment of the auditor. Consequently, engagement letters may not be a widespread practice in the public sector. Nevertheless, an engagement letter setting out the matters referred to in paragraph 11 may be useful to both the public sector auditor and the client. Public sector auditors, therefore, consider agreeing with the client the terms of a review engagement by way of an engagement letter.*

2. *In the public sector, the auditor's statutory audit obligation may extend to other work, such as a review of interim financial information. Where this is the case, the public sector auditor cannot avoid such an obligation and, consequently, may not be in a position not to accept (see paragraph 50) or to withdraw from a review engagement (see paragraphs 36 and 40(b)). The public sector auditor also may not be in the position to resign from the appointment to audit the annual financial statements (see paragraphs 40(c)) and 62).*

3. *Paragraph 41 discusses the auditor's responsibility when a matter comes to the auditor's attention that causes the auditor to believe in the existence of fraud or noncompliance by the entity with laws and regulations. In the public sector, the auditor may be subject to statutory or other regulatory requirements to report such a matter to regulatory or other public authorities.*

Appendix 1

Example of an Engagement Letter for a Review of Interim Financial Information

The following letter is to be used as a guide in conjunction with the consideration outlined in paragraph 10 of this ISRE and will need to be adapted according to individual requirements and circumstances.

To the Board of Directors (or the appropriate representative of senior management)

We are providing this letter to confirm our understanding of the terms and objectives of our engagement to review the entity's interim balance sheet as at June 30, 20X1 and the related statements of income, changes in equity and cash flows for the six-month period then ended.

Our review will be conducted in accordance with International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the International Auditing and Assurance Standards Board with the objective of providing us with a basis for reporting whether anything has come to our attention that causes us to believe that the interim financial information is not prepared, in all material respects, in accordance with the [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting when the financial reporting framework used is not International Financial Reporting Standards]. Such a review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures and does not, ordinarily, require corroboration of the information obtained. The scope of a review of interim financial information is substantially less than the scope of an audit conducted in accordance with International Standards on Auditing whose objective is the expression of an opinion regarding the financial statements and, accordingly, we shall express no such opinion.

We expect to report on the interim financial information as follows:

[Include text of sample report.]

Responsibility for the interim financial information, including adequate disclosure, is that of management of the entity. This includes designing, implementing and maintaining internal control relevant to the preparation and presentation of interim financial information that is free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances. As part of our review, we will request written representations from management concerning assertions made in connection with the review. We will also request that where any document containing interim financial information indicates that the interim financial information has been reviewed, our report will also be included in the document.

A review of interim financial information does not provide assurance that we will become aware of all significant matters that might be identified in an audit. Further, our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we will inform you of any material matters that come to our attention.

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

[Insert additional information here regarding fee arrangements and billings, as appropriate.]

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

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

Acknowledged on behalf of ABC Entity by

(signed)

Name and Title

Date

Appendix 2

Analytical Procedures the Auditor May Consider When Performing a Review of Interim Financial Information

Examples of analytical procedures the auditor may consider when performing a review of interim financial information include the following:

- Comparing the interim financial information with the interim financial information of the immediately preceding interim period, with the interim financial information of the corresponding interim period of the preceding financial year, with the interim financial information that was expected by management for the current period, and with the most recent audited annual financial statements.
- Comparing current interim financial information with anticipated results, such as budgets or forecasts (for example, comparing tax balances and the relationship between the provision for income taxes to pretax income in the current interim financial information with corresponding information in (a) budgets, using expected rates, and (b) financial information for prior periods).
- Comparing current interim financial information with relevant non-financial information.
- Comparing the recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and applying relationships that are reasonably expected to exist based on the auditor's understanding of the entity and of the industry in which the entity operates.
- Comparing ratios and indicators for the current interim period with those of entities in the same industry.
- Comparing relationships among elements in the current interim financial information with corresponding relationships in the interim financial information of prior periods, for example, expense by type as a percentage of sales, assets by type as a percentage of total assets, and percentage of change in sales to percentage of change in receivables.
- Comparing disaggregated data. The following are examples of how data may be disaggregated:
    - By period, for example, revenue or expense items disaggregated into quarterly, monthly, or weekly amounts.
    - By product line or source of revenue.
    - By location, for example, by component.

- By attributes of the transaction, for example, revenue generated by designers, architects, or craftsmen.
- By several attributes of the transaction, for example, sales by product and month.

Appendix 3

Example of a Management Representation Letter

The following letter is not intended to be a standard letter. Representations by management will vary from entity to entity and from one interim period to the next.

(Entity Letterhead)

(To Auditor) (Date)

Opening paragraphs if interim financial information comprises condensed financial statements:

This representation letter is provided in connection with your review of the condensed balance sheet of ABC Entity as of March 31, 20X1 and the related condensed statements of income, changes in equity and cash flows for the three-month period then ended for the purposes of expressing a conclusion whether anything has come to your attention that causes you to believe that the interim financial information is not prepared, in all material respects, in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

We acknowledge our responsibility for the preparation and presentation of the interim financial information in accordance with [indicate applicable financial reporting framework].

Opening paragraphs if interim financial information comprises a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation:

This representation letter is provided in connection with your review of the balance sheet of ABC Entity as of March 31, 20X1 and the related statements of income, changes in equity and cash flows for the three-month period then ended and a summary of the significant accounting policies and other explanatory notes for the purposes of expressing a conclusion whether anything has come to your attention that causes you to believe that the interim financial information does not give a true and fair view of *(or "does not present fairly, in all material respects,")* the financial position of ABC Entity as at March 31, 20X1, and of its financial performance and its cash flows in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

We acknowledge our responsibility for the fair presentation of the interim financial information in accordance with [indicate applicable financial reporting framework].

We confirm, to the best of our knowledge and belief, the following representations:

- The interim financial information referred to above has been prepared and presented in accordance with [indicate applicable financial reporting framework].
- We have made available to you all books of account and supporting documentation, and all minutes of meetings of shareholders and the board of directors (namely those held on [insert applicable dates]).
- There are no material transactions that have not been properly recorded in the accounting records underlying the interim financial information.
- There has been no known actual or possible noncompliance with laws and regulations that could have a material effect on the interim financial information in the event of noncompliance.
- We acknowledge responsibility for the design and implementation of internal control to prevent and detect fraud and error.
- We have disclosed to you all significant facts relating to any known frauds or suspected frauds that may have affected the entity.
- We have disclosed to you the results of our assessment of the risk that the interim financial information may be materially misstated as the result of fraud.
- We believe the effects of uncorrected misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the interim financial information taken as a whole.
- We confirm the completeness of the information provided to you regarding the identification of related parties.
- The following have been properly recorded and, when appropriate, adequately disclosed in the interim financial information:
  - Related party transactions, including sales, purchases, loans, transfers, leasing arrangements and guarantees, and amounts receivable from or payable to related parties;
  - Guarantees, whether written or oral, under which the entity is contingently liable; and
  - Agreements and options to buy back assets previously sold.
- The presentation and disclosure of the fair value measurements of assets and liabilities are in accordance with [indicate applicable financial reporting framework]. The assumptions used reflect our intent and ability to carry specific courses of action on behalf of the entity, where relevant to the fair value measurements or disclosure.
- We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities reflected in the interim financial information.

- We have no plans to abandon lines of product or other plans or intentions that will result in any excess or obsolete inventory, and no inventory is stated at an amount in excess of realizable value.
- The entity has satisfactory title to all assets and there are no liens or encumbrances on the entity's assets.
- We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent.
- [Add any additional representations related to new accounting standards that are being implemented for the first time and consider any additional representations required by a new International Standard on Auditing that are relevant to interim financial information.]

To the best of our knowledge and belief, no events have occurred subsequent to the balance sheet date and through the date of this letter that may require adjustment to or disclosure in the aforementioned interim financial information.

____

(Senior Executive Officer)

____

(Senior Financial Officer)

Appendix 4

Examples of Review Reports on Interim Financial Information

Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying balance sheet of ABC Entity as of March 31, 20X1 and the related statements of income, changes in equity and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes.[3] Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity."[4] A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of *(or "does not present fairly, in all material respects,")* the financial position of the entity as

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3 The auditor may wish to specify the regulatory authority or equivalent with whom the interim financial information is filed.

4 In the case of a review of historical financial information other than interim financial information, this sentence should read as follows: "We conducted our review in accordance with International Standard on Review Engagements 2410, which applies to a review of historical financial information performed by the independent auditor of the entity." The remainder of the report should be adapted as necessary in the circumstances.

at March 31, 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with [applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

AUDITOR

Date

Address

Other Interim Financial Information (see paragraph 43(j))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying [condensed] balance sheet of ABC Entity as of March 31, 20X1 and the related [condensed] statements of income, changes in equity and cash flows for the three-month period then ended.[5] Management is responsible for the preparation and presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity."[6] A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information is not prepared, in all material respects, in accordance with [applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

AUDITOR

Date

Address

5 See footnote 3.

6 See footnote 4.

Appendix 5

Examples of Review Reports with a Qualified Conclusion for a Departure from the Applicable Financial Reporting Framework

Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying balance sheet of ABC Entity as of March 31, 20X1 and the related statements of income, changes in equity and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes.[7] Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity."[8] A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Qualified Conclusion

Based on information provided to us by management, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalized to conform with [indicate applicable financial reporting framework]. This information indicates that if these lease obligations were capitalized at March 31, 20X1, property would be increased by $______, long-term debt by $______, and net income

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7 See footnote 3.

8 See footnote 4.

and earnings per share would be increased (decreased) by $________, $_________, $________, and $________, respectively for the three-month period then ended.

