



HANDBOOK OF
INTERNATIONAL QUALITY CONTROL,
AUDITING, REVIEW, OTHER ASSURANCE,
AND RELATED SERVICES PRONOUNCEMENTS

2010 EDITION
PART II

INTERNATIONAL FEDERATION OF ACCOUNTANTS

International Federation of Accountants
545 Fifth Avenue, 14th Floor
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CHANGES OF SUBSTANCE FROM PART I OF THE 2008 EDITION OF THE HANDBOOK

Changes

The International Auditing Practice Statements (IAPSs) contained in this handbook have not been revised to reflect changes resulting from the IAASB's Clarity project. The IAASB is presently undertaking a project to consider whether there is a need to amend the status of the IAPSs. More information on this project can be obtained at <http://www.ifac.org/IAASB/index.php>.

IAPS 1005, "The Special Considerations in the Audit of Small Entities," and IAPS 1014, "Reporting by Auditors on Compliance with International Financial Reporting Standards" were withdrawn when the clarified ISAs became effective. Guidance in these IAPSs has been included, as appropriate, in the body of the relevant clarified ISAs.

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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.

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.

This 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

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 COSO⁴ 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 engagement⁶ 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.
 - Inappropriately using the words “assurance,” “audit” or “review.”

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.

- 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

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.

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 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

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.

- (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 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, recalculation, re-performance, analytical procedures and inquiry. Such

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.

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

- (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.

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).

- (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
 - (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: <ul style="list-style-type: none"> • 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 procedures¹²	The assurance report
		<p>procedures, including , where applicable, obtaining corroborating information, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and</p> <ul style="list-style-type: none"> • Evaluating the evidence obtained (Paragraphs 51 and 52) 	
Limited assurance engagement	<p>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)</p>	<p>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)</p>	<p>Description of the engagement circumstances, and a negative form of expression of the conclusion (Paragraph 59)</p>

**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 directors¹ and management, the bank's external auditors, and the banking supervisors in different countries

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 Basel Committee's paper "Enhancing Corporate Governance for Banking Organisations" published in September 1999 should be referred to.

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, 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 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

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.

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.
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

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.

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.

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- 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

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- 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

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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

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- 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.

⁵ The auditor complies with relevant national ethical standards and the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants.

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 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

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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

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.

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.

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.

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.

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 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.

⁸ Many banks furnish copies of the external auditor's communications to management and other special reports directly to the banking supervisor.

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

THE RELATIONSHIP BETWEEN BANKING
SUPERVISORS AND BANKS' EXTERNAL AUDITORS

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 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 effect 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.
 - 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.

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.

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 policies 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

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 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.

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 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.

³ IAPS 1001, “IT Environments—Stand-Alone Personal Computers” was withdrawn in December 2004.

- 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.

Coordinating the Work to be Performed

50. Given the size and geographic dispersion of most banks, co-coordinating 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

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.

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:
- (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:

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.

- 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.

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 400⁶ 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.

⁶ See footnote 4.

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.
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.

⁷ ISA 500, "Audit Evidence" was withdrawn in December 2004 when the revised ISA 500, "Audit Evidence" became effective.

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
 - 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.

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.	<p>BALANCES WITH OTHER BANKS</p> <p>Existence</p> <p>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."</p> <p>Valuation</p> <p>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.</p> <p>Presentation and Disclosure</p> <p>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</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>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”).</p> <p>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.</p>
<p>84.</p>	<p>MONEY MARKET INSTRUMENTS</p> <p>Existence</p> <p>The auditor considers the need for physical inspection or confirmation with external custodians and the reconciliation of the related amounts with the accounting records.</p> <p>Rights and Obligations</p> <p>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.</p> <p>The auditor tests for the existence of sale and forward repurchase agreements for evidence of unrecorded liabilities and losses.</p> <p>Valuation</p> <p>The auditor considers the appropriateness of the valuation techniques employed in light of the creditworthiness of the issuer.</p> <p>Measurement</p> <p>The auditor considers whether there is a need to test for the proper accrual of income earned on</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
85.	<p>money market instruments, which in some cases is through the amortization of a purchase discount.</p> <p>The auditor also considers whether:</p> <ul style="list-style-type: none"> • 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). <p>SECURITIES HELD FOR TRADING PURPOSES</p> <p>Appendix 2 gives further examples of internal control considerations and audit procedures in respect of trading operations.</p> <p>Existence</p> <p>The auditor considers physical inspection of securities or confirmation with external custodians and the reconciliation of the amounts with the accounting records.</p> <p>Rights and Obligations</p> <p>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.</p> <p>The auditor tests for the existence of sale and forward repurchase agreements for evidence of unrecorded liabilities and losses.</p> <p>Valuation</p> <p>Financial reporting frameworks often prescribe different valuation bases for securities depending</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>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.</p> <p>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.</p> <p>The auditor also considers whether to reperform the valuation calculations and the extent of tests of the controls over the bank's valuation procedures.</p> <p>Measurement</p> <p>The auditor also considers whether:</p> <ul style="list-style-type: none"> • The relationship between the types of securities owned and the related income is reasonable; and

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Financial Statement Item	Financial Statement Assertions of Particular Importance
86. (Those involving current investment of funds, for example, blocks of loans purchased for resale, purchases of securitized assets)	<ul style="list-style-type: none"> • 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). <p>OTHER FINANCIAL ASSETS</p> <p>Rights and Obligations</p> <p>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.</p> <p>Valuation</p> <p>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.</p>
87.	<p>Portfolio Investments</p> <p>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.</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>Valuation</p> <p>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.</p> <p>Measurement</p> <p>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.</p> <p>The auditor also considers whether:</p> <ul style="list-style-type: none"> • 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.

Financial Statement Item	Financial Statement Assertions of Particular Importance
<p>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)</p> <ul style="list-style-type: none"> • Personal • Commercial • Government • Domestic • Foreign 	<p>Valuation</p> <p>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.</p> <p>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.</p> <p>LOANS</p> <p>Existence</p> <p>The auditor considers the need for external confirmation of the existence of loans.</p> <p>Valuation</p> <p>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.</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>Appendix 2 gives further information on the auditor's consideration of loans.</p> <p>The major audit concern is the adequacy of the recorded provision for loan losses.</p> <p>In establishing the nature, extent and timing of the work to be performed, the auditor considers the following factors:</p> <ul style="list-style-type: none"> • 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: <ul style="list-style-type: none"> ○ 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: <p>The concentration of loans to specific:</p> <ul style="list-style-type: none"> ○ 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);

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<ul style="list-style-type: none"> ○ 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. <p>Identified potential non-performing loans, with particular attention to:</p> <ul style="list-style-type: none"> ○ The previous loss and recovery experience, including the adequacy and timeliness of provisions and charge-offs; and ○ Results of regulatory examinations. <p>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.</p> <p>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:</p> <ul style="list-style-type: none"> ● 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. <p>Presentation and Disclosure</p> <p>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.</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
90.	ACCOUNTS WITH DEPOSITORS
(a) General deposits	<p>Completeness</p> <p>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.</p> <p>Presentation and Disclosure</p> <p>The auditor determines whether deposit liabilities are classified in accordance with regulations and relevant accounting principles.</p> <p>Where deposit liabilities have been secured by specific assets, the auditor considers the need for appropriate disclosure.</p> <p>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.</p>
(b) Items in transit	<p>Existence</p> <p>The auditor determines whether items in transit between branches, between the bank and its consolidated subsidiaries, and between the bank and counterparties, are eliminated and that reconciling items have been appropriately addressed and accounted for.</p> <p>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.</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
91.	<p data-bbox="543 256 851 279">CAPITAL AND RESERVES</p> <p data-bbox="543 296 1054 673">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.</p> <p data-bbox="543 699 841 722">Presentation and Disclosure</p> <p data-bbox="543 739 1054 1147">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.</p> <p data-bbox="543 1164 1054 1281">In addition, where applicable regulations provide for restrictions on the distribution of retained earnings, the auditor considers whether the restrictions are adequately disclosed.</p> <p data-bbox="543 1298 1054 1456">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).</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
<p>92. (For example, commitments to lend funds and to guarantee repayment of funds by customers to third parties)</p>	<p>PROVISIONS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES (OTHER THAN DERIVATIVES AND OFF-BALANCE SHEET FINANCIAL INSTRUMENTS)</p> <p>Completeness</p> <p>Many contingent assets and liabilities are recorded without there being a corresponding liability or asset (memorandum items). The auditor therefore:</p> <ul style="list-style-type: none"> • 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.

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p data-bbox="543 248 648 274">Valuation</p> <p data-bbox="543 288 1055 569">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.</p>
	<p data-bbox="543 595 841 621">Presentation and Disclosure</p> <p data-bbox="543 635 1055 1072">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.</p>
	<p data-bbox="543 1098 1055 1411">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.</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
<p>93. (For example, foreign exchange contracts, interest rate and currency swaps, futures, options, and forward rate agreements)</p>	<p>DERIVATIVES AND OFF-BALANCE SHEET FINANCIAL INSTRUMENTS</p> <p>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.</p> <p>Rights and Obligations</p> <p>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.</p> <p>Existence</p> <p>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.</p> <p>Completeness</p> <p>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:</p> <ul style="list-style-type: none"> • 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

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<ul style="list-style-type: none"> <li data-bbox="543 239 1061 270">• The adequacy of internal audit review. <p data-bbox="543 279 1061 565">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);</p> <p data-bbox="543 574 1061 800">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.</p> <p data-bbox="543 817 648 848">Valuation</p> <p data-bbox="543 857 1061 953">Similar considerations arise here as arise for Other Financial Assets above. However, the following further considerations also arise.</p> <p data-bbox="543 961 1061 1343">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.</p> <p data-bbox="543 1352 1061 1517">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.</p> <p data-bbox="543 1525 1061 1583">Additionally, the auditor considers the need for and adequacy of fair value adjustments to</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p data-bbox="579 234 1113 364">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:</p> <ul data-bbox="579 364 1113 937" style="list-style-type: none"> <li data-bbox="579 364 1113 503">• 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. <li data-bbox="579 503 1113 763">• 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. <li data-bbox="579 763 1113 937">• 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. <p data-bbox="579 937 1113 1102">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.</p> <p data-bbox="579 1102 1113 1241">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:</p> <ul data-bbox="579 1241 1113 1578" style="list-style-type: none"> <li data-bbox="579 1241 1113 1380">• There may be no legal precedents concerning the terms of the underlying agreements. This makes it difficult to assess the enforceability of those terms. <li data-bbox="579 1380 1113 1578">• 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

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>misstatements or detect and correct them on a timely basis.</p> <ul style="list-style-type: none"> • 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. <p>Measurement</p> <p>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.</p> <p>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.</p> <p>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.</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p data-bbox="579 243 887 269">Presentation and Disclosure</p> <p data-bbox="579 277 1114 633">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.</p> <p data-bbox="579 642 1096 668">The following additional considerations may arise:</p> <ul data-bbox="579 677 1114 1145" style="list-style-type: none"> <li data-bbox="579 677 1114 972">• 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. <li data-bbox="579 980 1114 1145">• 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.	<p data-bbox="579 1163 1028 1223">INTEREST INCOME AND INTEREST EXPENSE</p> <p data-bbox="579 1241 739 1267">Measurement</p> <p data-bbox="579 1284 1114 1380">Interest income and expense ordinarily comprise two of the main items in a bank's income statement. The auditor considers:</p> <ul data-bbox="579 1388 1114 1562" style="list-style-type: none"> <li data-bbox="579 1388 1114 1484">• Whether satisfactory procedures exist for the proper accounting of accrued income and expenditure at the year-end; <li data-bbox="579 1492 1114 1562">• Assessing the adequacy of the related system of internal control; and

