

**International Auditing and  
Assurance Standards Board®**

**Handbook of International  
Quality Control, Auditing,  
Review, Other Assurance,  
and Related Services  
Pronouncements**

***2020 Edition  
Volume I***

**IAPN.**

**ISA.**

**ISQC.**

**ISQM.**

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

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# CHANGES OF SUBSTANCE FROM THE 2018 EDITION OF THE HANDBOOK AND RECENT DEVELOPMENTS

## 2019 IAASB Handbook

There is no 2019 IAASB Handbook. The only new standard effective in 2019 was ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, which was effective for audits of financial statements for periods beginning on or after December 15, 2019, and was included in Volume 1 of the 2018 Handbook. ISA 540 (Revised) has been incorporated in the 2020 IAASB Handbook (see below). The 2018 IAASB Handbook remains effective for 2018 and 2019.

## References

This handbook contains references to International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs). Unless otherwise indicated, references to IASs and IFRSs are to the IASs and IFRSs in effect at the date of preparing a pronouncement. Accordingly, readers are cautioned that, where a revised IAS or IFRS has been issued subsequently, reference should be made to the most recent IAS or IFRS.

References to “country” in this handbook should be read as “country or jurisdiction.”

## Pronouncements Issued by the International Auditing and Assurance Standards Board

This handbook contains the complete set of International Auditing and Assurance Standards Board’s (IAASB) standards on quality control, quality management, auditing, review, other assurance and related services, as well as the non-authoritative International Auditing Practice Notes (IAPN). It also includes a preface to the IAASB’s pronouncements, a glossary of terms, and other non-authoritative material. This 2020 edition of the IAASB Handbook replaces the 2018 edition of the IAASB Handbook.

## Additions and Changes

### *Part I of the IAASB Handbook*

#### ISA 540 (Revised)

International Standard on Auditing (ISA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* has replaced ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

ISA 540 (Revised) has been incorporated into the 2020 IAASB Handbook. This standard was presented on pages 1043–1113 in the 2018 edition of the IAASB

Handbook. Changes have been made throughout as appropriate for referencing to the revised standard. Changes for the conforming and consequential amendments to other international standards presented on pages 1114–1146 of the 2018 edition of the IAASB Handbook have also been made in the 2020 edition of the IAASB Handbook. Other changes include updating the cross-referencing, where relevant, to changes made to the other ISAs because of the revised standard.

IAPN 1000 has not been updated for changes to ISA 540 (Revised) yet – conforming changes will be made to IAPN 1000 for changes to ISA 540 (Revised) and ISA 315 (Revised 2019) in the 2021 IAASB Handbook.

Conforming Amendments to the IAASB International Standards as a Result of the Revised IESBA Code

Changes for the conforming amendments arising from the restructured IESBA Code have been made in Parts I and II of the 2020 IAASB Handbook.

#### *Part II of the IAASB Handbook*

With the exception of the conforming amendments arising for the restructured IESBA Code noted above, there are no other additions to Part II of the IAASB Handbook.

#### *Part III of the Handbook*

There are no additions to Part III of the IAASB Handbook.

### **Withdrawals**

The following standards included in the 2018 IAASB Handbook have been withdrawn and replaced with a revised standard that is now effective:

#### *Part I of the IAASB Handbook*

- ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

#### *Part II of the IAASB Handbook*

There are no withdrawals in Part II of the 2020 IAASB Handbook.

### **Standards Not Yet Effective**

The following standards, which are not yet effective, have been included in the back of Part I of the 2020 edition of the IAASB Handbook:

- ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement* (pages 1059–1187)

- Conforming and Consequential Amendments to Other ISAs Arising from ISA 315 (Revised 2019) (pages 1188-1277)
- ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* (pages 1278–1364)
- ISQM 2, *Engagement Quality Reviews* (pages 1365–1386)
- ISA 220 (Revised), *Quality Management for an Audit of Financial Statements* (pages 1387–1431)
- Conforming and Consequential Amendments to Other ISAs Arising from the Quality Management Projects (pages 1432–1464)

The following standards, which are not yet effective, have been included in the back of Part II of the 2020 edition of the IAASB Handbook:

- ISRS 4400 (Revised), *Agreed-Upon Procedures Engagements*

### **Editorial and Other Changes Made in the 2020 IAASB Handbook**

In addition to minor editorials made, the following lists the changes that have been made to the previously published handbook or pronouncements.

#### *Part I*

- Glossary of Terms has been updated for new and revised definitions from ISA 540 (Revised) and the Conforming Amendments to the IAASB International Standards as a Result of the Revised IESBA Code
- ISA 210, footnote 7—reference updated to “paragraph 22”
- ISA 210, footnote 9—reference updated to “paragraph 22(b)(ii)”
- ISA 240, paragraph 10—asterisk (\*) has been removed
- ISA 500, paragraph A41—5<sup>th</sup> bullet has been changed from “...of the relevance and/or reliability...” to “...of the relevance or reliability... (this paragraph has been inserted from the conforming amendments to ISA 540 (Revised))
- ISA 705 (Revised), paragraph A7—the reference in the hanging paragraph has been changed to paragraph A17 of ISA 450 (previously paragraph A13a of ISA 450)
- ISQM 1, Paragraph A177—the last hanging sentence at the end is now included in the bullet list
- ISA 220 (Revised), Paragraph A4—in the second sentence a change has been made to insert ‘that’...’communicating information that enables...”