Qualified Conclusion

Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of *(or "does not present fairly, in all material respects,")* the financial position of the entity as at March 31, 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with [indicate applicable financial reporting framework, including the reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

AUDITOR

Date

Address

Other Interim Financial Information (see paragraph 43(j))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying [condensed] balance sheet of ABC Entity as of March 31, 20X1 and the related [condensed] statements of income, changes in equity and cash flows for the three-month period then ended.[9] Management is responsible for the preparation and presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity."[10] A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Qualified Conclusion

Based on information provided to us by management, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalized to conform with [indicate applicable financial reporting framework]. This information indicates that if these lease obligations were capitalized at March 31, 20X1, property would be increased by $______, long-term debt by $______, and net income and earnings per share would be increased (decreased) by $________, $_________, $________, and $________, respectively for the three-month period then ended.

Qualified Conclusion

Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that causes us to believe that the accompanying interim financial information is not prepared, in all material respects, in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework

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9 See footnote 3.

10 See footnote 4.

when the financial reporting framework used is not International Financial Reporting Standards].

AUDITOR

Date

Address

Appendix 6

Examples of Review Reports with a Qualified Conclusion for a Limitation on Scope Not Imposed By Management

Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying balance sheet of ABC Entity as of March 31, 20X1 and the related statements of income, changes in equity and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes.[11] Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

Except as explained in the following paragraph, we conducted our review in accordance with International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity."[12] A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Qualified Conclusion

As a result of a fire in a branch office on (date) that destroyed its accounts receivable records, we were unable to complete our review of accounts receivable totaling $________ included in the interim financial information. The entity is in the process of reconstructing these records and is uncertain as to whether these records will support the amount shown above and the related allowance for uncollectible accounts. Had we been

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11 See footnote 3.

12 See footnote 4.

able to complete our review of accounts receivable, matters might have come to our attention indicating that adjustments might be necessary to the interim financial information.

Qualified Conclusion

Except for the adjustments to the interim financial information that we might have become aware of had it not been for the situation described above, based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of *(or "does not present fairly, in all material respects,")* the financial position of the entity as at March 31, 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

AUDITOR

Date

Address

Other Interim Financial Information (see paragraph 43(j))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying [condensed] balance sheet of ABC Entity as of March 31, 20X1 and the related [condensed] statements of income, changes in equity and cash flows for the three-month period then ended.[13] Management is responsible for the preparation and presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

Except as explained in the following paragraph, we conducted our review in accordance with International Standards on Review Engagements 2410, "Review of Interim Financial Information Performed by the Auditor of the Entity."[14] A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Qualified Conclusion

As a result of a fire in a branch office on (date) that destroyed its accounts receivable records, we were unable to complete our review of accounts receivable totaling $________ included in the interim financial information. The entity is in the process of reconstructing these records and is uncertain as to whether these records will support the amount shown above and the related allowance for uncollectible accounts. Had we been able to complete our review of accounts receivable, matters might have come to our attention indicating that adjustments might be necessary to the interim financial information.

Qualified Conclusion

Except for the adjustments to the interim financial information that we might have become aware of had it not been for the situation described above, based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information is not prepared, in all material respects, in accordance with

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13 See footnote 3.

14 See footnote 4.

[indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

AUDITOR

Date

Address

Appendix 7

Examples of Review Reports with an Adverse Conclusion for a Departure from the Applicable Financial Reporting Framework

Complete Set of General Purpose Financial Statements Prepared in Accordance with a Financial Reporting Framework Designed to Achieve Fair Presentation (see paragraph 43(i))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying balance sheet of ABC Entity as of March 31, 20X1 and the related statements of income, changes in equity and cash flows for the three-month period then ended, and a summary of significant accounting policies and other explanatory notes.[15] Management is responsible for the preparation and fair presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Auditor of the Entity."[16] A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Adverse Conclusion

Commencing this period, management of the entity ceased to consolidate the financial statements of its subsidiary companies since management considers consolidation to be inappropriate because of the existence of new substantial non-controlling interests. This is not in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework

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15 See footnote 3.

16 See footnote 4.

when the financial reporting framework used is not International Financial Reporting Standards]. Had consolidated financial statements been prepared, virtually every account in the interim financial information would have been materially different.

Adverse Conclusion

Our review indicates that, because the entity's investment in subsidiary companies is not accounted for on a consolidated basis, as described in the preceding paragraph, this interim financial information does not give a true and fair view of *(or "does not present fairly, in all material respects,")* the financial position of the entity as at March 31, 20X1, and of its financial performance and its cash flows for the three-month period then ended in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

AUDITOR

Date

Address

Other Interim Financial Information (see paragraph 43(j))

Report on Review of Interim Financial Information

(Appropriate addressee)

Introduction

We have reviewed the accompanying [condensed] balance sheet of ABC Entity as of March 31, 20X1 and the related [condensed] statements of income, changes in equity and cash flows for the three-month period then ended.[17] Management is responsible for the preparation and presentation of this interim financial information in accordance with [indicate applicable financial reporting framework]. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independence Auditor of the Entity."[18] A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Basis for Adverse Conclusion

Commencing this period, management of the entity ceased to consolidate the financial statements of its subsidiary companies since management considers consolidation to be inappropriate because of the existence of new substantial non-controlling interests. This is not in accordance with [indicate applicable financial reporting framework, including the reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards]. Had consolidated financial statements been prepared, virtually every account in the interim financial information would have been materially different.

Adverse Conclusion

Our review indicates that, because the entity's investment in subsidiary companies is not accounted for on a consolidated basis, as described in the preceding paragraph, this interim financial information is not prepared, in all material respects, in accordance with [indicate applicable financial reporting framework, including a reference to the

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[17] See footnote 3.

[18] See footnote 4.

jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not International Financial Reporting Standards].

AUDITOR

Date

Address

INTERNATIONAL STANDARD ON ASSURANCE ENGAGEMENTS 3000

ASSURANCE ENGAGEMENTS OTHER THAN AUDITS OR REVIEWS OF HISTORICAL FINANCIAL INFORMATION

(Effective for assurance reports dated on or after January 1, 2005)

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International Standard on Assurance Engagements (ISAE) 3000, "Assurance Engagements Other than Audits or Reviews of Historical Financial Information" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAEs.

Introduction

1. The purpose of this International Standard on Assurance Engagements (ISAE) is to establish basic principles and essential procedures for, and to provide guidance to, professional accountants in public practice (for purposes of this ISAE referred to as "practitioners") for the performance of assurance engagements other than audits or reviews of historical financial information covered by International Standards on Auditing (ISAs) or International Standards on Review Engagements (ISREs).

2. This ISAE uses the terms "reasonable assurance engagement" and "limited assurance engagement" to distinguish between the two types of assurance engagement a practitioner is permitted to perform. The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement[1] as the basis for a positive form of expression of the practitioner's conclusion. The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Relationship with the Framework, Other ISAEs, ISAs and ISREs

3. **The practitioner should comply with this ISAE and other relevant ISAEs when performing an assurance engagement other than an audit or review of historical financial information covered by ISAs or ISREs.** This ISAE is to be read in the context of the "International Framework for Assurance Engagements" (the Framework), which defines and describes the elements and objectives of an assurance engagement, and identifies those engagements to which ISAEs apply. This ISAE has been written for general application to assurance engagements other than audits or reviews of historical financial information covered by ISAs or ISREs. Other ISAEs may relate to topics that apply to all subject matters or be subject matter specific. Although ISAs and ISREs do not apply to engagements covered by ISAEs, they may nevertheless provide guidance to practitioners.

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[1] Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

Ethical Requirements

4. **The practitioner should comply with the requirements of Parts A and B of the IFAC *Code of Ethics for Professional Accountants* (the Code).**

5. The Code provides a framework of principles that members of assurance teams, firms and network firms use to identify threats to independence,[2] evaluate the significance of those threats and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level, such that independence of mind and independence in appearance are not compromised.

Quality Control

6. **The practitioner should implement quality control procedures that are applicable to the individual engagement.** Under International Standard on Quality Control (ISQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements,"[3] a firm of professional accountants has an obligation to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that the assurance reports issued by the firm or engagement partners are appropriate in the circumstances. In addition, elements of quality control that are relevant to an individual engagement include leadership responsibilities for quality on the engagement, ethical requirements, acceptance and continuance of client relationships and specific engagements, assignment of engagement teams, engagement performance, and monitoring.

Engagement Acceptance and Continuance

7. **The practitioner should accept (or continue where applicable) an assurance engagement only if the subject matter is the responsibility of a party other than the intended users or the practitioner.** As indicated in paragraph 27 of the Framework, the responsible party can be one of the intended users, but not the only one. Acknowledgement by the responsible

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2 If a professional accountant not in public practice, for example an internal auditor, applies ISAEs, and (a) the Framework or ISAEs are referred to in the professional accountant's report; and (b) the professional accountant or other members of the assurance team and, when applicable, the professional accountant's employer, are not independent of the entity in respect of which the assurance engagement is being performed, the lack of independence and the nature of the relationship(s) with the assurance client are prominently disclosed in the professional accountant's report. Also, that report does not include the word "independent" in its title, and the purpose and users of the report are restricted.

3 ISQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements" was issued in February 2004. Systems of quality control in compliance with ISQC 1 are required to be established by June 15, 2005.

party provides evidence that the appropriate relationship exists, and also establishes a basis for a common understanding of the responsibility of each party. A written acknowledgement is the most appropriate form of documenting the responsible party's understanding. In the absence of an acknowledgement of responsibility, the practitioner considers:

(a) Whether it is appropriate to accept the engagement. Accepting it may be appropriate when, for example, other sources, such as legislation or a contract, indicate responsibility; and

(b) If the engagement is accepted, whether to disclose these circumstances in the assurance report.

8. **The practitioner should accept (or continue where applicable) an assurance engagement only if, on the basis of a preliminary knowledge of the engagement circumstances, nothing comes to the attention of the practitioner to indicate that the requirements of the Code or of the ISAEs will not be satisfied.** The practitioner considers the matters in paragraph 17 of the Framework and does not accept the engagement unless it exhibits all the characteristics required in that paragraph. Also, if the party engaging the practitioner (the "engaging party") is not the responsible party, the practitioner considers the effect of this on access to records, documentation and other information the practitioner may require to complete the engagement.