Financial Statement Item	Financial Statement Assertions of Particular Importance
95.	<ul style="list-style-type: none"> • Using analytical procedures in assessing the reasonableness of the reported amounts. Such techniques include comparison of reported interest yields in percentage terms: <ul style="list-style-type: none"> ○ To market rates; ○ To central bank rates; ○ To advertised rates (by type of loan or deposit); and ○ Between portfolios. <p>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.</p> <p>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.</p> <p style="text-align: center;">PROVISIONS FOR LOAN LOSSES</p> <p>Measurement</p> <p>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</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>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.</p>
<p>96.</p>	<p>FEE AND COMMISSION INCOME</p> <p>Completeness</p> <p>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.</p> <p>Measurement</p> <p>The auditor considers matters such as the following:</p> <ul style="list-style-type: none"> • 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.
<p>97.</p>	<p>PROVISION FOR TAXES ON INCOME</p> <p>Measurement</p> <p>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</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
98.	<p data-bbox="540 239 1057 366">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.</p> <p data-bbox="540 392 956 418">RELATED PARTY TRANSACTIONS</p> <p data-bbox="540 435 826 461">Presentation and Disclosure</p> <p data-bbox="540 482 1057 1055">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.</p> <p data-bbox="540 1069 1057 1572">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</p>

Financial Statement Item	Financial Statement Assertions of Particular Importance
	<p>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.</p> <p>Valuation</p> <p>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.</p> <p>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.</p>

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

Financial Statement Item	Financial Statement Assertions of Particular Importance
100. (Including, where applicable, a Statement of Accounting Policies)	<p>liability from a breach of its fiduciary duties, including the safekeeping of assets.</p> <p>Presentation and Disclosure</p> <p>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.</p> <p>NOTES TO THE FINANCIAL STATEMENTS</p> <p>Presentation and Disclosure</p> <p>The auditor determines whether the notes to the bank's financial statements are in accordance with the applicable financial reporting framework.</p>

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.
- 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

⁸ See footnote 1.

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 discretionary accounts Exploiting weaknesses in matching procedures	Loans to fictitious borrowers Use of nominee companies Deposit transformation Transactions with connected companies Kickbacks and inducements Use of parallel organizations Funds transformation Selling recovered

AUDITING

AUDITS OF THE FINANCIAL STATEMENTS OF BANKS

	Deposit Taking	Dealing	Lending
		<p>Mismarking of book</p> <p>Collusion in providing valuations (Valuation rings)</p> <p>Theft or misuse of collateral held as security</p>	<p>collateral at below market prices</p> <p>Bribes to obtain the release of security or to reduce the amount claimed</p> <p>Theft or misuse of collateral held as security</p>
External Fraud	<p>Money laundering</p> <p>Fraudulent instructions</p> <p>Counterfeit currency or drafts</p> <p>Fraudulent use of Check float periods (Check kiting)</p>	<p>Fraudulent custodial sales</p> <p>False information or documents regarding counterparties</p>	<p>Impersonation and false information on loan applications and subsequently provided documents</p> <p>Double-pledging of collateral</p> <p>Fraudulent valuations (Land flips)</p> <p>Forged or valueless collateral</p> <p>Misappropriation of loan funds by agents/ customers</p> <p>Unauthorized sale of collateral</p>

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 weak 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.

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:
 - (c) Origination and disbursement.
 - (d) Monitoring.
 - (e) Collection.
 - (f) 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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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 the risk of a material misstatement in the financial statements. This assessment includes

³ See footnote 1.

⁴ See footnote 2.

THE CONSIDERATION OF ENVIRONMENTAL MATTERS
IN THE AUDIT OF FINANCIAL STATEMENTS

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 11⁵). 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 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;

⁵ See footnote 2.

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- (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.
 - 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.

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.

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 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;

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.

⁹ “Environmental risk” is defined in paragraph 18 of this Statement as a possible component of inherent risk.

- (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 (“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.

¹⁰ See footnote 2.

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

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.

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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 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

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.

- 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.
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

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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 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.

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).

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. 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.*

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.

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?

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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:

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- 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;

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- 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.

Insurance

7. Inquire about existing (and earlier) insurance cover for environmental risk and discuss this with management.

¹⁵ “Environmental Audit” see paragraph 45.

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.

THE CONSIDERATION OF ENVIRONMENTAL MATTERS
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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.

THE CONSIDERATION OF ENVIRONMENTAL MATTERS
IN THE AUDIT OF FINANCIAL STATEMENTS

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.

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 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;

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.

- 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 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 400⁴ requires that, in developing the overall audit plan, the auditor assess the inherent risk at the financial statement level. ISA 400 requires the 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.

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.

- *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 400⁵ 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

⁵ See footnote 3.

a pervasive influence on the way business activities are structured, objectives established and risks assessed.

34. ISA 400⁶ 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;
 - 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

⁶ See footnote 3.

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 400⁷ 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.

⁷ See footnote 3.

- *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:
 - 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.

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

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.

- 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 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 400⁹ 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.

⁹ See footnote 3.

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
 - 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 400¹⁰ 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,

¹⁰ See footnote 3.

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 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.

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.

- *Involvement of an outside organization.* When planning the substantive procedures for derivatives, the auditor considers whether another 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 700¹² 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.
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;

¹² See footnote 11.

- 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 700¹³ 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 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;

¹³ See footnote 11.

- 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 700¹⁴ 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 charged with governance. ISA 400¹⁵ 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;

¹⁴ See footnote 11.

¹⁵ See footnote 3.

- 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.

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-commerce¹). 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 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

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.

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 IT⁵ 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.
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

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.

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 310⁶ 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.

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.

⁶ See footnote 3.

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 400⁷ 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 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;

⁷ See footnote 4.

⁸ IAPS 1009, “Computer-Assisted Audit Techniques” was withdrawn in December 2004.

- 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 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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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 Ethics Standards Board for Accountants (the IESBA Code).** 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.

* Paragraph 2 of this ISRE was amended in December 2007 to clarify the application of the ISRE.

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;**
 - (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**

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.

- 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:**
- (iii) **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**
 - (iv) **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)

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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 framework¹ 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.*

¹ For example, International Financial Reporting Standards as issued by the International Accounting Standards Board.

* Paragraph 3a and footnote 4 were inserted in this ISRE in December 2007 to clarify the application of the ISRE.

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 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**
 - (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.

REVIEW OF INTERIM FINANCIAL INFORMATION PERFORMED
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- 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 significant deficiencies 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 significant deficiencies 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:

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- 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 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

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.

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.*

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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.

REVIEW OF INTERIM FINANCIAL INFORMATION PERFORMED
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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.

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- 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:

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- 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.

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- 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)

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

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.

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“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 [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,

⁷ See footnote 3.

⁸ See footnote 4.

REVIEW OF INTERIM FINANCIAL INFORMATION PERFORMED
BY THE INDEPENDENT AUDITOR OF THE ENTITY

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 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

⁹ See footnote 3.

¹⁰ See footnote 4.

REVIEW OF INTERIM FINANCIAL INFORMATION PERFORMED
BY THE INDEPENDENT AUDITOR OF THE ENTITY

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 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

¹¹ See footnote 3.

¹² See footnote 4.

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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 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

¹³ See footnote 3.

¹⁴ See footnote 4.

REVIEW OF INTERIM FINANCIAL INFORMATION PERFORMED
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[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

¹⁵ See footnote 3.

¹⁶ See footnote 4.

REVIEW OF INTERIM FINANCIAL INFORMATION PERFORMED
BY THE INDEPENDENT AUDITOR OF THE ENTITY

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 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

¹⁷ See footnote 3.

¹⁸ See footnote 4.

REVIEW OF INTERIM FINANCIAL INFORMATION PERFORMED
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[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

**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 engagement¹ 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.

Ethical Requirements

4. **The practitioner should comply with the requirements of Parts A and B of the *Code of Ethics for Professional Accountants*, issued by the International Ethics Standards Board for Accountants (the IESBA Code).**

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.

5. The IESBA 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 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:

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.

- (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 IESBA 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, recalculation, 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

⁴ See footnote 2.

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:
 - 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

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.

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:

- (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

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.

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

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).

- (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.**
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.*

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.**
- (m) 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.

28. The following is an example of an extract from an unmodified report on a forecast:

We have examined the forecast¹ 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 with²

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.

29. The following is an example of an extract from an unmodified report on a projection:

We have examined the projection³ 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 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,

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.

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 with⁴

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.

30. **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.
31. **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.**
32. **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 ASSURANCE
ENGAGEMENTS (ISAE) 3402**

**ASSURANCE REPORTS ON CONTROLS AT A
SERVICE ORGANIZATION**

(Effective for service auditors' assurance reports covering periods ending on or after
June 15, 2011)

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<p>International Standard on Assurance Engagements (ISAE) 3402, “Assurance Reports on Controls at a Service Organization” should be read in conjunction with the “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance, and Related Services.”</p>
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Introduction

Scope of this ISAE

1. This International Standard on Assurance Engagements (ISAE) deals with assurance engagements undertaken by a professional accountant in public practice¹ to provide a report for use by user entities and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting. It complements ISA 402,² in that reports prepared in accordance with this ISAE are capable of providing appropriate evidence under ISA 402. (Ref: Para. A1)
2. The "International Framework for Assurance Engagements" (the Assurance Framework) states that an assurance engagement may be a "reasonable assurance" engagement or a "limited assurance" engagement; that an assurance engagement may be either an "assertion-based" engagement or a "direct reporting" engagement; and, that the assurance conclusion for an assertion-based engagement can be worded either in terms of the responsible party's assertion or directly in terms of the subject matter and the criteria.³ This ISAE only deals with assertion-based engagements that convey reasonable assurance, with the assurance conclusion worded directly in terms of the subject matter and the criteria.⁴
3. This ISAE applies only when the service organization is responsible for, or otherwise able to make an assertion about, the suitable design of controls. This ISAE does not deal with assurance engagements:
 - (a) To report only on whether controls at a service organization operated as described, or
 - (b) To report on controls at a service organization other than those related to a service that is likely to be relevant to user entities' internal control as it relates to financial reporting (for example, controls that affect user entities' production or quality control).

¹ The *Code of Ethics for Professional Accountants* (IESBA Code), issued by the International Ethics Standards Board for Accountants, defines a professional accountant as "an individual who is a member of an IFAC member body," and a professional accountant in public practice as "a professional accountant, irrespective of functional classification (for example, 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."

² ISA 402, "Audit Considerations Relating to an Entity Using a Service Organization."

³ Assurance Framework, paragraphs 10, 11 and 57.

⁴ Paragraphs 13 and 52(k) of this ISAE.

This ISAE, however, provides some guidance for such engagements carried out under ISAE 3000.⁵ (Ref: Para. A2)

4. In addition to issuing an assurance report on controls, a service auditor may also be engaged to provide reports such as the following, which are not dealt with in this ISAE:
 - (a) A report on a user entity's transactions or balances maintained by a service organization; or
 - (b) An agreed-upon procedures report on controls at a service organization.