- Conforming Amendments for the Quality Management Projects, ISA 620—footnote 58 should reference ISA 220 (Revised) and ‘paragraph’ should be plural (i.e., paragraphs)
- Conforming Amendments for the Quality Management Projects, ISA 315 (Revised 2019)—the heading “Identifying and Assessing the Risks of Material Misstatements has been moved below the example box related to paragraph A69.

#### Changes to ISA 315 (Revised 2019) and its Conforming Amendments

- Paragraph 4—last sentence - ...”on a timely basis by the entity’s system of internal control” has been changes to “on a timely basis by the entity’s controls.”
- Paragraph 5—the sentence “As explained in ISA 200, inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others” has been deleted (this was deleted in ISA 200 and therefore needs to be deleted in the introductory paragraphs of ISA 315 (Revised 2019).
- Paragraph A11—the reference to footnote 22 in the second bullet (next to ISA 550) is redundant and has been removed.
- Paragraph A83 – example box—a comma has been inserted in the last sentence ... during the period, the auditor’s understanding...
- The heading above paragraph A90 has been changed for consistency to: *Understanding the Components of the Entity’s System of Internal Control*
- Appendix 3, Paragraph 9:
  - 7<sup>th</sup> bullet point – *Corporate Restructurings* – should be system of internal control (i.e., “of” was inserted).
  - 10<sup>th</sup> bullet point – *Use of IT* – second sub bullet: changed to Risks to the entity’s business strategy (i.e., “entity’ has become entity’s)
- Appendix 5, Paragraph 20—footnote 77 has been deleted
- Appendix 6, Paragraph 1(d)—the words “are also” have been deleted in the last sentence – sentence now reads... Network controls may be relevant when...
- Conforming Amendments to ISA 315 (Revised 2019), footnote 84 – the reference has been changed to “paragraph 13” (previously paragraphs 17-22)
- Conforming Amendments to ISA 315 (Revised 2019), ISA 230, Paragraph A28—the hanging sentence at the end is now included in the bullet list

- Conforming Amendments to ISA 315 (Revised 2019), ISA 240—the paragraph numbers for the requirements and application material have been updated to correspond to the 2018 IAASB Handbook version. There is no impact on the paragraphs presented for ISA 240.
- Conforming Amendments to ISA 315 (Revised 2019), ISA 265—footnote 88 has been added to Paragraph 1 and in Paragraph 2, second last sentence, the “internal control” has been changed to the “entity’s system of internal control.”
- Conforming Amendments to ISA 315 (Revised 2019), ISA 330, Paragraph A42 – the last bullet has been changed to a hanging paragraph.
- Conforming Amendments to ISA 315 (Revised 2019), ISA 330, Paragraph A46—the paragraph number has been corrected to A46.
- Conforming Amendments to ISA 315 (Revised 2019), ISA 330, footnote 118—has been changed to reference paragraph 37.
- Conforming Amendments to ISA 315 (Revised 2019), ISA 402—footnotes 103 and 104 have been added to footnote the names of the relevant standards.
- Conforming Amendments to ISA 315 (Revised 2019), ISA 402, Paragraph A19—footnote 108 has been added.
- Conforming Amendments to ISA 315 (Revised 2019), ISA 500, Paragraph A1—footnote 119 has been added.
- Conforming Amendments to ISA 315 (Revised 2019), Name of ISA 530 has been corrected to “Audit Sampling”
- Conforming Amendments to ISA 315 (Revised 2019), ISA 540 (Revised), Paragraph A19—the reference to paragraph 27 had a strike through and should not be deleted – the strikethrough has been removed.
- Conforming Amendments to ISA 315 (Revised 2019), ISA 540 (Revised), Paragraph 4—third sentence now shown as a strike through: “~~As explained in ISA 200, inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others.~~”
- Conforming Amendments to ISA 315 (Revised 2019), ISA 540 (Revised), Paragraph A39—part of a missing sentence replaced at end of second sentence: “... address such complexity or subjectivity may be more likely to be identified as relevant to the audit.”
- Conforming Amendments to ISA 315 (Revised 2019), ISA 540 (Revised), footnote 142 should only reference paragraph 22(b).