9. **The practitioner should accept (or continue where applicable) an assurance engagement only if the practitioner is satisfied that those persons who are to perform the engagement collectively possess the necessary professional competencies.** A practitioner may be requested to perform assurance engagements on a wide range of subject matters. Some subject matters may require specialized skills and knowledge beyond those ordinarily possessed by an individual practitioner (see paragraphs 26-32).

Agreeing on the Terms of the Engagement

10. **The practitioner should agree on the terms of the engagement with the engaging party.** To avoid misunderstandings, the agreed terms are recorded in an engagement letter or other suitable form of contract. If the engaging party is not the responsible party, the nature and content of an engagement letter or contract may vary. The existence of a legislative mandate may satisfy the requirement to agree on the terms of the engagement. Even in those situations an engagement letter may be useful for both the practitioner and engaging party.

11. **A practitioner should consider the appropriateness of a request, made before the completion of an assurance engagement, to change the engagement to a non-assurance engagement or from a reasonable assurance engagement to a limited assurance engagement, and should not**

agree to a change without reasonable justification. A change in circumstances that affects the intended users' requirements, or a misunderstanding concerning the nature of the engagement, ordinarily will justify a request for a change in the engagement. If such a change is made, the practitioner does not disregard evidence that was obtained prior to the change.

Planning and Performing the Engagement

12. **The practitioner should plan the engagement so that it will be performed effectively**. Planning involves developing an overall strategy for the scope, emphasis, timing and conduct of the engagement, and an engagement plan, consisting of a detailed approach for the nature, timing and extent of evidence-gathering procedures to be performed and the reasons for selecting them. Adequate planning helps to devote appropriate attention to important areas of the engagement, identify potential problems on a timely basis and properly organize and manage the engagement in order for it to be performed in an effective and efficient manner. Adequate planning also assists the practitioner to properly assign work to engagement team members, and facilitates their direction and supervision and the review of their work. Further, it assists, where applicable, the coordination of work done by other practitioners and experts. The nature and extent of planning activities will vary with the engagement circumstances, for example the size and complexity of the entity and the practitioner's previous experience with it. Examples of the main matters to be considered include:

    - The terms of the engagement.
    - The characteristics of the subject matter and the identified criteria.
    - The engagement process and possible sources of evidence.
    - The practitioner's understanding of the entity and its environment, including the risks that the subject matter information may be materially misstated.
    - Identification of intended users and their needs, and consideration of materiality and the components of assurance engagement risk.
    - Personnel and expertise requirements, including the nature and extent of experts' involvement.

13. Planning is not a discrete phase, but rather a continual and iterative process throughout the engagement. As a result of unexpected events, changes in conditions, or the evidence obtained from the results of evidence-gathering procedures, the practitioner may need to revise the overall strategy and engagement plan, and thereby the resulting planned nature, timing and extent of further procedures.

14. **The practitioner should plan and perform an engagement with an attitude of professional skepticism recognizing that circumstances may exist that cause the subject matter information to be materially misstated.** An attitude of professional skepticism means the practitioner makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party.

15. **The practitioner should obtain an understanding of the subject matter and other engagement circumstances, sufficient to identify and assess the risks of the subject matter information being materially misstated, and sufficient to design and perform further evidence-gathering procedures.**

16. Obtaining an understanding of the subject matter and other engagement circumstances is an essential part of planning and performing an assurance engagement. That understanding provides the practitioner with a frame of reference for exercising professional judgment throughout the engagement, for example when:

    - Considering the characteristics of the subject matter;
    - Assessing the suitability of criteria;
    - Identifying where special consideration may be necessary, for example factors indicative of fraud, and the need for specialized skills or the work of an expert;
    - Establishing and evaluating the continued appropriateness of quantitative materiality levels (where appropriate), and considering qualitative materiality factors;
    - Developing expectations for use when performing analytical procedures;
    - Designing and performing further evidence-gathering procedures to reduce assurance engagement risk to an appropriate level; and
    - Evaluating evidence, including the reasonableness of the responsible party's oral and written representations.

17. The practitioner uses professional judgment to determine the extent of the understanding required of the subject matter and other engagement circumstances. The practitioner considers whether the understanding is sufficient to assess the risks that the subject matter information may be materially misstated. The practitioner ordinarily has a lesser depth of understanding than the responsible party.

Assessing the Appropriateness of the Subject Matter

18. **The practitioner should assess the appropriateness of the subject matter.** An appropriate subject matter has the characteristics listed in paragraph 33 of

the Framework. The practitioner also identifies those characteristics of the subject matter that are particularly relevant to the intended users, which are to be described in the assurance report. As indicated in paragraph 17 of the Framework, a practitioner does not accept an assurance engagement unless the practitioner's preliminary knowledge of the engagement circumstances indicates that the subject matter is appropriate. After accepting the engagement, however, if the practitioner concludes that the subject matter is not appropriate, the practitioner expresses a qualified or adverse conclusion or a disclaimer of conclusion. In some cases the practitioner considers withdrawing from the engagement.

Assessing the Suitability of the Criteria

19. **The practitioner should assess the suitability of the criteria to evaluate or measure the subject matter.** Suitable criteria have the characteristics listed in paragraph 36 of the Framework. As indicated in paragraph 17 of the Framework, a practitioner does not accept an assurance engagement unless the practitioner's preliminary knowledge of the engagement circumstances indicates that the criteria to be used are suitable. After accepting the engagement, however, if the practitioner concludes that the criteria are not suitable, the practitioner expresses a qualified or adverse conclusion or a disclaimer of conclusion. In some cases the practitioner considers withdrawing from the engagement.

20. Paragraph 37 of the Framework indicates that criteria can either be established or specifically developed. Ordinarily, established criteria are suitable when they are relevant to the needs of the intended users. When established criteria exist for a subject matter, specific users may agree to other criteria for their specific purposes. For example, various frameworks can be used as established criteria for evaluating the effectiveness of internal control. Specific users may, however, develop a more detailed set of criteria that meet their specific needs in relation to, for example, prudential supervision. In such cases, the assurance report:

    (a) Notes, when it is relevant to the circumstances of the engagement, that the criteria are not embodied in laws or regulations, or issued by authorized or recognized bodies of experts that follow a transparent due process; and

    (b) States that it is only for the use of the specific users and for their purposes.

21. For some subject matters, it is likely that no established criteria exist. In those cases, criteria are specifically developed. The practitioner considers whether specifically developed criteria result in an assurance report that is misleading to the intended users. The practitioner attempts to have the intended users or the engaging party acknowledge that specifically developed criteria are

suitable for the intended users' purposes. The practitioner considers how the absence of such an acknowledgement affects what is to be done to assess the suitability of the identified criteria, and the information provided about the criteria in the assurance report.

Materiality and Assurance Engagement Risk

22. **The practitioner should consider materiality and assurance engagement risk when planning and performing an assurance engagement.**

23. The practitioner considers materiality when determining the nature, timing and extent of evidence-gathering procedures, and when evaluating whether the subject matter information is free of misstatement. Considering materiality requires the practitioner to understand and assess what factors might influence the decisions of the intended users. For example, when the identified criteria allow for variations in the presentation of the subject matter information, the practitioner considers how the adopted presentation might influence the decisions of the intended users. Materiality is considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users. The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular engagement are matters for the practitioner's judgment.

24. **The practitioner should reduce assurance engagement risk to an acceptably low level in the circumstances of the engagement.** In a reasonable assurance engagement, the practitioner reduces assurance engagement risk to an acceptably low level in the circumstances of the engagement to obtain reasonable assurance as the basis for a positive form of expression of the practitioner's conclusion. The level of assurance engagement risk is higher in a limited assurance engagement than in a reasonable assurance engagement because of the different nature, timing or extent of evidence-gathering procedures. However, in a limited assurance engagement, the combination of the nature, timing, and extent of evidence-gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance as the basis for a negative form of expression. To be meaningful, the level of assurance obtained is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

25. Paragraph 49 of the Framework indicates that, in general, assurance engagement risk comprises inherent risk, control risk and detection risk. The degree to which the practitioner considers each of these components is affected by the engagement circumstances, in particular the nature of the subject matter and whether a reasonable assurance or a limited assurance engagement is being performed.

Using the Work of an Expert

26. **When the work of an expert is used in the collection and evaluation of evidence, the practitioner and the expert should, on a combined basis, possess adequate skill and knowledge regarding the subject matter and the criteria for the practitioner to determine that sufficient appropriate evidence has been obtained.**

27. The subject matter and related criteria of some assurance engagements may include aspects requiring specialized knowledge and skills in the collection and evaluation of evidence. In these situations, the practitioner may decide to use the work of persons from other professional disciplines, referred to as experts, who have the required knowledge and skills. This ISAE does not provide guidance with respect to using the work of an expert for engagements where there is joint responsibility and reporting by a practitioner and one or more experts.

28. Due care is a required professional quality for all individuals, including experts, involved in an assurance engagement. Persons involved in assurance engagements will have different responsibilities assigned to them. The extent of proficiency required in performing those engagements will vary with the nature of their responsibilities. While experts do not require the same proficiency as the practitioner in performing all aspects of an assurance engagement, the practitioner determines that the experts have a sufficient understanding of the ISAEs to enable them to relate the work assigned to them to the engagement objective.

29. The practitioner adopts quality control procedures that address the responsibility of each person performing the assurance engagement, including the work of any experts who are not professional accountants, to ensure compliance with this ISAE and other relevant ISAEs in the context of their responsibilities.

30. **The practitioner should be involved in the engagement and understand the work for which an expert is used, to an extent that is sufficient to enable the practitioner to accept responsibility for the conclusion on the subject matter information.** The practitioner considers the extent to which it is reasonable to use the work of an expert in forming the practitioner's conclusion.

31. The practitioner is not expected to possess the same specialized knowledge and skills as the expert. The practitioner has however, sufficient skill and knowledge to:

    (a) Define the objectives of the assigned work and how this work relates to the objective of the engagement;

(b) Consider the reasonableness of the assumptions, methods and source data used by the expert; and

(c) Consider the reasonableness of the expert's findings in relation to the engagement circumstances and the practitioner's conclusion.