Relationship with Other Professional Pronouncements

5. The performance of assurance engagements other than audits or reviews of historical financial information requires the service auditor to comply with ISAE 3000. ISAE 3000 includes requirements in relation to such topics as engagement acceptance, planning, evidence, and documentation that apply to all assurance engagements, including engagements in accordance with this ISAE. This ISAE expands on how ISAE 3000 is to be applied in a reasonable assurance engagement to report on controls at a service organization. The Assurance Framework, which defines and describes the elements and objectives of an assurance engagement, provides the context for understanding this ISAE and ISAE 3000.
6. Compliance with ISAE 3000 requires, among other things, that the service auditor comply with the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code), and implement quality control procedures that are applicable to the individual engagement.⁶

Effective Date

7. This ISAE is effective for service auditors' assurance reports covering periods ending on or after June 15, 2011.

Objectives

8. The objectives of the service auditor are:
 - (a) To obtain reasonable assurance about whether, in all material respects, based on suitable criteria:
 - (i) The service organization's description of its system fairly presents the system as designed and implemented throughout

⁵ ISAE 3000, "Assurance Engagements Other than Audits or Reviews of Historical Financial Information."

⁶ ISAE 3000, paragraphs 4 and 6.

- the specified period (or in the case of a type 1 report, as at a specified date);
- (ii) The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period (or in the case of a type 1 report, as at a specified date);
 - (iii) Where included in the scope of the engagement, the controls operated effectively to provide reasonable assurance that the control objectives stated in the service organization's description of its system were achieved throughout the specified period.
- (b) To report on the matters in (a) above in accordance with the service auditor's findings.

Definitions

9. For purposes of this ISAE, the following terms have the meanings attributed below:
- (a) Carve-out method – Method of dealing with the services provided by a subservice organization, whereby the service organization's description of its system includes the nature of the services provided by a subservice organization, but that subservice organization's relevant control objectives and related controls are excluded from the service organization's description of its system and from the scope of the service auditor's engagement. The service organization's description of its system and the scope of the service auditor's engagement include controls at the service organization to monitor the effectiveness of controls at the subservice organization, which may include the service organization's review of an assurance report on controls at the subservice organization.
 - (b) Complementary user entity controls – Controls that the service organization assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives stated in the service organization's description of its system, are identified in that description.
 - (c) Control objective – The aim or purpose of a particular aspect of controls. Control objectives relate to risks that controls seek to mitigate.
 - (d) Controls at the service organization – Controls over the achievement of a control objective that is covered by the service auditor's assurance report. (Ref: Para. A3)

- (e) Controls at a subservice organization – Controls at a subservice organization to provide reasonable assurance about the achievement of a control objective.
- (f) Criteria – Benchmarks used to evaluate or measure a subject matter including, where relevant, benchmarks for presentation and disclosure.
- (g) Inclusive method – Method of dealing with the services provided by a subservice organization, whereby the service organization’s description of its system includes the nature of the services provided by a subservice organization, and that subservice organization’s relevant control objectives and related controls are included in the service organization’s description of its system and in the scope of the service auditor’s engagement. (Ref: Para. A4)
- (h) Internal audit function – An appraisal activity established or provided as a service to the service organization. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control.
- (i) Internal auditors – Those individuals who perform the activities of the internal audit function. Internal auditors may belong to an internal audit department or equivalent function.
- (j) Report on the description and design of controls at a service organization (referred to in this ISAE as a “type 1 report”) – A report that comprises:
 - (i) The service organization’s description of its system;
 - (ii) A written assertion by the service organization that, in all material respects, and based on suitable criteria:
 - a. The description fairly presents the service organization’s system as designed and implemented as at the specified date;
 - b. The controls related to the control objectives stated in the service organization’s description of its system were suitably designed as at the specified date; and
 - (iii) A service auditor’s assurance report that conveys reasonable assurance about the matters in (ii)a.–b. above.
- (k) Report on the description, design and operating effectiveness of controls at a service organization (referred to in this ISAE as a “type 2 report”) – A report that comprises:
 - (i) The service organization’s description of its system;
 - (ii) A written assertion by the service organization that, in all material respects, and based on suitable criteria:

- a. The description fairly presents the service organization's system as designed and implemented throughout the specified period;
 - b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period; and
 - c. The controls related to the control objectives stated in the service organization's description of its system operated effectively throughout the specified period; and
- (iii) A service auditor's assurance report that:
- a. Conveys reasonable assurance about the matters in (ii)a.–c. above; and
 - b. Includes a description of the tests of controls and the results thereof.
- (l) Service auditor – A professional accountant in public practice who, at the request of the service organization, provides an assurance report on controls at a service organization.
- (m) Service organization – A third-party organization (or segment of a third-party organization) that provides services to user entities that are likely to be relevant to user entities' internal control as it relates to financial reporting.
- (n) Service organization's system (or the system) – The policies and procedures designed and implemented by the service organization to provide user entities with the services covered by the service auditor's assurance report. The service organization's description of its system includes identification of: the services covered; the period, or in the case of a type 1 report, the date, to which the description relates; control objectives; and related controls.
- (o) Service organization's assertion – The written assertion about the matters referred to in paragraph 9(k)(ii) (or paragraph 9(j)(ii) in the case of a type 1 report).
- (p) Subservice organization – A service organization used by another service organization to perform some of the services provided to user entities that are likely to be relevant to user entities' internal control as it relates to financial reporting.
- (q) Test of controls – A procedure designed to evaluate the operating effectiveness of controls in achieving the control objectives stated in the service organization's description of its system.

- (r) User auditor – An auditor who audits and reports on the financial statements of a user entity.⁷
- (s) User entity – An entity that uses a service organization.

Requirements

ISAE 3000

- 10. The service auditor shall not represent compliance with this ISAE unless the service auditor has complied with the requirements of this ISAE and ISAE 3000.

Ethical Requirements

- 11. The service auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to assurance engagements. (Ref: Para. A5)

Management and Those Charged with Governance

- 12. Where this ISAE requires the service auditor to inquire of, request representations from, communicate with, or otherwise interact with the service organization, the service auditor shall determine the appropriate person(s) within the service organization's management or governance structure with whom to interact. This shall include consideration of which person(s) have the appropriate responsibilities for and knowledge of the matters concerned. (Ref: Para. A6)

Acceptance and Continuance

- 13. Before agreeing to accept, or continue, an engagement the service auditor shall:
 - (a) Determine whether:
 - (i) The service auditor has the capabilities and competence to perform the engagement; (Ref: Para. A7)
 - (ii) The criteria to be applied by the service organization to prepare the description of its system will be suitable and available to user entities and their auditors; and
 - (iii) The scope of the engagement and the service organization's description of its system will not be so limited that they are unlikely to be useful to user entities and their auditors.

⁷ In the case of a subservice organization, the service auditor of a service organization that uses the services of the subservice organization is also a user auditor.

- (b) Obtain the agreement of the service organization that it acknowledges and understands its responsibility:
 - (i) For the preparation of the description of its system, and accompanying service organization's assertion, including the completeness, accuracy and method of presentation of that description and assertion; (Ref: Para. A8)
 - (ii) To have a reasonable basis for the service organization's assertion accompanying the description of its system; (Ref: Para. A9)
 - (ii) For stating in the service organization's assertion the criteria it used to prepare the description of its system;
 - (iii) For stating in the description of its system:
 - a. The control objectives; and
 - b. Where they are specified by law or regulation, or another party (for example, a user group or a professional body), the party who specified them;
 - (iv) For identifying the risks that threaten achievement of the control objectives stated in the description of its system, and designing and implementing controls to provide reasonable assurance that those risks will not prevent achievement of the control objectives stated in the description of its system, and therefore that the stated control objectives will be achieved; and (Ref: Para. A10)
 - (v) To provide the service auditor with:
 - a. Access to all information, such as records, documentation and other matters, including service level agreements, of which the service organization is aware that is relevant to the description of the service organization's system and the accompanying service organization's assertion;
 - b. Additional information that the service auditor may request from the service organization for the purpose of the assurance engagement; and
 - c. Unrestricted access to persons within the service organization from whom the service auditor determines it necessary to obtain evidence.

Acceptance of a Change in the Terms of the Engagement

- 14. If the service organization requests a change in the scope of the engagement before the completion of the engagement, the service auditor shall be satisfied that there is a reasonable justification for the change. (Ref: Para. A11–A12)

Assessing the Suitability of the Criteria

15. As required by ISAE 3000, the service auditor shall assess whether the service organization has used suitable criteria in preparing the description of its system, in evaluating whether controls are suitably designed, and, in the case of a type 2 report, in evaluating whether controls are operating effectively.⁸
16. In assessing the suitability of the criteria to evaluate the service organization's description of its system, the service auditor shall determine if the criteria encompass, at a minimum:
 - (a) Whether the description presents how the service organization's system was designed and implemented, including, as appropriate:
 - (i) The types of services provided, including, as appropriate, classes of transactions processed;
 - (ii) The procedures, within both information technology and manual systems, by which services are provided, including, as appropriate, procedures by which transactions are initiated, recorded, processed, corrected as necessary, and transferred to the reports and other information prepared for user entities;
 - (iii) The related records and supporting information, including, as appropriate, accounting records, supporting information and specific accounts that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the reports and other information prepared for user entities;
 - (iv) How the service organization's system deals with significant events and conditions, other than transactions;
 - (v) The process used to prepare reports and other information for user entities;
 - (vi) The specified control objectives and controls designed to achieve those objectives;
 - (vii) Complementary user entity controls contemplated in the design of the controls; and
 - (viii) Other aspects of the service organization's control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that are relevant to the services provided.

⁸ ISAE 3000, paragraph 19.

- (b) In the case of a type 2 report, whether the description includes relevant details of changes to the service organization's system during the period covered by the description.
 - (c) Whether the description omits or distorts information relevant to the scope of the service organization's system being described, while acknowledging that the description is prepared to meet the common needs of a broad range of user entities and their auditors and may not, therefore, include every aspect of the service organization's system that each individual user entity and its auditor may consider important in its particular environment.
17. In assessing the suitability of the criteria to evaluate the design of controls, the service auditor shall determine if the criteria encompass, at a minimum, whether:
- (a) The service organization has identified the risks that threaten achievement of the control objectives stated in the description of its system; and
 - (b) The controls identified in that description would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved.
18. In assessing the suitability of the criteria to evaluate the operating effectiveness of controls in providing reasonable assurance that the stated control objectives identified in the description will be achieved, the service auditor shall determine if the criteria encompass, at a minimum, whether the controls were consistently applied as designed throughout the specified period. This includes whether manual controls were applied by individuals who have the appropriate competence and authority. (Ref: Para. A13–A15)

Materiality

19. When planning and performing the engagement, the service auditor shall consider materiality with respect to the fair presentation of the description, the suitability of the design of controls and, in the case of a type 2 report, the operating effectiveness of controls. (Ref: Para. A16–A18)

Obtaining an Understanding of the Service Organization's System

20. The service auditor shall obtain an understanding of the service organization's system, including controls that are included in the scope of the engagement. (Ref: Para. A19–A20)

Obtaining Evidence Regarding the Description

21. The service auditor shall obtain and read the service organization's description of its system, and shall evaluate whether those aspects of the description

included in the scope of the engagement are fairly presented, including whether: (Ref: Para. A21–A22)

- (a) Control objectives stated in the service organization’s description of its system are reasonable in the circumstances; (Ref: Para. A23)
 - (b) Controls identified in that description were implemented;
 - (c) Complementary user entity controls, if any, are adequately described; and
 - (d) Services performed by a subservice organization, if any, are adequately described, including whether the inclusive method or the carve-out method has been used in relation to them.
22. The service auditor shall determine, through other procedures in combination with inquiries, whether the service organization’s system has been implemented. Those other procedures shall include observation, and inspection of records and other documentation, of the manner in which the service organization’s system operates and controls are applied. (Ref: Para. A24)

Obtaining Evidence Regarding Design of Controls

23. The service auditor shall determine which of the controls at the service organization are necessary to achieve the control objectives stated in the service organization’s description of its system, and shall assess whether those controls were suitably designed. This determination shall include: (Ref: Para. A25–A27)
- (a) Identifying the risks that threaten the achievement of the control objectives stated in the service organization’s description of its system; and
 - (b) Evaluating the linkage of controls identified in the service organization’s description of its system with those risks.