32. **The practitioner should obtain sufficient appropriate evidence that the expert's work is adequate for the purposes of the assurance engagement.** In assessing the sufficiency and appropriateness of the evidence provided by the expert, the practitioner evaluates:

(a) The professional competence, including experience, and objectivity of the expert;

(b) The reasonableness of the assumptions, methods and source data used by the expert; and

(c) The reasonableness and significance of the expert's findings in relation to the circumstances of the engagement and the practitioner's conclusion.

Obtaining Evidence

33. **The practitioner should obtain sufficient appropriate evidence on which to base the conclusion.** Sufficiency is the measure of the quantity of evidence. Appropriateness is the measure of the quality of evidence; that is, its relevance and its reliability. The practitioner considers the relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an evidence-gathering procedure for which there is no alternative. The practitioner uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of evidence, and thus its sufficiency and appropriateness, to support the assurance report.

34. An assurance engagement rarely involves the authentication of documentation, nor is the practitioner trained as or expected to be an expert in such authentication. However, the practitioner considers the reliability of the information to be used as evidence, for example photocopies, facsimiles, filmed, digitized or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.

35. Sufficient appropriate evidence in a reasonable assurance engagement is obtained as part of an iterative, systematic engagement process involving:

(a) Obtaining an understanding of the subject matter and other engagement circumstances which, depending on the subject matter, includes obtaining an understanding of internal control;

(b) Based on that understanding, assessing the risks that the subject matter information may be materially misstated;

(c) Responding to assessed risks, including developing overall responses, and determining the nature, timing and extent of further procedures;

(d) Performing further procedures clearly linked to the identified risks, using a combination of inspection, observation, confirmation, re-calculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures, including obtaining corroborating information from sources independent of the entity, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and

(e) Evaluating the sufficiency and appropriateness of evidence.

36. "Reasonable assurance" is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- The use of selective testing.
- The inherent limitations of internal control.
- The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
- The use of judgment in gathering and evaluating evidence and forming conclusions based on that evidence.
- In some cases, the characteristics of the subject matter.

37. Both reasonable assurance and limited assurance engagements require the application of assurance skills and techniques and the gathering of sufficient appropriate evidence as part of an iterative, systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances. The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance engagement are, however, deliberately limited relative to a reasonable assurance engagement. For some subject matters, there may be specific ISAEs to provide guidance on procedures for gathering sufficient appropriate evidence for a limited assurance engagement. In the absence of a specific ISAE, the procedures for gathering sufficient appropriate evidence will vary with the circumstances of the engagement, in particular: the subject matter, and the needs of the intended users and the engaging party, including relevant time and cost constraints. For both reasonable assurance and limited assurance engagements, if the practitioner becomes aware of a matter that leads the practitioner to question whether a material modification should be made to the

subject matter information, the practitioner pursues the matter by performing other procedures sufficient to enable the practitioner to report.

Representations by the Responsible Party

38. **The practitioner should obtain representations from the responsible party, as appropriate.** Written confirmation of oral representations reduces the possibility of misunderstandings between the practitioner and the responsible party. In particular, the practitioner requests from the responsible party a written representation that evaluates or measures the subject matter against the identified criteria, whether or not it is to be made available as an assertion to the intended users. Having no written representation may result in a qualified conclusion or a disclaimer of conclusion on the basis of a limitation on the scope of the engagement. The practitioner may also include a restriction on the use of the assurance report.

39. During an assurance engagement, the responsible party may make representations to the practitioner, either unsolicited or in response to specific inquiries. When such representations relate to matters that are material to the subject matter's evaluation or measurement, the practitioner:

    (a) Evaluates their reasonableness and consistency with other evidence obtained, including other representations;

    (b) Considers whether those making the representations can be expected to be well informed on the particular matters; and

    (c) Obtains corroborative evidence in the case of a reasonable assurance engagement. The practitioner may also seek corroborative evidence in the case of a limited assurance engagement.

40. Representations by the responsible party cannot replace other evidence the practitioner could reasonably expect to be available. An inability to obtain sufficient appropriate evidence regarding a matter that has, or may have, a material effect on the evaluation or measurement of the subject matter, when such evidence would ordinarily be available, constitutes a limitation on the scope of the engagement, even if a representation from the responsible party has been received on the matter.

Considering Subsequent Events

41. **The practitioner should consider the effect on the subject matter information and on the assurance report of events up to the date of the assurance report.** The extent of consideration of subsequent events depends on the potential for such events to affect the subject matter information and to affect the appropriateness of the practitioner's conclusion. Consideration of subsequent events in some assurance engagements may not be relevant because of the nature of the subject matter. For example, when the engagement

requires a conclusion about the accuracy of a statistical return at a point in time, events occurring between that point in time and the date of the assurance report, may not affect the conclusion, or require disclosure in the return or the assurance report.

Documentation

42. **The practitioner should document matters that are significant in providing evidence that supports the assurance report and that the engagement was performed in accordance with ISAEs.**

43. Documentation includes a record of the practitioner's reasoning on all significant matters that require the exercise of judgment, and related conclusions. The existence of difficult questions of principle or judgment, calls for the documentation to include the relevant facts that were known by the practitioner at the time the conclusion was reached.

44. It is neither necessary nor practical to document every matter the practitioner considers. In applying professional judgment to assessing the extent of documentation to be prepared and retained, the practitioner may consider what is necessary to provide an understanding of the work performed and the basis of the principal decisions taken (but not the detailed aspects of the engagement) to another practitioner who has no previous experience with the engagement. That other practitioner may only be able to obtain an understanding of detailed aspects of the engagement by discussing them with the practitioner who prepared the documentation.

Preparing the Assurance Report

45. **The practitioner should conclude whether sufficient appropriate evidence has been obtained to support the conclusion expressed in the assurance report.** In developing the conclusion, the practitioner considers all relevant evidence obtained, regardless of whether it appears to corroborate or to contradict the subject matter information.

46. **The assurance report should be in writing and should contain a clear expression of the practitioner's conclusion about the subject matter information.**

47. Oral and other forms of expressing conclusions can be misunderstood without the support of a written report. For this reason, the practitioner does not report orally or by use of symbols without also providing a definitive written assurance report that is readily available whenever the oral report is provided or the symbol is used. For example, a symbol could be hyperlinked to a written assurance report on the Internet.

48. This ISAE does not require a standardized format for reporting on all assurance engagements. Instead it identifies in paragraph 49 the basic elements

the assurance report is to include. Assurance reports are tailored to the specific engagement circumstances. The practitioner chooses a "short form" or "long form" style of reporting to facilitate effective communication to the intended users. "Short-form" reports ordinarily include only the basic elements. "Long-form" reports often describe in detail the terms of the engagement, the criteria being used, findings relating to particular aspects of the engagement and, in some cases, recommendations, as well as the basic elements. Any findings and recommendations are clearly separated from the practitioner's conclusion on the subject matter information, and the wording used in presenting them makes it clear they are not intended to affect the practitioner's conclusion. The practitioner may use headings, paragraph numbers, typographical devices, for example the bolding of text, and other mechanisms to enhance the clarity and readability of the assurance report.

Assurance Report Content

49. **The assurance report should include the following basic elements:**

(a) **A title that clearly indicates the report is an independent assurance report:**[4] an appropriate title helps to identify the nature of the assurance report, and to distinguish it from reports issued by others, such as those who do not have to comply with the same ethical requirements as the practitioner.

(b) **An addressee:** an addressee identifies the party or parties to whom the assurance report is directed. Whenever practical, the assurance report is addressed to all the intended users, but in some cases there may be other intended users.

(c) **An identification and description of the subject matter information and, when appropriate, the subject matter:** this includes for example:

- The point in time or period of time to which the evaluation or measurement of the subject matter relates;
- Where applicable, the name of the entity or component of the entity to which the subject matter relates; and
- An explanation of those characteristics of the subject matter or the subject matter information of which the intended users should be aware, and how such characteristics may influence the precision of the evaluation or measurement of the subject matter against the identified criteria, or the persuasiveness of available evidence. For example:

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4 See footnote 2.

- ◦ The degree to which the subject matter information is qualitative versus quantitative, objective versus subjective, or historical versus prospective.
- ◦ Changes in the subject matter or other engagement circumstances that affect the comparability of the subject matter information from one period to the next.

When the practitioner's conclusion is worded in terms of the responsible party's assertion, that assertion is appended to the assurance report, reproduced in the assurance report or referenced therein to a source that is available to the intended users.

(d) **Identification of the criteria:** the assurance report identifies the criteria against which the subject matter was evaluated or measured so the intended users can understand the basis for the practitioner's conclusion. The assurance report may include the criteria, or refer to them if they are contained in an assertion prepared by the responsible party that is available to the intended users or if they are otherwise available from a readily accessible source. The practitioner considers whether it is relevant to the circumstances, to disclose:

- The source of the criteria, and whether or not the criteria are embodied in laws or regulations, or issued by authorized or recognized bodies of experts that follow a transparent due process, that is, whether they are established criteria in the context of the subject matter (and if they are not, a description of why they are considered suitable);
- Measurement methods used when the criteria allow for choice between a number of methods;
- Any significant interpretations made in applying the criteria in the engagement circumstances; and
- Whether there have been any changes in the measurement methods used.

(e) **Where appropriate, a description of any significant, inherent limitation associated with the evaluation or measurement of the subject matter against the criteria:** while in some cases, inherent limitations can be expected to be well understood by readers of an assurance report, in other cases it may be appropriate to make explicit reference in the assurance report. For example, in an assurance report related to the effectiveness of internal control, it may be appropriate to note that the historic evaluation of effectiveness is not relevant to future periods due to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

(f) **When the criteria used to evaluate or measure the subject matter are available only to specific intended users, or are relevant only to a specific purpose, a statement restricting the use of the assurance report to those intended users or that purpose:** in addition, whenever the assurance report is intended only for specific intended users or a specific purpose, the practitioner considers stating this fact in the assurance report.[5] This provides a caution to readers that the assurance report is restricted to specific users or for specific purposes.

(g) **A statement to identify the responsible party and to describe the responsible party's and the practitioner's responsibilities:** this informs the intended users that the responsible party is responsible for the subject matter in the case of a direct reporting engagement, or the subject matter information in the case of an assertion-based engagement,[6] and that the practitioner's role is to independently express a conclusion about the subject matter information.

(h) **A statement that the engagement was performed in accordance with ISAEs:** where there is a subject matter specific ISAE, that ISAE may require that the assurance report refer specifically to it.

(i) **A summary of the work performed:** the summary will help the intended users understand the nature of the assurance conveyed by the assurance report. ISA 700, "The Auditor's Report on Financial Statements"[7] and ISRE 2400, "Engagements to Review Financial Statements" provide a guide to the appropriate type of summary.

Where no specific ISAE provides guidance on evidence-gathering procedures for a particular subject matter, the summary might include a more detailed description of the work performed.

Because in a limited assurance engagement an appreciation of the nature, timing, and extent of evidence-gathering procedures performed is essential to understanding the assurance conveyed by a conclusion expressed in the negative form, the summary of the work performed:

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5 While an assurance report may be restricted whenever it is intended only for specified intended users or for a specific purpose, the absence of a restriction regarding a particular reader or purpose does not itself indicate that a legal responsibility is owed by the practitioner in relation to that reader or for that purpose. Whether a legal responsibility is owed will depend on the legal circumstances of each case and the relevant jurisdiction.

6 Refer to paragraph 10 of the Framework for an explanation of the distinction between a direct engagement and an assertion-based engagement.

7 ISA 700, "The Auditor's Report on Financial Statements" was withdrawn in December 2006 when ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" became effective.

(i) Is ordinarily more detailed than for a reasonable assurance engagement and identifies the limitations on the nature, timing, and extent of evidence-gathering procedures. It may be appropriate to indicate procedures that were not performed that would ordinarily be performed in a reasonable assurance engagement; and

(ii) States that the evidence-gathering procedures are more limited than for a reasonable assurance engagement, and that therefore less assurance is obtained than in a reasonable assurance engagement.

(j) **The practitioner's conclusion:** where the subject matter information is made up of a number of aspects, separate conclusions may be provided on each aspect. While not all such conclusions need to relate to the same level of evidence-gathering procedures, each conclusion is expressed in the form that is appropriate to either a reasonable-assurance or a limited assurance engagement.

Where appropriate, the conclusion should inform the intended users of the context in which the practitioner's conclusion is to be read: the practitioner's conclusion may, for example, include wording such as: "This conclusion has been formed on the basis of, and is subject to the inherent limitations outlined elsewhere in this independent assurance report." This would be appropriate, for example, when the report includes an explanation of particular characteristics of the subject matter of which the intended users should be aware.

In a reasonable assurance engagement, the conclusion should be expressed in the positive form: for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*" or "In our opinion *the responsible party's* assertion that internal control is effective, in all material respects, based on *XYZ criteria,* is fairly stated."

In a limited assurance engagement, the conclusion should be expressed in the negative form: for example: "Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on *XYZ criteria*" or "Based on our work described in this report, nothing has come to our attention that causes us to believe that *the responsible party's* assertion that internal control is effective, in all material respects, based on *XYZ criteria,* is not fairly stated."

Where the practitioner expresses a conclusion that is other than unqualified, the assurance report should contain a clear description of all the reasons: (also see paragraphs 51-53).

(k) **The assurance report date:** this informs the intended users that the practitioner has considered the effect on the subject matter information and on the assurance report of events that occurred up to that date.

(l) **The name of the firm or the practitioner, and a specific location, which ordinarily is the city where the practitioner maintains the office that has responsibility for the engagement:** this informs the intended users of the individual or firm assuming responsibility for the engagement.

50. The practitioner may expand the assurance report to include other information and explanations that are not intended to affect the practitioner's conclusion. Examples include: details of the qualifications and experience of the practitioner and others involved with the engagement, disclosure of materiality levels, findings relating to particular aspects of the engagement, and recommendations. Whether to include any such information depends on its significance to the needs of the intended users. Additional information is clearly separated from the practitioner's conclusion and worded in such a manner so as not to affect that conclusion.

Qualified Conclusions, Adverse Conclusions and Disclaimers of Conclusion

51. **The practitioner should not express an unqualified conclusion when the following circumstances exist and, in the practitioner's judgment, the effect of the matter is or may be material:**

(a) **There is a limitation on the scope of the practitioner's work, that is, circumstances prevent, or the responsible party or the engaging party imposes a restriction that prevents, the practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level. The practitioner should express a qualified conclusion or a disclaimer of conclusion;**

(b) **In those cases where:**

(i) **The practitioner's conclusion is worded in terms of the responsible party's assertion, and that assertion is not fairly stated, in all material respects; or**

(ii) **The practitioner's conclusion is worded directly in terms of the subject matter and the criteria, and the subject matter information is materially misstated,**[8]

the practitioner should express a qualified or adverse conclusion; or

(c) **When it is discovered, after the engagement has been accepted, that the criteria are unsuitable or the subject matter is not appropriate for an assurance engagement. The practitioner should express:**

(i) **A qualified conclusion or adverse conclusion when the unsuitable criteria or inappropriate subject matter is likely to mislead the intended users; or**

(ii) **A qualified conclusion or a disclaimer of conclusion in other cases.**

52. **The practitioner should express a qualified conclusion when the effect of a matter is not so material or pervasive as to require an adverse conclusion or a disclaimer of conclusion. A qualified conclusion is expressed as being "except for" the effects of the matter to which the qualification relates.**

53. In those cases where the practitioner's unqualified conclusion would be worded in terms of the responsible party's assertion, and that assertion has identified and properly described that the subject matter information is materially misstated, the practitioner either:

(a) Expresses a qualified or adverse conclusion worded directly in terms of the subject matter and the criteria; or

(b) If specifically required by the terms of the engagement to word the conclusion in terms of the responsible party's assertion, expresses an unqualified conclusion but emphasizes the matter by specifically referring to it in the assurance report.

Other Reporting Responsibilities

54. **The practitioner should consider other reporting responsibilities, including the appropriateness of communicating relevant matters of governance interest arising from the assurance engagement with those charged with governance.**

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8 In those direct reporting engagements where the subject matter information is presented only in the practitioner's conclusion, and the practitioner concludes that the subject matter does not, in all material respects, conform with the criteria, for example: "In our opinion, except for *[...]*, internal control is effective, in all material respects, based on *XYZ criteria,*" such a conclusion would also be considered to be qualified (or adverse as appropriate).

55. In this ISAE, "governance" describes the role of persons entrusted with the supervision, control and direction of a responsible party.[9] Those charged with governance ordinarily are accountable for ensuring that an entity achieves its objectives and for reporting to interested parties. If the engaging party is different from the responsible party it may not be appropriate to communicate directly with the responsible party or those charged with governance over the responsible party.

56. In this ISAE, "relevant matters of governance interest" are those that arise from the assurance engagement and, in the practitioner's opinion, are both important and relevant to those charged with governance. Relevant matters of governance interest include only those matters that have come to the attention of the practitioner while performing the assurance engagement. If the terms of the engagement do not specifically require it, the practitioner is not required to design procedures for the specific purpose of identifying matters of governance interest.

Effective Date

57. This ISAE is effective for assurance engagements where the assurance report is dated on or after January 1, 2005. Earlier application is permissible.

Public Sector Perspective

1. This ISAE is applicable to all professional accountants in the public sector who are independent of the entity for which they perform assurance engagements. Where professional accountants in the public sector are not independent of the entity for which they perform an assurance engagement, this ISAE should be applied with particular reference to the guidance in footnotes 2 and 4.

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9 In many countries, principles of governance have been developed as a point of reference for establishing good governance behavior. Such principles often focus on publicly traded companies; they may however, also serve to improve governance in other forms of entities. There is no single model of good governance. Governance structures and practices vary from country to country.

INTERNATIONAL STANDARD ON ASSURANCE ENGAGEMENTS 3400

(Previously ISA 810)

THE EXAMINATION OF PROSPECTIVE FINANCIAL INFORMATION

(This Standard is effective)

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International Standard on Assurance Engagements (ISAE) 3400, "The Examination of Prospective Financial Information" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAEs.

Introduction

1. The purpose of this International Standard on Assurance Engagements (ISAE) is to establish standards and provide guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions. This ISAE does not apply to the examination of prospective financial information expressed in general or narrative terms, such as that found in management's discussion and analysis in an entity's annual report, though many of the procedures outlined herein may be suitable for such an examination.

2. **In an engagement to examine prospective financial information, the auditor should obtain sufficient appropriate evidence as to whether:**

   (a) **Management's best-estimate assumptions on which the prospective financial information is based are not unreasonable and, in the case of hypothetical assumptions, such assumptions are consistent with the purpose of the information;**

   (b) **The prospective financial information is properly prepared on the basis of the assumptions;**

   (c) **The prospective financial information is properly presented and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; and**

   (d) **The prospective financial information is prepared on a consistent basis with historical financial statements, using appropriate accounting principles.**

3. "Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires the exercise of considerable judgment. Prospective financial information can be in the form of a forecast, a projection or a combination of both, for example, a one year forecast plus a five year projection.

4. A "forecast" means prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).

5. A "projection" means prospective financial information prepared on the basis of:

   (a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or

(b) A mixture of best-estimate and hypothetical assumptions.

Such information illustrates the possible consequences as of the date the information is prepared if the events and actions were to occur (a "what-if" scenario).

6. Prospective financial information can include financial statements or one or more elements of financial statements and may be prepared:

   (a) As an internal management tool, for example, to assist in evaluating a possible capital investment; or

   (b) For distribution to third parties in, for example:

   - A prospectus to provide potential investors with information about future expectations.
   - An annual report to provide information to shareholders, regulatory bodies and other interested parties.
   - A document for the information of lenders which may include, for example, cash flow forecasts.