Obtaining Evidence Regarding Operating Effectiveness of Controls

24. When providing a type 2 report, the service auditor shall test those controls that the service auditor has determined are necessary to achieve the control objectives stated in the service organization’s description of its system, and assess their operating effectiveness throughout the period. Evidence obtained in prior engagements about the satisfactory operation of controls in prior periods does not provide a basis for a reduction in testing, even if it is supplemented with evidence obtained during the current period. (Ref: Para. A28–A32)
25. When designing and performing tests of controls, the service auditor shall:
- (a) Perform other procedures in combination with inquiry to obtain evidence about:
 - (i) How the control was applied;

- (ii) The consistency with which the control was applied; and
 - (iii) By whom or by what means the control was applied;
 - (b) Determine whether controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain evidence supporting the operating effectiveness of those indirect controls; and (Ref: Para. A33–A34)
 - (c) Determine means of selecting items for testing that are effective in meeting the objectives of the procedure. (Ref: Para. A35–A36)
26. When determining the extent of tests of controls, the service auditor shall consider matters including the characteristics of the population to be tested, which includes the nature of controls, the frequency of their application (for example, monthly, daily, a number of times per day), and the expected rate of deviation.

Sampling

27. When the service auditor uses sampling, the service auditor shall: (Ref: Para. A35–A36)
- (a) Consider the purpose of the procedure and the characteristics of the population from which the sample will be drawn when designing the sample;
 - (b) Determine a sample size sufficient to reduce sampling risk to an appropriately low level;
 - (c) Select items for the sample in such a way that each sampling unit in the population has a chance of selection;
 - (d) If a designed procedure is not applicable to a selected item, perform the procedure on a replacement item; and
 - (e) If unable to apply the designed procedures, or suitable alternative procedures, to a selected item, treat that item as a deviation.

Nature and Cause of Deviations

28. The service auditor shall investigate the nature and cause of any deviations identified and shall determine whether:
- (a) Identified deviations are within the expected rate of deviation and are acceptable; therefore, the testing that has been performed provides an appropriate basis for concluding that the control is operating effectively throughout the specified period;
 - (b) Additional testing of the control or of other controls is necessary to reach a conclusion on whether the controls relative to a particular control

objective are operating effectively throughout the specified period; or (Ref: Para. A25)

- (c) The testing that has been performed provides an appropriate basis for concluding that the control did not operate effectively throughout the specified period.
29. In the extremely rare circumstances when the service auditor considers a deviation discovered in a sample to be an anomaly and no other controls have been identified that allow the service auditor to conclude that the relevant control objective is operating effectively throughout the specified period, the service auditor shall obtain a high degree of certainty that such deviation is not representative of the population. The service auditor shall obtain this degree of certainty by performing additional procedures to obtain sufficient appropriate evidence that the deviation does not affect the remainder of the population.

The Work of an Internal Audit Function⁹

Obtaining an Understanding of the Internal Audit Function

30. If the service organization has an internal audit function, the service auditor shall obtain an understanding of the nature of the responsibilities of the internal audit function and of the activities performed in order to determine whether the internal audit function is likely to be relevant to the engagement. (Ref: Para. A37)

Determining Whether and to What Extent to Use the Work of the Internal Auditors

31. The service auditor shall determine:
- (a) Whether the work of the internal auditors is likely to be adequate for purposes of the engagement; and
 - (b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the service auditor's procedures.
32. In determining whether the work of the internal auditors is likely to be adequate for purposes of the engagement, the service auditor shall evaluate:
- (a) The objectivity of the internal audit function;
 - (b) The technical competence of the internal auditors;
 - (c) Whether the work of the internal auditors is likely to be carried out with due professional care; and

⁹ This ISAE does not deal with instances when individual internal auditors provide direct assistance to the service auditor in carrying out audit procedures.

- (d) Whether there is likely to be effective communication between the internal auditors and the service auditor.
33. In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the service auditor's procedures, the service auditor shall consider: (Ref: Para. A38)
- (a) The nature and scope of specific work performed, or to be performed, by the internal auditors;
 - (b) The significance of that work to the service auditor's conclusions; and
 - (c) The degree of subjectivity involved in the evaluation of the evidence gathered in support of those conclusions.

Using the Work of the Internal Audit Function

34. In order for the service auditor to use specific work of the internal auditors, the service auditor shall evaluate and perform procedures on that work to determine its adequacy for the service auditor's purposes. (Ref: Para. A39)
35. To determine the adequacy of specific work performed by the internal auditors for the service auditor's purposes, the service auditor shall evaluate whether:
- (a) The work was performed by internal auditors having adequate technical training and proficiency;
 - (b) The work was properly supervised, reviewed and documented;
 - (c) Adequate evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
 - (d) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
 - (e) Exceptions relevant to the engagement or unusual matters disclosed by the internal auditors are properly resolved.

Effect on the Service Auditor's Assurance Report

36. If the work of the internal audit function has been used, the service auditor shall make no reference to that work in the section of the service auditor's assurance report that contains the service auditor's opinion. (Ref: Para. A40)
37. In the case of a type 2 report, if the work of the internal audit function has been used in performing tests of controls, that part of the service auditor's assurance report that describes the service auditor's tests of controls and the results thereof shall include a description of the internal auditor's work and of the service auditor's procedures with respect to that work. (Ref: Para. A41)

Written Representations

38. The service auditor shall request the service organization to provide written representations: (Ref: Para. A42)
- (a) That reaffirm the assertion accompanying the description of the system;
 - (b) That it has provided the service auditor with all relevant information and access agreed to;¹⁰ and
 - (c) That it has disclosed to the service auditor any of the following of which it is aware:
 - (i) Non-compliance with laws and regulations, fraud, or uncorrected deviations attributable to the service organization that may affect one or more user entities;
 - (ii) Design deficiencies in controls;
 - (iii) Instances where controls have not operated as described; and
 - (iv) Any events subsequent to the period covered by the service organization's description of its system up to the date of the service auditor's assurance report that could have a significant effect on the service auditor's assurance report.
39. The written representations shall be in the form of a representation letter addressed to the service auditor. The date of the written representations shall be as near as practicable to, but not after, the date of the service auditor's assurance report.
40. If, having discussed the matter with the service auditor, the service organization does not provide one or more of the written representations requested in accordance with paragraph 38(a) and (b) of this ISAE, the service auditor shall disclaim an opinion. (Ref: Para. A43)

Other Information

41. The service auditor shall read the other information, if any, included in a document containing the service organization's description of its system and the service auditor's assurance report, to identify material inconsistencies, if any, with that description. While reading the other information for the purpose of identifying material inconsistencies, the service auditor may become aware of an apparent misstatement of fact in that other information.
42. If the service auditor becomes aware of a material inconsistency or an apparent misstatement of fact in the other information, the service auditor

¹⁰ Paragraph 13(b)(v) of this ISAE.

shall discuss the matter with the service organization. If the service auditor concludes that there is a material inconsistency or a misstatement of fact in the other information that the service organization refuses to correct, the service auditor shall take further appropriate action. (Ref: Para. A44–A45)

Subsequent Events

43. The service auditor shall inquire whether the service organization is aware of any events subsequent to the period covered by the service organization's description of its system up to the date of the service auditor's assurance report that could have a significant effect on the service auditor's assurance report. If the service auditor is aware of such an event, and information about that event is not disclosed by the service organization, the service auditor shall disclose it in the service auditor's assurance report.
44. The service auditor has no obligation to perform any procedures regarding the description of the service organization's system, or the suitability of design or operating effectiveness of controls, after the date of the service auditor's assurance report.

Documentation

45. The service auditor shall prepare documentation that is sufficient to enable an experienced service auditor, having no previous connection with the engagement, to understand:
 - (a) The nature, timing, and extent of the procedures performed to comply with this ISAE and applicable legal and regulatory requirements;
 - (b) The results of the procedures performed, and the evidence obtained; and
 - (c) Significant matters arising during the engagement, and the conclusions reached thereon and significant professional judgments made in reaching those conclusions.
46. In documenting the nature, timing and extent of procedures performed, the service auditor shall record:
 - (a) The identifying characteristics of the specific items or matters being tested;
 - (b) Who performed the work and the date such work was completed; and
 - (c) Who reviewed the work performed and the date and extent of such review.
47. If the service auditor uses specific work of the internal auditors, the service auditor shall document the conclusions reached regarding the evaluation of the adequacy of the work of the internal auditors, and the procedures performed by the service auditor on that work.

48. The service auditor shall document discussions of significant matters with the service organization and others including the nature of the significant matters discussed and when and with whom the discussions took place.
49. If the service auditor has identified information that is inconsistent with the service auditor's final conclusion regarding a significant matter, the service auditor shall document how the service auditor addressed the inconsistency.
50. The service auditor shall assemble the documentation in an engagement file and complete the administrative process of assembling the final engagement file on a timely basis after the date of the service auditor's assurance report.¹¹
51. After the assembly of the final engagement file has been completed, the service auditor shall not delete or discard documentation before the end of its retention period. (Ref: Para. A46)
52. If the service auditor finds it necessary to modify existing engagement documentation or add new documentation after the assembly of the final engagement file has been completed and that documentation does not affect the service auditor's report, the service auditor shall, regardless of the nature of the modifications or additions, document:
 - (a) The specific reasons for making them; and
 - (b) When and by whom they were made and reviewed.

Preparing the Service Auditor's Assurance Report

Content of the Service Auditor's Assurance Report

53. The service auditor's assurance report shall include the following basic elements: (Ref: Para. A47)
 - (a) A title that clearly indicates the report is an independent service auditor's assurance report.
 - (b) An addressee.
 - (c) Identification of:
 - (i) The service organization's description of its system, and the service organization's assertion, which includes the matters described in paragraph 9(k)(ii) for a type 2 report, or paragraph 9(j)(ii) for a type 1 report.
 - (ii) Those parts of the service organization's description of its system, if any, that are not covered by the service auditor's opinion.

¹¹ International Standard on Quality Control (ISQC) 1, paragraphs A54–A55, provide further guidance.