7. Management is responsible for the preparation and presentation of the prospective financial information, including the identification and disclosure of the assumptions on which it is based. The auditor may be asked to examine and report on the prospective financial information to enhance its credibility whether it is intended for use by third parties or for internal purposes.

The Auditor's Assurance Regarding Prospective Financial Information

8. Prospective financial information relates to events and actions that have not yet occurred and may not occur. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future oriented and, therefore, speculative in nature, as distinct from the evidence ordinarily available in the audit of historical financial information. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.

9. Further, given the types of evidence available in assessing the assumptions on which the prospective financial information is based, it may be difficult for the auditor to obtain a level of satisfaction sufficient to provide a positive expression of opinion that the assumptions are free of material misstatement. Consequently, in this ISAE, when reporting on the reasonableness of management's assumptions the auditor provides only a moderate level of assurance. However, when in the auditor's judgment an appropriate level of satisfaction has been obtained, the auditor is not precluded from expressing positive assurance regarding the assumptions.

Acceptance of Engagement

10. Before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:
    - The intended use of the information;
    - Whether the information will be for general or limited distribution;
    - The nature of the assumptions, that is, whether they are best-estimate or hypothetical assumptions;
    - The elements to be included in the information; and
    - The period covered by the information.
11. **The auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.**
12. **The auditor and the client should agree on the terms of the engagement.** It is in the interests of both entity and auditor that the auditor sends an engagement letter to help in avoiding misunderstandings regarding the engagement. An engagement letter would address the matters in paragraph 10 and set out management's responsibilities for the assumptions and for providing the auditor with all relevant information and source data used in developing the assumptions.

Knowledge of the Business

13. **The auditor should obtain a sufficient level of knowledge of the business to be able to evaluate whether all significant assumptions required for the preparation of the prospective financial information have been identified.** The auditor would also need to become familiar with the entity's process for preparing prospective financial information, for example, by considering the following:
    - The internal controls over the system used to prepare prospective financial information and the expertise and experience of those persons preparing the prospective financial information.
    - The nature of the documentation prepared by the entity supporting management's assumptions.
    - The extent to which statistical, mathematical and computer-assisted techniques are used.
    - The methods used to develop and apply assumptions.
    - The accuracy of prospective financial information prepared in prior periods and the reasons for significant variances.

14. **The auditor should consider the extent to which reliance on the entity's historical financial information is justified.** The auditor requires a knowledge of the entity's historical financial information to assess whether the prospective financial information has been prepared on a basis consistent with the historical financial information and to provide a historical yardstick for considering management's assumptions. The auditor will need to establish, for example, whether relevant historical information was audited or reviewed and whether acceptable accounting principles were used in its preparation.

15. If the audit or review report on prior period historical financial information was other than unmodified or if the entity is in a start-up phase, the auditor would consider the surrounding facts and the effect on the examination of the prospective financial information.

Period Covered

16. **The auditor should consider the period of time covered by the prospective financial information.** Since assumptions become more speculative as the length of the period covered increases, as that period lengthens, the ability of management to make best-estimate assumptions decreases. The period would not extend beyond the time for which management has a reasonable basis for the assumptions. The following are some of the factors that are relevant to the auditor's consideration of the period of time covered by the prospective financial information:

    - Operating cycle, for example, in the case of a major construction project the time required to complete the project may dictate the period covered.
    - The degree of reliability of assumptions, for example, if the entity is introducing a new product the prospective period covered could be short and broken into small segments, such as weeks or months. Alternatively, if the entity's sole business is owning a property under long-term lease, a relatively long prospective period might be reasonable.
    - The needs of users, for example, prospective financial information may be prepared in connection with an application for a loan for the period of time required to generate sufficient funds for repayment. Alternatively, the information may be prepared for investors in connection with the sale of debentures to illustrate the intended use of the proceeds in the subsequent period.

Examination Procedures

17. **When determining the nature, timing and extent of examination procedures, the auditor's considerations should include:**

    (a) **The likelihood of material misstatement;**

    (b) **The knowledge obtained during any previous engagements;**

(c) **Management's competence regarding the preparation of prospective financial information;**

(d) **The extent to which the prospective financial information is affected by the management's judgment; and**

(e) **The adequacy and reliability of the underlying data.**

18. The auditor would assess the source and reliability of the evidence supporting management's best-estimate assumptions. Sufficient appropriate evidence supporting such assumptions would be obtained from internal and external sources including consideration of the assumptions in the light of historical information and an evaluation of whether they are based on plans that are within the entity's capacity.

19. The auditor would consider whether, when hypothetical assumptions are used, all significant implications of such assumptions have been taken into consideration. For example, if sales are assumed to grow beyond the entity's current plant capacity, the prospective financial information will need to include the necessary investment in the additional plant capacity or the costs of alternative means of meeting the anticipated sales, such as subcontracting production.

20. Although evidence supporting hypothetical assumptions need not be obtained, the auditor would need to be satisfied that they are consistent with the purpose of the prospective financial information and that there is no reason to believe they are clearly unrealistic.

21. The auditor will need to be satisfied that the prospective financial information is properly prepared from management's assumptions by, for example, making clerical checks such as recomputation and reviewing internal consistency, that is, the actions management intends to take are compatible with each other and there are no inconsistencies in the determination of the amounts that are based on common variables such as interest rates.

22. The auditor would focus on the extent to which those areas that are particularly sensitive to variation will have a material effect on the results shown in the prospective financial information. This will influence the extent to which the auditor will seek appropriate evidence. It will also influence the auditor's evaluation of the appropriateness and adequacy of disclosure.

23. When engaged to examine one or more elements of prospective financial information, such as an individual financial statement, it is important that the auditor consider the interrelationship of other components in the financial statements.

24. When any elapsed portion of the current period is included in the prospective financial information, the auditor would consider the extent to which procedures need to be applied to the historical information. Procedures will

vary depending on the circumstances, for example, how much of the prospective period has elapsed.

25. **The auditor should obtain written representations from management regarding the intended use of the prospective financial information, the completeness of significant management assumptions and management's acceptance of its responsibility for the prospective financial information.**

Presentation and Disclosure

26. When assessing the presentation and disclosure of the prospective financial information, in addition to the specific requirements of any relevant statutes, regulations or professional standards, the auditor will need to consider whether:

    (a) The presentation of prospective financial information is informative and not misleading;

    (b) The accounting policies are clearly disclosed in the notes to the prospective financial information;

    (c) The assumptions are adequately disclosed in the notes to the prospective financial information. It needs to be clear whether assumptions represent management's best-estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this uncertainty and the resulting sensitivity of results needs to be adequately disclosed;

    (d) The date as of which the prospective financial information was prepared is disclosed. Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time;

    (e) The basis of establishing points in a range is clearly indicated and the range is not selected in a biased or misleading manner when results shown in the prospective financial information are expressed in terms of a range; and

    (f) Any change in accounting policy since the most recent historical financial statements is disclosed, along with the reason for the change and its effect on the prospective financial information.

Report on Examination of Prospective Financial Information

27. **The report by an auditor on an examination of prospective financial information should contain the following:**

    (a) **Title;**

    (b) **Addressee;**

(c) **Identification of the prospective financial information;**

(d) **A reference to the ISAE or relevant national standards or practices applicable to the examination of prospective financial information;**

(e) **A statement that management is responsible for the prospective financial information including the assumptions on which it is based;**

(f) **When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information;**

(g) **A statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information;**

(h) **An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework;**

(i) **Appropriate caveats concerning the achievability of the results indicated by the prospective financial information;**

(j) **Date of the report which should be the date procedures have been completed;**

(k) **Auditor's address; and**

(l) **Signature.**

28. Such a report would:

- State whether, based on the examination of the evidence supporting the assumptions, anything has come to the auditor's attention which causes the auditor to believe that the assumptions do not provide a reasonable basis for the prospective financial information.
- Express an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework.
- State that:
  - Actual results are likely to be different from the prospective financial information since anticipated events frequently do not occur as expected and the variation could be material. Likewise, when the prospective financial information is expressed as a range, it would be stated that there can be no assurance that actual results will fall within the range; and

- ◦ In the case of a projection, the prospective financial information has been prepared for (state purpose), using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that the prospective financial information is not used for purposes other than that described.

29. The following is an example of an extract from an unmodified report on a forecast:

    We have examined the forecast[1] in accordance with the International Standard on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the forecast including the assumptions set out in Note X on which it is based.

    Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions and is presented in accordance with ....[2]

    Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

30. The following is an example of an extract from an unmodified report on a projection:

    We have examined the projection[3] in accordance with the International Standard on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the projection including the assumptions set out in Note X on which it is based.

    This projection has been prepared for (describe purpose). As the entity is in a start-up phase the projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that this

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1 Include name of the entity, the period covered by the forecast and provide suitable identification, such as by reference to page numbers or by identifying the individual statements.

2 Indicate the relevant financial reporting framework.

3 Include name of the entity, the period covered by the projection and provide suitable identification, such as by reference to page numbers or by identifying the individual statements.

projection may not be appropriate for purposes other than that described above.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection, assuming that (state or refer to the hypothetical assumptions). Further, in our opinion the projection is properly prepared on the basis of the assumptions and is presented in accordance with ....[4]

Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

31. **When the auditor believes that the presentation and disclosure of the prospective financial information is not adequate, the auditor should express a qualified or adverse opinion in the report on the prospective financial information, or withdraw from the engagement as appropriate.** An example would be where financial information fails to disclose adequately the consequences of any assumptions which are highly sensitive.

32. **When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion in the report on the prospective financial information, or withdraw from the engagement.**

33. **When the examination is affected by conditions that preclude application of one or more procedures considered necessary in the circumstances, the auditor should either withdraw from the engagement or disclaim the opinion and describe the scope limitation in the report on the prospective financial information.**

[4] See footnote 2.

INTERNATIONAL STANDARD ON RELATED SERVICES 4400

(Previously ISA 920)

ENGAGEMENTS TO PERFORM AGREED-UPON PROCEDURES REGARDING FINANCIAL INFORMATION

(This Standard is effective)

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International Standard on Related Services (ISRS) 4400, "Engagements to Perform Agreed-upon Procedures Regarding Financial Information" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISRSs.

Introduction

1. The purpose of this International Standard on Related Services (ISRS) is to establish standards and provide guidance on the auditor's[1] professional responsibilities when an engagement to perform agreed-upon procedures regarding financial information is undertaken and on the form and content of the report that the auditor issues in connection with such an engagement.

2. This ISRS is directed toward engagements regarding financial information. However, it may provide useful guidance for engagements regarding non-financial information, provided the auditor has adequate knowledge of the subject matter in question and reasonable criteria exist on which to base findings. Guidance in the International Standards on Auditing (ISAs) may be useful to the auditor in applying this ISRS.

3. An engagement to perform agreed-upon procedures may involve the auditor in performing certain procedures concerning individual items of financial data (for example, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity), a financial statement (for example, a balance sheet) or even a complete set of financial statements.

Objective of an Agreed-Upon Procedures Engagement

4. **The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.**

5. As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.

6. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

General Principles of an Agreed-Upon Procedures Engagement

7. **The auditor should comply with the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants.** Ethical principles governing the auditor's professional responsibilities for this type of engagement are:

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[1] The term "auditor" is used throughout the pronouncements of the International Auditing and Assurance Standards Board when describing both audit, review, other assurance and related services that may be performed. Such reference is not intended to imply that a person performing review, other assurance or related services need be the auditor of the entity's financial statements.

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality;

(e) Professional behavior; and

(f) Technical standards.

Independence is not a requirement for agreed-upon procedures engagements; however, the terms or objectives of an engagement or national standards may require the auditor to comply with the independence requirements of IFAC's *Code of Ethics for Professional Accountants*. Where the auditor is not independent, a statement to that effect would be made in the report of factual findings.

8. **The auditor should conduct an agreed-upon procedures engagement in accordance with this ISRS and the terms of the engagement.**

Defining the Terms of the Engagement

9. **The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.** Matters to be agreed include the following:

   - Nature of the engagement including the fact that the procedures performed will not constitute an audit or a review and that accordingly no assurance will be expressed.
   - Stated purpose for the engagement.
   - Identification of the financial information to which the agreed-upon procedures will be applied.
   - Nature, timing and extent of the specific procedures to be applied.
   - Anticipated form of the report of factual findings.
   - Limitations on distribution of the report of factual findings. When such limitation would be in conflict with the legal requirements, if any, the auditor would not accept the engagement.

10. In certain circumstances, for example, when the procedures have been agreed to between the regulator, industry representatives and representatives of the accounting profession, the auditor may not be able to discuss the procedures with all the parties who will receive the report. In such cases, the auditor may consider, for example, discussing the procedures to be applied with appropriate

representatives of the parties involved, reviewing relevant correspondence from such parties or sending them a draft of the type of report that will be issued.

11. It is in the interests of both the client and the auditor that the auditor sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor's responsibilities and the form of reports to be issued.

12. Matters that would be included in the engagement letter include the following:

    - A listing of the procedures to be performed as agreed upon between the parties.
    - A statement that the distribution of the report of factual findings would be restricted to the specified parties who have agreed to the procedures to be performed.

    In addition, the auditor may consider attaching to the engagement letter a draft of the type of report of factual findings that will be issued. An example of an engagement letter appears in Appendix 1 to this ISRS.

Planning

13. **The auditor should plan the work so that an effective engagement will be performed.**

Documentation

14. **The auditor should document matters which are important in providing evidence to support the report of factual findings, and evidence that the engagement was carried out in accordance with this ISRS and the terms of the engagement.**

Procedures and Evidence

15. **The auditor should carry out the procedures agreed upon and use the evidence obtained as the basis for the report of factual findings.**

16. The procedures applied in an engagement to perform agreed-upon procedures may include the following:

    - Inquiry and analysis.
    - Recomputation, comparison and other clerical accuracy checks.
    - Observation.
    - Inspection.

- Obtaining confirmations.

Appendix 2 to this ISRS is an example report which contains an illustrative list of procedures which may be used as one part of a typical agreed-upon procedures engagement.

Reporting

17. The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedures of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed.

18. **The report of factual findings should contain:**

    (a) **Title;**

    (b) **Addressee (ordinarily the client who engaged the auditor to perform the agreed-upon procedures);**

    (c) **Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;**

    (d) **A statement that the procedures performed were those agreed upon with the recipient;**

    (e) **A statement that the engagement was performed in accordance with the International Standard on Related Services applicable to agreed-upon procedures engagements, or with relevant national standards or practices;**

    (f) **When relevant a statement that the auditor is not independent of the entity;**

    (g) **Identification of the purpose for which the agreed-upon procedures were performed;**

    (h) **A listing of the specific procedures performed;**

    (i) **A description of the auditor's factual findings including sufficient details of errors and exceptions found;**

    (j) **Statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;**

    (k) **A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;**

    (l) **A statement that the report is restricted to those parties that have agreed to the procedures to be performed;**

(m) **A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole;**

(n) **Date of the report;**

(o) **Auditor's address; and**

(p) **Auditor's signature.**

Appendix 2 to this ISRS contains an example of a report of factual findings issued in connection with an engagement to perform agreed-upon procedures regarding financial information.

Public Sector Perspective

1. The report in a public sector engagement may not be restricted only to those parties that have agreed to the procedures to be performed, but made available also to a wider range of entities or people (for example, a parliamentary investigation about a specific public entity or governmental department).

2. It also has to be noted that public sector mandates vary significantly and caution has to be taken to distinguish engagements that are truly "agreed-upon procedures" from engagements that are expected to be audits of financial information, such as performance reports.

Appendix 1

Example of an Engagement Letter for an Agreed-Upon Procedures Engagement

The following letter is for use as a guide in conjunction with paragraph 9 of this ISRS and is not intended to be a standard letter. The engagement letter will need to be varied according to individual requirements and circumstances.

To the Board of Directors or other appropriate representatives of the client who engaged the auditor

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services that we will provide. Our engagement will be conducted in accordance with the International Standard on Related Services (or refer to relevant national standards or practices) applicable to agreed-upon procedures engagements and we will indicate so in our report.

We have agreed to perform the following procedures and report to you the factual findings resulting from our work:

(Describe the nature, timing and extent of the procedures to be performed, including specific reference, where applicable, to the identity of documents and records to be read, individuals to be contacted and parties from whom confirmations will be obtained.)

The procedures that we will perform are solely to assist you in (state purpose). Our report is not to be used for any other purpose and is solely for your information.

The procedures that we will perform will not constitute an audit or a review made in accordance with International Standards on Auditing or International Standards on Review Engagements (or refer to relevant national standards or practices) and, consequently, no assurance will be expressed.

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

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

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the terms of the engagement including the specific procedures which we have agreed will be performed.

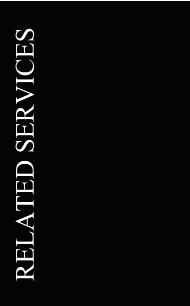
XYZ & Co

Acknowledged on behalf of ABC Company by

(signed)

Name and Title

Date



Appendix 2

Example of a Report of Factual Findings in Connection with Accounts Payable

REPORT OF FACTUAL FINDINGS

To (those who engaged the auditor)

We have performed the procedures agreed with you and enumerated below with respect to the accounts payable of ABC Company as at (date), set forth in the accompanying schedules (not shown in this example). Our engagement was undertaken in accordance with the International Standard on Related Services (or refer to relevant national standards or practices) applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in evaluating the validity of the accounts payable and are summarized as follows:

1. We obtained and checked the addition of the trial balance of accounts payable as at (date) prepared by ABC Company, and we compared the total to the balance in the related general ledger account.
2. We compared the attached list (not shown in this example) of major suppliers and the amounts owing at (date) to the related names and amounts in the trial balance.
3. We obtained suppliers' statements or requested suppliers to confirm balances owing at (date).
4. We compared such statements or confirmations to the amounts referred to in 2. For amounts which did not agree, we obtained reconciliations from ABC Company. For reconciliations obtained, we identified and listed outstanding invoices, credit notes and outstanding checks, each of which was greater than xxx. We located and examined such invoices and credit notes subsequently received and checks subsequently paid and we ascertained that they should in fact have been listed as outstanding on the reconciliations.

We report our findings below:

(a) With respect to item 1 we found the addition to be correct and the total amount to be in agreement.

(b) With respect to item 2 we found the amounts compared to be in agreement.

(c) With respect to item 3 we found there were suppliers' statements for all such suppliers.

(d) With respect to item 4 we found the amounts agreed, or with respect to amounts which did not agree, we found ABC Company had prepared reconciliations and that the credit notes, invoices and outstanding checks over

xxx were appropriately listed as reconciling items with the following exceptions:

(Detail the exceptions)

Because the above procedures do not constitute either an audit or a review made in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), we do not express any assurance on the accounts payable as of (date).

Had we performed additional procedures or had we performed an audit or review of the financial statements in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the accounts and items specified above and does not extend to any financial statements of ABC Company, taken as a whole.

AUDITOR

Date
Address

INTERNATIONAL STANDARD ON RELATED SERVICES 4410

(Previously ISA 930)

ENGAGEMENTS TO COMPILE FINANCIAL STATEMENTS

(This Standard is effective)

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International Standard on Related Services (ISRS) 4410, "Engagements to Compile Financial Statements" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISRSs.

Introduction

1. The purpose of this International Standard on Related Services (ISRS) is to establish standards and provide guidance on the accountant's[1] professional responsibilities when an engagement to compile financial information is undertaken and the form and content of the report the accountant issues in connection with such a compilation.