- (iii) If the description refers to the need for complementary user entity controls, a statement that the service auditor has not evaluated the suitability of design or operating effectiveness of complementary user entity controls, and that the control objectives stated in the service organization's description of its system can be achieved only if complementary user entity controls are suitably designed or operating effectively, along with the controls at the service organization.
 - (iv) If services are performed by a subservice organization, the nature of activities performed by the subservice organization as described in the service organization's description of its system and whether the inclusive method or the carve-out method has been used in relation to them. Where the carve-out method has been used, a statement that the service organization's description of its system excludes the control objectives and related controls at relevant subservice organizations, and that the service auditor's procedures do not extend to controls at the subservice organization. Where the inclusive method has been used, a statement that the service organization's description of its system includes control objectives and related controls at the subservice organization, and that the service auditor's procedures extended to controls at the subservice organization.
- (d) Identification of the criteria, and the party specifying the control objectives.
 - (e) A statement that the report and, in the case of a type 2 report, the description of tests of controls are intended only for user entities and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements. (Ref: Para. A48)
 - (f) A statement that the service organization is responsible for:
 - (i) Preparing the description of its system, and the accompanying assertion, including the completeness, accuracy and method of presentation of that description and that assertion;
 - (ii) Providing the services covered by the service organization's description of its system;
 - (iii) Stating the control objectives (where not identified by law or regulation, or another party, for example, a user group or a professional body); and

- (iv) Designing and implementing controls to achieve the control objectives stated in the service organization’s description of its system.
- (g) A statement that the service auditor’s responsibility is to express an opinion on the service organization’s description, on the design of controls related to the control objectives stated in that description and, in the case of a type 2 report, on the operating effectiveness of those controls, based on the service auditor’s procedures.
- (h) A statement that the engagement was performed in accordance with ISAE 3402, “Assurance Reports on Controls at a Service Organization,” which requires that the service auditor comply with ethical requirements and plan and perform procedures to obtain reasonable assurance about whether, in all material respects, the service organization’s description of its system is fairly presented and the controls are suitably designed and, in the case of a type 2 report, are operating effectively.
- (i) A summary of the service auditor’s procedures to obtain reasonable assurance and a statement of the service auditor’s belief that the evidence obtained is sufficient and appropriate to provide a basis for the service auditor’s opinion, and, in the case of a type 1 report, a statement that the service auditor has not performed any procedures regarding the operating effectiveness of controls and therefore no opinion is expressed thereon.
- (j) A statement of the limitations of controls and, in the case of a type 2 report, of the risk of projecting to future periods any evaluation of the operating effectiveness of controls.
- (k) The service auditor’s opinion, expressed in the positive form, on whether, in all material respects, based on suitable criteria:
 - (i) In the case of a type 2 report:
 - a. The description fairly presents the service organization’s system that had been designed and implemented throughout the specified period;
 - b. The controls related to the control objectives stated in the service organization’s description of its system were suitably designed throughout the specified period; and
 - c. The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the specified period.

- (ii) In the case of a type 1 report:
 - a. The description fairly presents the service organization's system that had been designed and implemented as at the specified date; and
 - b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed as at the specified date.
 - (l) The date of the service auditor's assurance report, which shall be no earlier than the date on which the service auditor has obtained sufficient appropriate evidence on which to base the opinion.
 - (m) The name of the service auditor, and the location in the jurisdiction where the service auditor practices.
54. In the case of a type 2 report, the service auditor's assurance report shall include a separate section after the opinion, or an attachment, that describes the tests of controls that were performed and the results of those tests. In describing the tests of controls, the service auditor shall clearly state which controls were tested, identify whether the items tested represent all or a selection of the items in the population, and indicate the nature of the tests in sufficient detail to enable user auditors to determine the effect of such tests on their risk assessments. If deviations have been identified, the service auditor shall include the extent of testing performed that led to identification of the deviations (including the sample size where sampling has been used), and the number and nature of the deviations noted. The service auditor shall report deviations even if, on the basis of tests performed, the service auditor has concluded that the related control objective was achieved. (Ref: Para. A18 and A49)

Modified Opinions

55. If the service auditor concludes that: (Ref: Para. A50–A52)
- (a) The service organization's description does not fairly present, in all material respects, the system as designed and implemented;
 - (b) The controls related to the control objectives stated in the description were not suitably designed, in all material respects;
 - (c) In the case of a type 2 report, the controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the service organization's description of its system were achieved, did not operate effectively, in all material respects; or
 - (d) The service auditor is unable to obtain sufficient appropriate evidence,

the service auditor's opinion shall be modified, and the service auditor's assurance report shall contain a clear description of all the reasons for the modification.

Other Communication Responsibilities

56. If the service auditor becomes aware of non-compliance with laws and regulations, fraud, or uncorrected errors attributable to the service organization that are not clearly trivial and may affect one or more user entities, the service auditor shall determine whether the matter has been communicated appropriately to affected user entities. If the matter has not been so communicated and the service organization is unwilling to do so, the service auditor shall take appropriate action. (Ref: Para. A53)

Application and Other Explanatory Material

Scope of this ISAE (Ref: Para. 1, 3)

- A1. Internal control is a process designed to provide reasonable assurance regarding the achievement of objectives related to the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Controls related to a service organization's operations and compliance objectives may be relevant to a user entity's internal control as it relates to financial reporting. Such controls may pertain to assertions about presentation and disclosure relating to account balances, classes of transactions or disclosures, or may pertain to evidence that the user auditor evaluates or uses in applying auditing procedures. For example, a payroll processing service organization's controls related to the timely remittance of payroll deductions to government authorities may be relevant to a user entity as late remittances could incur interest and penalties that would result in a liability for the user entity. Similarly, a service organization's controls over the acceptability of investment transactions from a regulatory perspective may be considered relevant to a user entity's presentation and disclosure of transactions and account balances in its financial statements. The determination of whether controls at a service organization related to operations and compliance are likely to be relevant to user entities' internal control as it relates to financial reporting is a matter of professional judgment, having regard to the control objectives set by the service organization and the suitability of the criteria.
- A2. The service organization may not be able to assert that the system is suitably designed when, for example, the service organization is operating a system that has been designed by a user entity or is stipulated in a contract between a user entity and the service organization. Because of the inextricable link

between the suitable design of controls and their operating effectiveness, the absence of an assertion with respect to the suitability of design will likely preclude the service auditor from concluding that the controls provide reasonable assurance that the control objectives have been met and thus from opining on the operating effectiveness of controls. As an alternative, the practitioner may choose to accept an agreed-upon procedures engagement to perform tests of controls, or an assurance engagement under ISAE 3000 to conclude on whether, based on tests of controls, the controls have operated as described.

Definitions (Ref: Para. 9(d), 9(g))

- A3. The definition of “controls at the service organization” includes aspects of user entities’ information systems maintained by the service organization, and may also include aspects of one or more of the other components of internal control at a service organization. For example, it may include aspects of a service organization’s control environment, monitoring, and control activities when they relate to the services provided. It does not, however, include controls at a service organization that are not related to the achievement of the control objectives stated in the service organization’s description of its system, for example, controls related to the preparation of the service organization’s own financial statements.
- A4. When the inclusive method is used, the requirements in this ISAE also apply to the services provided by the subservice organization, including obtaining agreement regarding the matters in paragraph 13(b)(i)–(v) as applied to the subservice organization rather than the service organization. Performing procedures at the subservice organization entails coordination and communication between the service organization, the subservice organization, and the service auditor. The inclusive method generally is feasible only if the service organization and the subservice organization are related, or if the contract between the service organization and the subservice organization provides for its use.

Ethical Requirements (Ref: Para. 11)

- A5. The service auditor is subject to relevant independence requirements, which ordinarily comprise Parts A and B of the IESBA Code together with national requirements that are more restrictive. In performing an engagement in accordance with this ISAE, the IESBA Code does not require the service auditor to be independent from each user entity.

Management and Those Charged with Governance (Ref: Para. 12)

- A6. Management and governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. Such diversity means that it is not possible for

this ISAE to specify for all engagements the person(s) with whom the service auditor is to interact regarding particular matters. For example, the service organization may be a segment of a third-party organization and not a separate legal entity. In such cases, identifying the appropriate management personnel or those charged with governance from whom to request written representations may require the exercise of professional judgment.

Acceptance and Continuance

Capabilities and Competence to Perform the Engagement (Ref: Para. 13(a)(i))

- A7. Relevant capabilities and competence to perform the engagement include matters such as the following:
- Knowledge of the relevant industry;
 - An understanding of information technology and systems;
 - Experience in evaluating risks as they relate to the suitable design of controls; and
 - Experience in the design and execution of tests of controls and the evaluation of the results.

Service Organization's Assertion (Ref: Para. 13(b)(i))

- A8. Refusal, by a service organization, to provide a written assertion, subsequent to an agreement by the service auditor to accept, or continue, an engagement, represents a scope limitation that causes the service auditor to withdraw from the engagement. If law or regulation does not allow the service auditor to withdraw from the engagement, the service auditor disclaims an opinion.

Reasonable Basis for Service Organization's Assertion (Ref: Para. 13(b)(ii))

- A9. In the case of a type 2 report, the service organization's assertion includes a statement that the controls related to the control objectives stated in the service organization's description of its system operated effectively throughout the specified period. This assertion may be based on the service organization's monitoring activities. Monitoring of controls is a process to assess the effectiveness of controls over time. It involves assessing the effectiveness of controls on a timely basis, identifying and reporting deficiencies to appropriate individuals within the service organization, and taking necessary corrective actions. The service organization accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of both. The greater the degree and effectiveness of ongoing monitoring activities, the less need for separate evaluations. Ongoing monitoring activities are often built into the normal recurring activities of a service organization and include regular management and supervisory activities. Internal auditors or personnel performing similar functions may contribute to the monitoring of a service

organization's activities. Monitoring activities may also include using information communicated by external parties, such as customer complaints and regulator comments, which may indicate problems or highlight areas in need of improvement. The fact that the service auditor will report on the operating effectiveness of controls is not a substitute for the service organization's own processes to provide a reasonable basis for its assertion.

Identification of Risks (Ref: Para. 13(b)(iv))

- A10. As noted in paragraph 9(c), control objectives relate to risks that controls seek to mitigate. For example, the risk that a transaction is recorded at the wrong amount or in the wrong period can be expressed as a control objective that transactions are recorded at the correct amount and in the correct period. The service organization is responsible for identifying the risks that threaten achievement of the control objectives stated in the description of its system. The service organization may have a formal or informal process for identifying relevant risks. A formal process may include estimating the significance of identified risks, assessing the likelihood of their occurrence, and deciding about actions to address them. However, since control objectives relate to risks that controls seek to mitigate, thoughtful identification of control objectives when designing and implementing the service organization's system may itself comprise an informal process for identifying relevant risks.

Acceptance of a Change in the Terms of the Engagement (Ref: Para. 14)

- A11. A request to change the scope of the engagement may not have a reasonable justification when, for example, the request is made to exclude certain control objectives from the scope of the engagement because of the likelihood that the service auditor's opinion would be modified; or the service organization will not provide the service auditor with a written assertion and the request is made to perform the engagement under ISAE 3000.
- A12. A request to change the scope of the engagement may have a reasonable justification when, for example, the request is made to exclude from the engagement a subservice organization when the service organization cannot arrange for access by the service auditor, and the method used for dealing with the services provided by that subservice organization is changed from the inclusive method to the carve-out method.

Assessing the Suitability of the Criteria (Ref: Para. 15–18)

- A13. Criteria need to be available to the intended users to allow them to understand the basis for the service organization's assertion about the fair presentation of its description of the system, the suitability of the design of controls and, in the case of a type 2 report, the operating effectiveness of the controls related to the control objectives.

A14. ISAE 3000 requires the service auditor, among other things, to assess the suitability of criteria, and the appropriateness of the subject matter.¹² The subject matter is the underlying condition of interest to intended users of an assurance report. The following table identifies the subject matter and minimum criteria for each of the opinions in type 2 and type 1 reports.

	Subject matter	Criteria	Comment
<i>Opinion about the fair presentation of the description of the service organization's system (type 1 and type 2 reports)</i>	The service organization's system that is likely to be relevant to user entities' internal control as it relates to financial reporting and is covered by the service auditor's assurance report.	The description is fairly presented if it: <ul style="list-style-type: none"> (a) presents how the service organization's system was designed and implemented including, as appropriate, the matters identified in paragraph 16(a)(i)–(viii); (b) in the case of a type 2 report, includes relevant details of changes to the service organization's system during the period covered by the description; and (c) does not omit or distort information relevant to the scope of the service organization's system being described, while acknowledging that the description is prepared to meet the common needs of a broad range of user entities and may not, therefore, include every aspect of the service organization's system that each individual user entity may consider important in its own particular environment. 	The specific wording of the criteria for this opinion may need to be tailored to be consistent with criteria established by, for example, law or regulation, user groups, or a professional body. Examples of criteria for this opinion are provided in the illustrative service organization's assertion in Appendix 1. Paragraphs A21–A24 offer further guidance on determining whether these criteria are met. (In terms of the requirements of ISAE 3000, the subject matter information ¹³ for this opinion is the service organization's description of its system and the service organization's assertion that the description is fairly presented.)

¹² ISAE 3000, paragraphs 18–19.

¹³ The “subject matter information” is the outcome of the evaluation or measurement of the subject matter that results from applying the criteria to the subject matter.

	Subject matter	Criteria	Comment	
<i>Opinion about suitability of design, and operating effectiveness (type 2 reports)</i>	The suitability of the design and operating effectiveness of those controls that are necessary to achieve the control objectives stated in the service organization's description of its system.	<p>The controls are suitably designed and operating effectively if:</p> <p>(a) the service organization has identified the risks that threaten achievement of the control objectives stated in the description of its system;</p> <p>(b) the controls identified in that description would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved; and</p> <p>(c) the controls were consistently applied as designed throughout the specified period. This includes whether manual controls were applied by individuals who have the appropriate competence and authority.</p>	When the criteria for this opinion are met, controls will have provided reasonable assurance that the related control objectives were achieved throughout the specified period. (In terms of the requirements of ISAE 3000, the subject matter information for this opinion is the service organization's assertion that controls are suitably designed and that they are operating effectively.)	The control objectives, which are stated in the service organization's description of its system, are part of the criteria for these opinions. The stated control objectives will differ from engagement to engagement. If, as part of forming the opinion on the description, the service auditor concludes the stated control objectives are not fairly presented then those control objectives would not be suitable as part of the criteria for forming an opinion on either the design or operating effectiveness of controls.
<i>Opinion about suitability of design (type 1 reports)</i>	The suitability of the design of those controls that are necessary to achieve the control objectives stated in the service organization's description of its system.	<p>The controls are suitably designed if:</p> <p>(a) the service organization has identified the risks that threaten achievement of the control objectives stated in the description of its system; and</p> <p>(b) the controls identified in that description would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved.</p>	Meeting these criteria does not, of itself, provide any assurance that the related control objectives were achieved because no assurance has been obtained about the operation of controls. (In terms of the requirements of ISAE 3000, the subject matter information for this opinion is the service organization's assertion that controls are suitably designed.)	

AUDITING

- A15. Paragraph 16(a) identifies a number of elements that are included in the service organization's description of its system as appropriate. These elements may not be appropriate if the system being described is not a system that processes transactions, for example, if the system relates to general controls over the hosting of an IT application but not the controls embedded in the application itself.

Materiality (Ref: Para. 19, 54)

- A16. In an engagement to report on controls at a service organization, the concept of materiality relates to the system being reported on, not the financial statements of user entities. The service auditor plans and performs procedures to determine whether the service organization's description of its system is fairly presented in all material respects, whether controls at the service organization are suitably designed in all material respects and, in the case of a type 2 report, whether controls at the service organization are operating effectively in all material respects. The concept of materiality takes into account that the service auditor's assurance report provides information about the service organization's system to meet the common information needs of a broad range of user entities and their auditors who have an understanding of the manner in which that system has been used.
- A17. Materiality with respect to the fair presentation of the service organization's description of its system, and with respect to the design of controls, includes primarily the consideration of qualitative factors, for example: whether the description includes the significant aspects of processing significant transactions; whether the description omits or distorts relevant information; and the ability of controls, as designed, to provide reasonable assurance that control objectives would be achieved. Materiality with respect to the service auditor's opinion on the operating effectiveness of controls includes the consideration of both quantitative and qualitative factors, for example, the tolerable rate and observed rate of deviation (a quantitative matter), and the nature and cause of any observed deviation (a qualitative matter).
- A18. The concept of materiality is not applied when disclosing, in the description of the tests of controls, the results of those tests where deviations have been identified. This is because, in the particular circumstances of a specific user entity or user auditor, a deviation may have significance beyond whether or not, in the opinion of the service auditor, it prevents a control from operating effectively. For example, the control to which the deviation relates may be particularly significant in preventing a certain type of error that may be material in the particular circumstances of a user entity's financial statements.

Obtaining an Understanding of the Service Organization’s System (Ref: Para. 20)

- A19. Obtaining an understanding of the service organization’s system, including controls, included in the scope of the engagement, assists the service auditor in:
- Identifying the boundaries of that system, and how it interfaces with other systems.
 - Assessing whether the service organization’s description fairly presents the system that has been designed and implemented.
 - Determining which controls are necessary to achieve the control objectives stated in the service organization’s description of its system.
 - Assessing whether controls were suitably designed.
 - Assessing, in the case of a type 2 report, whether controls were operating effectively.
- A20. The service auditor’s procedures to obtain this understanding may include:
- Inquiring of those within the service organization who, in the service auditor’s judgment, may have relevant information.
 - Observing operations and inspecting documents, reports, printed and electronic records of transaction processing.
 - Inspecting a selection of agreements between the service organization and user entities to identify their common terms.
 - Reperforming control procedures.

Obtaining Evidence Regarding the Description (Ref: Para. 21–22)

- A21. Considering the following questions may assist the service auditor in determining whether those aspects of the description included in the scope of the engagement are fairly presented in all material respects:
- Does the description address the major aspects of the service provided (within the scope of the engagement) that could reasonably be expected to be relevant to the common needs of a broad range of user auditors in planning their audits of user entities’ financial statements?
 - Is the description prepared at a level of detail that could reasonably be expected to provide a broad range of user auditors with sufficient information to obtain an understanding of internal control in accordance with ISA 315?¹⁴ The description need not address every aspect of the service organization’s processing or the services provided to user entities,

¹⁴ ISA 315, “Identifying and Assessing Risks of Material Misstatement through Understanding the Entity and Its Environment.”

and need not be so detailed as to potentially allow a reader to compromise security or other controls at the service organization.

- Is the description prepared in a manner that does not omit or distort information that may affect the common needs of a broad range of user auditors' decisions, for example, does the description contain any significant omissions or inaccuracies in processing of which the service auditor is aware?
- Where some of the control objectives stated in the service organization's description of its system have been excluded from the scope of the engagement, does the description clearly identify the excluded objectives?
- Have the controls identified in the description been implemented?
- Are complementary user entity controls, if any, described adequately? In most cases, the description of control objectives is worded such that the control objectives are capable of being achieved through effective operation of controls implemented by the service organization alone. In some cases, however, the control objectives stated in the service organization's description of its system cannot be achieved by the service organization alone because their achievement requires particular controls to be implemented by user entities. This may be the case where, for example, the control objectives are specified by a regulatory authority. When the description does include complementary user entity controls, the description separately identifies those controls along with the specific control objectives that cannot be achieved by the service organization alone.
- If the inclusive method has been used, does the description separately identify controls at the service organization and controls at the subservice organization? If the carve-out method is used, does the description identify the functions that are performed by the subservice organization? When the carve-out method is used, the description need not describe the detailed processing or controls at the subservice organization.

A22. The service auditor's procedures to evaluate the fair presentation of the description may include:

- Considering the nature of user entities and how the services provided by the service organization are likely to affect them, for example, whether user entities are from a particular industry and whether they are regulated by government agencies.
- Reading standard contracts, or standard terms of contracts, (if applicable) with user entities to gain an understanding of the service organization's contractual obligations.

- Observing procedures performed by service organization personnel.
 - Reviewing the service organization’s policy and procedure manuals and other systems documentation, for example, flowcharts and narratives.
- A23. Paragraph 21(a) requires the service auditor to evaluate whether the control objectives stated in the service organization’s description of its system are reasonable in the circumstances. Considering the following questions may assist the service auditor in this evaluation:
- Have the stated control objectives been designated by the service organization or by outside parties such as a regulatory authority, a user group, or a professional body that follows a transparent due process?
 - Where the stated control objectives have been specified by the service organization, do they relate to the types of assertions commonly embodied in the broad range of user entities’ financial statements to which controls at the service organization could reasonably be expected to relate? Although the service auditor ordinarily will not be able to determine how controls at a service organization specifically relate to the assertions embodied in individual user entities’ financial statements, the service auditor’s understanding of the nature of the service organization’s system, including controls, and services being provided is used to identify the types of assertions to which those controls are likely to relate.
 - Where the stated control objectives have been specified by the service organization, are they complete? A complete set of control objectives can provide a broad range of user auditors with a framework to assess the effect of controls at the service organization on the assertions commonly embodied in user entities’ financial statements.
- A24. The service auditor’s procedures to determine whether the service organization’s system has been implemented may be similar to, and performed in conjunction with, procedures to obtain an understanding of that system. They may also include tracing items through the service organization’s system and, in the case of a type 2 report, specific inquiries about changes in controls that were implemented during the period. Changes that are significant to user entities or their auditors are included in the description of the service organization’s system.

Obtaining Evidence Regarding Design of Controls (Ref: Para. 23, 28(b))

- A25. From the viewpoint of a *user entity* or a *user auditor*, a control is suitably designed if, individually or in combination with other controls, it would, when complied with satisfactorily, provide reasonable assurance that material misstatements are prevented, or detected and corrected. A *service organization* or a *service auditor*, however, is not aware of the circumstances at individual

user entities that would determine whether or not a misstatement resulting from a control deviation is material to those user entities. Therefore, from the viewpoint of a service auditor, a control is suitably designed if, individually or in combination with other controls, it would, when complied with satisfactorily, provide reasonable assurance that control objectives stated in the service organization's description of its system are achieved.

- A26. A service auditor may consider using flowcharts, questionnaires, or decision tables to facilitate understanding the design of the controls.
- A27. Controls may consist of a number of activities directed at the achievement of a control objective. Consequently, if the service auditor evaluates certain activities as being ineffective in achieving a particular control objective, the existence of other activities may allow the service auditor to conclude that controls related to the control objective are suitably designed.