2. This ISRS is directed toward the compilation of financial information. However, it is to be applied to the extent practicable to engagements to compile non-financial information, provided the accountant has adequate knowledge of the subject matter in question. Engagements to provide limited assistance to a client in the preparation of financial statements (for example, on the selection of an appropriate accounting policy), do not constitute an engagement to compile financial information.

Objective of a Compilation Engagement

3. **The objective of a compilation engagement is for the accountant to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarize financial information.** This ordinarily entails reducing detailed data to a manageable and understandable form without a requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the accountant to express any assurance on the financial information. However, users of the compiled financial information derive some benefit as a result of the accountant's involvement because the service has been performed with professional competence and due care.

4. A compilation engagement would ordinarily include the preparation of financial statements (which may or may not be a complete set of financial statements) but may also include the collection, classification and summarization of other financial information.

General Principles of a Compilation Engagement

5. **The accountant should comply with the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants**. Ethical principles governing the accountant's professional responsibilities for this type of engagement are:

   (a) Integrity;

   (b) Objectivity;

[1] For the purposes of this ISRS and to distinguish between an audit and a compilation engagement the term "accountant" (rather than "auditor") has been used throughout to refer to a professional accountant in public practice.

(c) Professional competence and due care;

(d) Confidentiality;

(e) Professional behavior; and

(f) Technical standards.

Independence is not a requirement for a compilation engagement. However, where the accountant is not independent, a statement to that effect would be made in the accountant's report.

6. **In all circumstances when an accountant's name is associated with financial information compiled by the accountant, the accountant should issue a report.**

Defining the Terms of the Engagement

7. **The accountant should ensure that there is a clear understanding between the client and the accountant regarding the terms of the engagement. Matters to be considered include the following:**

- Nature of the engagement including the fact that neither an audit nor a review will be carried out and that accordingly no assurance will be expressed.
- Fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist.
- Nature of the information to be supplied by the client.
- Fact that management is responsible for the accuracy and completeness of the information supplied to the accountant for the completeness and accuracy of the compiled financial information.
- Basis of accounting on which the financial information is to be compiled and the fact that it, and any known departures therefrom, will be disclosed.
- Intended use and distribution of the information, once compiled.
- Form of report to be rendered regarding the financial information compiled, when the accountant's name is to be associated therewith.

8. An engagement letter will be of assistance in planning the compilation work. It is in the interests of both the accountant and the entity that the accountant sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the accountant's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the accountant's responsibilities and the form of reports to be issued. An example of an engagement letter for a compilation engagement appears in Appendix 1 to this ISRS.

Planning

9. **The accountant should plan the work so that an effective engagement will be performed.**

Documentation

10. **The accountant should document matters which are important in providing evidence that the engagement was carried out in accordance with this ISRS and the terms of the engagement.**

Procedures

11. **The accountant should obtain a general knowledge of the business and operations of the entity and should be familiar with the accounting principles and practices of the industry in which the entity operates and with the form and content of the financial information that is appropriate in the circumstances.**

12. To compile financial information, the accountant requires a general understanding of the nature of the entity's business transactions, the form of its accounting records and the accounting basis on which the financial information is to be presented. The accountant ordinarily obtains knowledge of these matters through experience with the entity or inquiry of the entity's personnel.

13. Other than as noted in this ISRS, the accountant is not ordinarily required to:

    (a) Make any inquiries of management to assess the reliability and completeness of the information provided;

    (b) Assess internal controls;

    (c) Verify any matters; or

    (d) Verify any explanations.

14. **If the accountant becomes aware that information supplied by management is incorrect, incomplete, or otherwise unsatisfactory, the accountant should consider performing the above procedures and request management to provide additional information. If management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for the withdrawal.**

15. **The accountant should read the compiled information and consider whether it appears to be appropriate in form and free from obvious material misstatements.** In this sense, misstatements include the following:

    - Mistakes in the application of the applicable financial reporting framework.

- Non-disclosure of the financial reporting framework and any known departures therefrom.
- Non-disclosure of any other significant matters of which the accountant has become aware.

The applicable financial reporting framework and any known departures therefrom should be disclosed within the financial information, though their effects need not be quantified.

16. **If the accountant becomes aware of material misstatements, the accountant should try to agree appropriate amendments with the entity. If such amendments are not made and the financial information is considered to be misleading, the accountant should withdraw from the engagement.**

Responsibility of Management

17. **The accountant should obtain an acknowledgment from management of its responsibility for the appropriate presentation of the financial information and of its approval of the financial information.** Such acknowledgment may be provided by representations from management which cover the accuracy and completeness of the underlying accounting data and the complete disclosure of all material and relevant information to the accountant.

Reporting on a Compilation Engagement

18. **Reports on compilation engagements should contain[2] the following:**

    (a) **Title;**

    (b) **Addressee;**

    (c) **A statement that the engagement was performed in accordance with the International Standard on Related Services applicable to compilation engagements, or with national standards and practices;**

    (d) **When relevant, a statement that the accountant is not independent of the entity;**

    (e) **Identification of the financial information noting that it is based on information provided by management;**

    (f) **A statement that management is responsible for the financial information compiled by the accountant;**

[2] It may also be appropriate for the accountant to refer to the special purpose for which or party for whom the information has been prepared. Alternatively, or in addition, the accountant may add some form of caution designed to ensure that it is not used for purposes other than those intended.

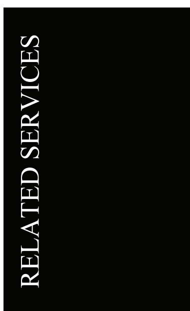
(g) **A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;**

(h) **A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the applicable financial reporting framework;**

(i) **Date of the report;**

(j) **Accountant's address; and**

(k) **Accountant's signature.**



Appendix 2 to this ISRS contains examples of compilation reports.

19. **The financial information compiled by the accountant should contain a reference such as "Unaudited," "Compiled without Audit or Review" or "Refer to Compilation Report" on each page of the financial information or on the front of the complete set of financial statements.**

Appendix 1

Example of an Engagement Letter for a Compilation Engagement

The following letter is for use as a guide in conjunction with the considerations outlined in paragraph 7 of this ISRS and will need to be varied according to individual requirements and circumstances. This example is for the compilation of financial statements.

To the Board of Directors or the appropriate representatives of senior management

This letter is to confirm our understanding of the terms of our engagement and the nature and limitations of the services we will provide.

You have requested that we perform the following services:

On the basis of information you provide, we will compile, in accordance with the International Standard on Related Services (or refer to relevant national standards or practices) applicable to compilation engagements, the balance sheet of ABC Company as of December 31, 19XX and related statements of income and cash flows for the year then ended on a cash basis. We will not carry out audit or review engagement procedures in relation to such financial statements. Consequently, no assurance on the financial statements will be expressed. Our report on the financial statements of ABC Company is presently expected to read as follows:

(see Appendix 2 to this ISRS)

Management is responsible for both the accuracy and completeness of the information supplied to us and is responsible to users for the financial information compiled by us. This includes the maintenance of adequate accounting records and internal controls and the selection and application of appropriate accounting policies. Our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we will inform you of any such matters which come to our attention.

The information will be prepared in accordance with [applicable financial reporting framework]. Any known departures from this framework will be disclosed within the financial statements and when considered necessary will be referred to in our compilation report.

We understand that the intended use and distribution of the information we have compiled is [specify] and that should this change in a material respect, that you will inform us.

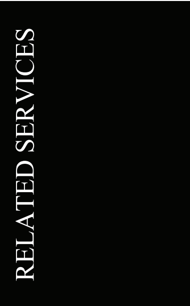
We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information requested in connection with our compilation.

Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly

rates vary according to the degree of responsibility involved and the experience and skill required.

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

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



XYZ & Co

Acknowledged on behalf of ABC Company by

(signed)

Name and Title

Date

Appendix 2

Examples of Compilation Reports

Example of a Report on an Engagement to Compile Financial Statements

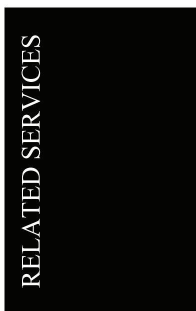
COMPILATION REPORT TO .....

On the basis of information provided by management we have compiled, in accordance with the International Standard on Related Services (or refer to relevant national standards or practices) applicable to compilation engagements, the balance sheet of ABC Company as of December 31, 19XX and statements of income and cash flows for the year then ended. Management is responsible for these financial statements. We have not audited or reviewed these financial statements and accordingly express no assurance thereon.[3]

ACCOUNTANT

Date
Address

[3] See footnote 2.



Example of a Report on an Engagement to Compile Financial Statements with an Additional Paragraph that Draws Attention to a Departure from the Applicable Financial Reporting Framework

COMPILATION REPORT TO .....

On the basis of information provided by management we have compiled, in accordance with the International Standard on Related Services (or refer to relevant national standards or practices) applicable to compilation engagements, the balance sheet of XYZ Company as of December 31, 19XX and the related statements of income and cash flows for the year then ended. Management is responsible for these financial statements. We have not audited or reviewed these financial statements and accordingly express no assurance thereon.[4]

We draw attention to Note X to the financial statements because management has elected not to capitalize the leases on plant and machinery which is a departure from the applicable financial reporting framework.

ACCOUNTANT

Date
Address

[4] See footnote 2.

STUDIES

Study 1
The Determination and Communication of Levels of Assurance Other than High

Issued June 2002

This is an extensive study of the determination and communication of levels of assurance other than high. The accurate determination and effective communication of levels of assurance provided in assurance engagements are critical issues for the well-being of the profession and the future development of assurance services. The development stage of new assurance services requires many decisions regarding their design, including how their level of assurance is determined and communicated. These decisions are very important as they will affect the risks and opportunities associated with providing new assurance services. The information contained in this study, which consists of an extensive literature review of related initiatives within and outside the profession, accompanied by two empirical studies, are an important input for decision-making regarding the determination and communication of levels of assurance. This study was conducted by an international network of auditing academics.

The study is available on the website of the IAASB at http://www.iaasb.org.