Obtaining Evidence Regarding Operating Effectiveness of Controls

Assessing Operating Effectiveness (Ref: Para. 24)

- A28. From the viewpoint of a *user entity* or a *user auditor*, a control is operating effectively if, individually or in combination with other controls, it provides reasonable assurance that material misstatements, whether due to fraud or error, are prevented, or detected and corrected. A *service organization* or a *service auditor*, however, is not aware of the circumstances at individual user entities that would determine whether a misstatement resulting from a control deviation had occurred and, if so, whether it is material. Therefore, from the viewpoint of a service auditor, a control is operating effectively if, individually or in combination with other controls, it provides reasonable assurance that control objectives stated in the service organization's description of its system are achieved. Similarly, a service organization or a service auditor is not in a position to determine whether any observed control deviation would result in a material misstatement from the viewpoint of an individual user entity.
- A29. Obtaining an understanding of controls sufficient to opine on the suitability of their design is not sufficient evidence regarding their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls as they were designed and implemented. For example, obtaining information about the implementation of a manual control at a point in time does not provide evidence about operation of the control at other times. However, because of the inherent consistency of IT processing, performing procedures to determine the design of an automated control, and whether it has been implemented, may serve as evidence of that control's operating effectiveness, depending on the service auditor's assessment and testing of other controls, such as those over program changes.
- A30. To be useful to user auditors, a type 2 report ordinarily covers a minimum period of six months. If the period is less than six months, the service auditor may

consider it appropriate to describe the reasons for the shorter period in the service auditor's assurance report. Circumstances that may result in a report covering a period of less than six months include when (a) the service auditor is engaged close to the date by which the report on controls is to be issued; (b) the service organization (or a particular system or application) has been in operation for less than six months; or (c) significant changes have been made to the controls and it is not practicable either to wait six months before issuing a report or to issue a report covering the system both before and after the changes.

- A31. Certain control procedures may not leave evidence of their operation that can be tested at a later date and, accordingly, the service auditor may find it necessary to test the operating effectiveness of such control procedures at various times throughout the reporting period.
- A32. The service auditor provides an opinion on the operating effectiveness of controls throughout each period, therefore, sufficient appropriate evidence about the operation of controls during the current period is required for the service auditor to express that opinion. Knowledge of deviations observed in prior engagements may, however, lead the service auditor to increase the extent of testing during the current period.

Testing of Indirect Controls (Ref: Para. 25(b))

- A33. In some circumstances, it may be necessary to obtain evidence supporting the effective operation of indirect controls. For example, when the service auditor decides to test the effectiveness of a review of exception reports detailing sales in excess of authorized credit limits, the review and related follow up is the control that is directly of relevance to the service auditor. Controls over the accuracy of the information in the reports (for example, the general IT controls) are described as "indirect" controls.
- A34. Because of the inherent consistency of IT processing, evidence about the implementation of an automated application control, when considered in combination with evidence about the operating effectiveness of the service organization's general controls (in particular, change controls), may also provide substantial evidence about its operating effectiveness.

Means of Selecting Items for Testing (Ref: Para. 25(c), 27)

- A35. The means of selecting items for testing available to the service auditor are:
- (a) Selecting all items (100% examination). This may be appropriate for testing controls that are applied infrequently, for example, quarterly, or when evidence regarding application of the control makes 100% examination efficient;
 - (b) Selecting specific items. This may be appropriate where 100% examination would not be efficient and sampling would not be effective,

such as testing controls that are not applied sufficiently frequently to render a large population for sampling, for example, controls that are applied monthly or weekly; and

- (c) Sampling. This may be appropriate for testing controls that are applied frequently in a uniform manner and which leave documentary evidence of their application.

A36. While selective examination of specific items will often be an efficient means of obtaining evidence, it does not constitute sampling. The results of procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide evidence concerning the remainder of the population. Sampling, on the other hand, is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it.

The Work of an Internal Audit Function

Obtaining an Understanding of the Internal Audit Function (Ref: Para. 30)

A37. An internal audit function may be responsible for providing analyses, evaluations, assurances, recommendations, and other information to management and those charged with governance. An internal audit function at a service organization may perform activities related to the service organization's own system of internal control, or activities related to the services and systems, including controls, that the service organization is providing to user entities.

Determining Whether and to What Extent to Use the Work of the Internal Auditors (Ref: Para. 33)

A38. In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the service auditor's procedures, the following factors may suggest the need for different or less extensive procedures than would otherwise be the case:

- The nature and scope of specific work performed, or to be performed, by the internal auditors is quite limited.
- The work of the internal auditors relates to controls that are less significant to the service auditor's conclusions.
- The work performed, or to be performed, by the internal auditors does not require subjective or complex judgments.

Using the Work of the Internal Audit Function (Ref: Para. 34)

A39. The nature, timing and extent of the service auditor's procedures on specific work of the internal auditors will depend on the service auditor's assessment of the significance of that work to the service auditor's conclusions (for example,

the significance of the risks that the controls tested seek to mitigate), the evaluation of the internal audit function and the evaluation of the specific work of the internal auditors. Such procedures may include:

- Examination of items already examined by the internal auditors;
- Examination of other similar items; and
- Observation of procedures performed by the internal auditors.

Effect on the Service Auditor's Assurance Report (Ref: Para. 36–37)

- A40. Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the service organization as is required of the service auditor when performing the engagement. The service auditor has sole responsibility for the opinion expressed in the service auditor's assurance report, and that responsibility is not reduced by the service auditor's use of the work of the internal auditors.
- A41. The service auditor's description of work performed by the internal audit function may be presented in a number of ways, for example:
- By including introductory material to the description of tests of controls indicating that certain work of the internal audit function was used in performing tests of controls.
 - Attribution of individual tests to internal audit.

Written Representations (Ref: Para. 38, 40)

- A42. The written representations required by paragraph 38 are separate from, and in addition to, the service organization's assertion, as defined at paragraph 9(o).
- A43. If the service organization does not provide the written representations requested in accordance with paragraph 38(c) of this ISAE, it may be appropriate for the service auditor's opinion to be modified in accordance with paragraph 55(d) of this ISAE.

Other Information (Ref: Para. 42)

- A44. The IESBA Code requires that a service auditor not be associated with information where the service auditor believes 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.¹⁵

If other information included in a document containing the service organization's description of its system and the service auditor's assurance report contains future-oriented information such as recovery or contingency plans, or plans for modifications to the system that will address deviations identified in the service auditor's assurance report, or claims of a promotional nature that cannot be reasonably substantiated, the service auditor may request that information be removed or restated.

- A45. If the service organization refuses to remove or restate the other information, further actions that may be appropriate include, for example:
- Requesting the service organization to consult with its legal counsel as to the appropriate course of action.
 - Describing the material inconsistency or material misstatement of fact in the assurance report.
 - Withholding the assurance report until the matter is resolved.
 - Withdrawing from the engagement.

Documentation (Ref: Para. 51)

- A46. ISQC 1 (or national requirements that are at least as demanding) requires firms to establish policies and procedures for the timely completion of the assembly of engagement files.¹⁶ An appropriate time limit within which to complete the assembly of the final engagement file is ordinarily not more than 60 days after the date of the service auditor's report.¹⁷

Preparing the Service Auditor's Assurance Report

Content of the Service Auditor's Assurance Report (Ref: Para. 53)

- A47. Illustrative examples of service auditors' assurance reports and related service organizations' assertions are contained in Appendices 1 and 2.

Intended Users and Purposes of the Service Auditor's Assurance Report (Ref: Para. 53(e))

- A48. The criteria used for engagements to report on controls at a service organization are relevant only for the purposes of providing information about the service organization's system, including controls, to those who

¹⁵ IESBA Code, paragraph 110.2.

¹⁶ ISQC 1, paragraph 45.

¹⁷ ISQC 1, paragraph A54.

have an understanding of how the system has been used for financial reporting by user entities. Accordingly this is stated in the service auditor's assurance report. In addition, the service auditor may consider it appropriate to include wording that specifically restricts distribution of the assurance report other than to intended users, its use by others, or its use for other purposes.

Description of the Tests of Controls (Ref: Para. 54)

- A49. In describing the nature of the tests of controls for a type 2 report, it assists readers of the service auditor's assurance report if the service auditor includes:
- The results of all tests where deviations have been identified, even if other controls have been identified that allow the service auditor to conclude that the relevant control objective has been achieved or the control tested has subsequently been removed from the service organization's description of its system.
 - Information about causative factors for identified deviations, to the extent the service auditor has identified such factors.

Modified Opinions (Ref: Para. 55)

- A50. Illustrative examples of elements of modified service auditor's assurance reports are contained in Appendix 3.
- A51. Even if the service auditor has expressed an adverse opinion or disclaimed an opinion, it may be appropriate to describe in the basis for modification paragraph the reasons for any other matters of which the service auditor is aware that would have required a modification to the opinion, and the effects thereof.
- A52. When expressing a disclaimer of opinion because of a scope limitation, it is not ordinarily appropriate to identify the procedures that were performed nor include statements describing the characteristics of a service auditor's engagement; to do so might overshadow the disclaimer of opinion.

Other Communication Responsibilities (Ref: Para. 56)

- A53. Appropriate actions to respond to the circumstances identified in paragraph 56 may include:
- Obtaining legal advice about the consequences of different courses of action.
 - Communicating with those charged with governance of the service organization.
 - Communicating with third parties (for example, a regulator) when required to do so.

- Modifying the service auditor's opinion, or adding an Other Matter paragraph.
- Withdrawing from the engagement.

Appendix 1

(Ref. Para. A47)

Example Service Organization's Assertions

The following examples of service organization's assertions are for guidance only and are not intended to be exhaustive or applicable to all situations.

Example 1: Type 2 Service Organization's Assertion

Assertion by the Service Organization

The accompanying description has been prepared for customers who have used *[the type or name of]* system and their auditors who have a sufficient understanding to consider the description, along with other information including information about controls operated by customers themselves, when assessing the risks of material misstatements of customers' financial statements. *[Entity's name]* confirms that:

- (a) The accompanying description at pages *[bb–cc]* fairly presents *[the type or name of]* system for processing customers' transactions throughout the period *[date]* to *[date]*. The criteria used in making this assertion were that the accompanying description:
- (i) Presents how the system was designed and implemented, including:
- The types of services provided, including, as appropriate, classes of transactions processed.
 - The procedures, within both information technology and manual systems, by which those transactions were initiated, recorded, processed, corrected as necessary, and transferred to the reports prepared for customers.
 - The related accounting records, supporting information and specific accounts that were used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information was transferred to the reports prepared for customers.
 - How the system dealt with significant events and conditions, other than transactions.
 - The process used to prepare reports for customers.
 - Relevant control objectives and controls designed to achieve those objectives.
 - Controls that we assumed, in the design of the system, would be implemented by user entities, and which, if necessary to achieve

control objectives stated in the accompanying description, are identified in the description along with the specific control objectives that cannot be achieved by ourselves alone.

- Other aspects of our control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that were relevant to processing and reporting customers' transactions.
- (ii) Includes relevant details of changes to the service organization's system during the period *[date]* to *[date]*.
- (iii) Does not omit or distort information relevant to the scope of the system being described, while acknowledging that the description is prepared to meet the common needs of a broad range of customers and their auditors and may not, therefore, include every aspect of the system that each individual customer may consider important in its own particular environment.
- (b) The controls related to the control objectives stated in the accompanying description were suitably designed and operated effectively throughout the period *[date]* to *[date]*. The criteria used in making this assertion were that:
- (i) The risks that threatened achievement of the control objectives stated in the description were identified;
 - (ii) The identified controls would, if operated as described, provide reasonable assurance that those risks did not prevent the stated control objectives from being achieved; and
 - (iii) The controls were consistently applied as designed, including that manual controls were applied by individuals who have the appropriate competence and authority, throughout the period *[date]* to *[date]*.

Example 2: Type 1 Service Organization's Assertion

The accompanying description has been prepared for customers who have used *[the type or name of]* system and their auditors who have a sufficient understanding to consider the description, along with other information including information about controls operated by customers themselves, when obtaining an understanding of customers' information systems relevant to financial reporting. *[Entity's name]* confirms that:

- (a) The accompanying description at pages *[bb-cc]* fairly presents *[the type or name of]* system for processing customers' transactions as at *[date]*. The criteria used in making this assertion were that the accompanying description:
- (i) Presents how the system was designed and implemented, including:
 - The types of services provided, including, as appropriate, classes of transactions processed.

- The procedures, within both information technology and manual systems, by which those transactions were initiated, recorded, processed, corrected as necessary, and transferred to the reports prepared for customers.
 - The related accounting records, supporting information and specific accounts that were used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the reports prepared customers.
 - How the system dealt with significant events and conditions, other than transactions.
 - The process used to prepare reports for customers.
 - Relevant control objectives and controls designed to achieve those objectives.
 - Controls that we assumed, in the design of the system, would be implemented by user entities, and which, if necessary to achieve control objectives stated in the accompanying description, are identified in the description along with the specific control objectives that cannot be achieved by ourselves alone.
 - Other aspects of our control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that were relevant to processing and reporting customers' transactions.
- (ii) Does not omit or distort information relevant to the scope of the system being described, while acknowledging that the description is prepared to meet the common needs of a broad range of customers and their auditors and may not, therefore, include every aspect of the system that each individual customer may consider important in its own particular environment.
- (b) The controls related to the control objectives stated in the accompanying description were suitably designed as at *[date]*. The criteria used in making this assertion were that:
- (i) The risks that threatened achievement of the control objectives stated in the description were identified; and
 - (ii) The identified controls would, if operated as described, provide reasonable assurance that those risks did not prevent the stated control objectives from being achieved.

Appendix 2

(Ref. Para. A47)

Illustrations of Service Auditor’s Assurance Reports

The following illustrations of reports are for guidance only and are not intended to be exhaustive or applicable to all situations.

Illustration 1: Type 2 Service Auditor’s Assurance Report**Independent Service Auditor’s Assurance Report on
the Description of Controls, their Design and Operating Effectiveness**

To: XYZ Service Organization

Scope

We have been engaged to report on XYZ Service Organization’s description at pages [bb–cc] of its [type or name of] system for processing customers’ transactions throughout the period [date] to [date] (the description), and on the design and operation of controls related to the control objectives stated in the description.¹⁸

XYZ Service Organization’s Responsibilities

XYZ Service Organization is responsible for: preparing the description and accompanying assertion at page [aa], including the completeness, accuracy and method of presentation of the description and assertion; providing the services covered by the description; stating the control objectives; and designing, implementing and effectively operating controls to achieve the stated control objectives.

Service Auditor’s Responsibilities

Our responsibility is to express an opinion on XYZ Service Organization’s description and on the design and operation of controls related to the control objectives stated in that description, based on our procedures. We conducted our engagement in accordance with International Standard on Assurance Engagements 3402, “Assurance Reports on Controls at a Service Organization,” issued by the International Auditing and Assurance Standards Board. That standard requires that we comply with ethical requirements and plan and perform our procedures to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls are suitably designed and operating effectively.

An assurance engagement to report on the description, design and operating effectiveness of controls at a service organization involves performing procedures to obtain evidence

¹⁸ If some elements of the description are not included in the scope of the engagement, this is made clear in the assurance report.

about the disclosures in the service organization's description of its system, and the design and operating effectiveness of controls. The procedures selected depend on the service auditor's judgment, including the assessment of the risks that the description is not fairly presented, and that controls are not suitably designed or operating effectively. Our procedures included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the control objectives stated in the description were achieved. An assurance engagement of this type also includes evaluating the overall presentation of the description, the suitability of the objectives stated therein, and the suitability of the criteria specified by the service organization and described at page [aa].

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Limitations of Controls at a Service Organization

XYZ Service Organization's description is prepared to meet the common needs of a broad range of customers and their auditors and may not, therefore, include every aspect of the system that each individual customer may consider important in its own particular environment. Also, because of their nature, controls at a service organization may not prevent or detect all errors or omissions in processing or reporting transactions. Also, the projection of any evaluation of effectiveness to future periods is subject to the risk that controls at a service organization may become inadequate or fail.

Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion are those described at page [aa]. In our opinion, in all material respects:

- (a) The description fairly presents the [the type or name of] system as designed and implemented throughout the period from [date] to [date];
- (b) The controls related to the control objectives stated in the description were suitably designed throughout the period from [date] to [date]; and
- (c) The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period from [date] to [date].

Description of Tests of Controls

The specific controls tested and the nature, timing and results of those tests are listed on pages [yy-zz].

Intended Users and Purpose

This report and the description of tests of controls on pages [yy–zz] are intended only for customers who have used XYZ Service Organization’s [type or name of] system, and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by customers themselves, when assessing the risks of material misstatements of customers’ financial statements.

[Service auditor’s signature]

[Date of the service auditor’s assurance report]

[Service auditor’s address]

Illustration 2: Type 1 Service Auditor’s Assurance Report

**Independent Service Auditor’s Assurance Report on
the Description of Controls and their Design**

To: XYZ Service Organization

Scope

We have been engaged to report on XYZ Service Organization’s description at pages [bb–cc] of its [type or name of] system for processing customers’ transactions as at [date] (the description), and on the design of controls related to the control objectives stated in the description.¹⁹

We did not perform any procedures regarding the operating effectiveness of controls included in the description and, accordingly, do not express an opinion thereon.

XYZ Service Organization’s Responsibilities

XYZ Service Organization is responsible for: preparing the description and accompanying assertion at page [aa], including the completeness, accuracy and method of presentation of the description and the assertion; providing the services covered by the description; stating the control objectives; and designing, implementing and effectively operating controls to achieve the stated control objectives.

Service Auditor’s Responsibilities

Our responsibility is to express an opinion on XYZ Service Organization’s description and on the design of controls related to the control objectives stated in that description, based on our procedures. We conducted our engagement in accordance with International Standard on Assurance Engagements 3402, “Assurance Reports on Controls at a Service Organization,” issued by the International Auditing and Assurance Standards Board. That

¹⁹ If some elements of the description are not included in the scope of the engagement, this is made clear in the assurance report.

standard requires that we comply with ethical requirements and plan and perform our procedures to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls are suitably designed in all material respects.

An assurance engagement to report on the description and design of controls at a service organization involves performing procedures to obtain evidence about the disclosures in the service organization's description of its system, and the design of controls. The procedures selected depend on the service auditor's judgment, including the assessment that the description is not fairly presented, and that controls are not suitably designed. An assurance engagement of this type also includes evaluating the overall presentation of the description, the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page [aa].

As noted above, we did not perform any procedures regarding the operating effectiveness of controls included in the description and, accordingly, do not express an opinion thereon.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Limitations of Controls at a Service Organization

XYZ Service Organization's description is prepared to meet the common needs of a broad range of customers and their auditors and may not, therefore, include every aspect of the system that each individual customer may consider important in its own particular environment. Also, because of their nature, controls at a service organization may not prevent or detect all errors or omissions in processing or reporting transactions.

Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion are those described at page [aa]. In our opinion, in all material respects:

- (a) The description fairly presents the [the type or name of] system as designed and implemented as at [date]; and
- (b) The controls related to the control objectives stated in the description were suitably designed as at [date].

Intended Users and Purpose

This report is intended only for customers who have used XYZ Service Organization's [type or name of] system, and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by customers themselves, when obtaining an understanding of customers' information systems relevant to financial reporting.

[Service auditor's signature]

[Date of the service auditor's assurance report]

[Service auditor's address]

Appendix 3

(Ref. Para. A50)

Illustrations of Modified Service Auditor's Assurance Reports

The following illustrations of modified reports are for guidance only and are not intended to be exhaustive or applicable to all situations. They are based on the illustrations of reports in Appendix 2.

Illustration 1: Qualified opinion – the service organization's description of the system is not fairly presented in all material respects

...

Service Auditor's Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

The accompanying description states at page [mm] that XYZ Service Organization uses operator identification numbers and passwords to prevent unauthorized access to the system. Based on our procedures, which included inquiries of staff personnel and observation of activities, we have determined that operator identification numbers and passwords are employed in Applications A and B but not in Applications C and D.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in XYZ Service Organization's assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

(a) ...

Illustration 2: Qualified opinion – the controls are not suitably designed to provide reasonable assurance that the control objectives stated in the service organization's description of its system will be achieved if the controls operate effectively

...

Service Auditor's Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

As discussed at page [mm] of the accompanying description, from time to time XYZ Service Organization makes changes in application programs to correct deficiencies or to enhance capabilities. The procedures followed in determining whether to make changes, in designing the changes and in implementing them, do not include review and approval by authorized individuals who are independent from those involved in making the changes. There are also no specified requirements to test such changes or provide test results to an authorized reviewer prior to implementing the changes.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in XYZ Service Organization’s assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

- (a) ...

Illustration 3: Qualified opinion – the controls did not operate effectively throughout the specified period (type 2 report only)

...

Service Auditor’s Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

XYZ Service Organization states in its description that it has automated controls in place to reconcile loan payments received with the output generated. However, as noted at page [mm] of the description, this control was not operating effectively during the period from dd/mm/yyyy to dd/mm/yyyy due to a programming error. This resulted in the non-achievement of the control objective “Controls provide reasonable assurance that loan payments received are properly recorded” during the period from dd/mm/yyyy to dd/mm/yyyy. XYZ implemented a change to the program performing the calculation as of [date], and our tests indicate that it was operating effectively during the period from dd/mm/yyyy to dd/mm/yyyy.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in XYZ Service

Organization’s assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

...

Example 4: Qualified opinion – the service auditor is unable to obtain sufficient appropriate evidence

...

Service Auditor’s Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

XYZ Service Organization states in its description that it has automated controls in place to reconcile loan payments received with the output generated. However, electronic records of the performance of this reconciliation for the period from dd/mm/yyyy to dd/mm/yyyy were deleted as a result of a computer processing error, and we were therefore unable to test the operation of this control for that period. Consequently, we were unable to determine whether the control objective “Controls provide reasonable assurance that loan payments received are properly recorded” operated effectively during the period from dd/mm/yyyy to dd/mm/yyyy.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in XYZ Service Organization’s assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

(a) ...

13–21.]



**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's¹ 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 Ethics Standards Board for Accountants (the IESBA Code).** Ethical principles governing the auditor's professional responsibilities for this type of engagement are:

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 the IESBA Code. 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

Illustration 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.

ENGAGEMENTS TO PERFORM AGREED-UPON PROCEDURES
REGARDING FINANCIAL INFORMATION

XYZ & Co

Acknowledged on behalf of ABC Company by
(signed)

Name and Title

Date

RELATED SERVICES

Appendix 2

Illustration 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

ENGAGEMENTS TO PERFORM AGREED-UPON PROCEDURES
REGARDING FINANCIAL INFORMATION

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's¹ 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 Ethics Standards Board for Accountants (the IESBA Code).** Ethical principles governing the accountant's professional responsibilities for this type of engagement are:
 - (a) Integrity;
 - (b) Objectivity;
 - (c) Professional competence and due care;

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.

- (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 contain² 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

Illustration 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

Illustrations of Compilation Reports

Illustration 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.

Illustration 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.



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

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