CHANGES OF SUBSTANCE FROM THE 2018 EDITION OF  
THE HANDBOOK AND RECENT DEVELOPMENTS

- Conforming Amendments to ISA 315 (Revised 2019), ISA 610, footnote 153 has been changed to reference ISA 315 (Revised 2019), paragraph 24(a)(ii)(e) and Appendix 4.
- Conforming Amendments to ISA 315 (Revised 2019), ISA 610, footnote 154 has been changed to reference ISA 315 (Revised 2019) paragraph 12(l)
- Conforming Amendments to ISA 315 (Revised 2019), ISA 720 (Revised), Paragraph A51—footnote 157 has been added: ISA 315 (Revised 2019), paragraphs 19-26 and 37

## THE INTERNATIONAL FEDERATION OF ACCOUNTANTS' ROLE

The International Federation of Accountants (IFAC) serves the public interest by contributing to the development of strong and sustainable organizations, markets, and economies. It advocates for transparency, accountability, and comparability of financial reporting; helps develop the accountancy profession; and communicates the importance and value of accountants to the global financial infrastructure. Founded in 1977, IFAC is currently comprised of more than 175 members and associates in more than 130 countries and jurisdictions, representing almost 3 million accountants in public practice, education, government service, industry, and commerce.

As part of its public interest mandate, IFAC contributes to the development, adoption, and implementation of high-quality international auditing and assurance standards, primarily through its support of the IAASB. IFAC provides human resources, facilities management, communications support, and funding to this independent standard-setting board, and facilitates the nominations and selection process for board members.

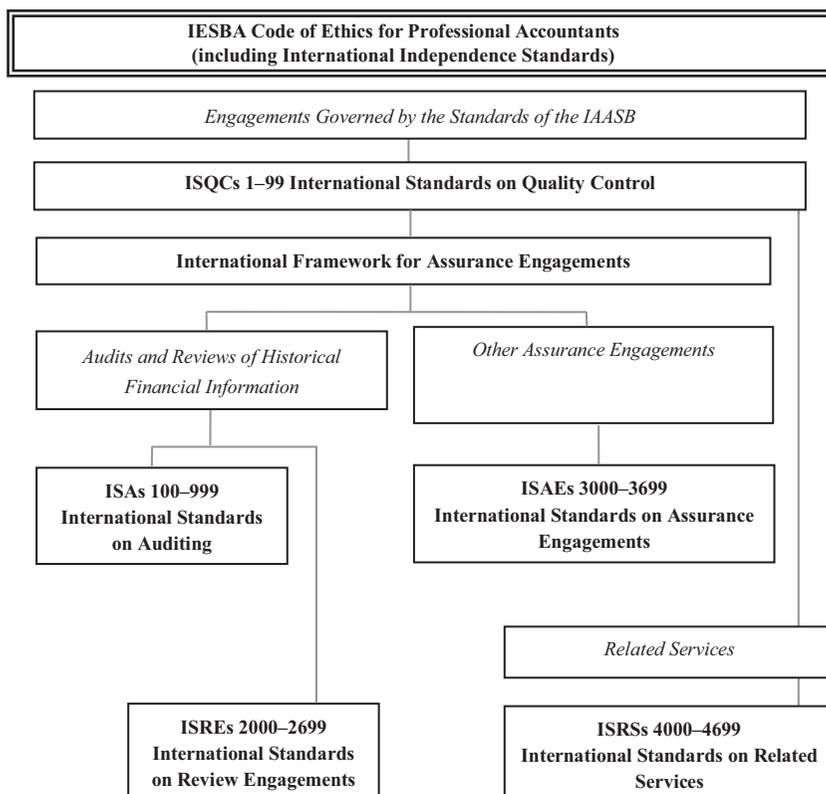
The IAASB sets its own agendas and approves its publications in accordance with its due process and without IFAC's involvement. IFAC has no ability to influence the agendas or publications. IFAC publishes the handbooks, standards, and other publications and owns the copyrights.

The IAASB's independence is safeguarded in a number of ways:

- formal, independent public interest oversight for standard setting by the Public Interest Oversight Board (see [www.ipiob.org](http://www.ipiob.org) for more information), which includes a rigorous due process involving public consultation;
- a public call for nominations, and formal, independent oversight of the nominations/selection process by the Public Interest Oversight Board;
- full transparency, both in terms of due process for standard setting, as well as public access to agenda materials, meetings, and a published basis for conclusions with each final standard;
- the involvement of a Consultative Advisory Group and observers in the standard-setting process; and
- the requirement that IAASB members, as well as nominating/employing organizations, commit to the board's independence, integrity, and public interest mission.

Visit the IFAC website at [www.ifac.org](http://www.ifac.org) for further information.

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



**PREFACE TO THE INTERNATIONAL QUALITY CONTROL,  
AUDITING, REVIEW, OTHER ASSURANCE, AND RELATED  
SERVICES PRONOUNCEMENTS**

(Effective as of December 15, 2011)

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## **Introduction**

1. This preface to the *International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements* is issued to facilitate understanding of the scope and authority of the pronouncements the International Auditing and Assurance Standards Board (IAASB) issues, as set forth in the IAASB's Terms of Reference.
2. The IAASB is committed to the goal of developing a set of International Standards and other pronouncements which are generally accepted worldwide. IAASB members act in the common interest of the public at large and the worldwide accountancy profession. This could result in their taking a position on a matter that is not in accordance with current practice in their country or firm or not in accordance with the position taken by those who put them forward for membership of the IAASB.

## **The IAASB's Pronouncements**

### **IAASB Authoritative Pronouncements**

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

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

5. International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information.
6. International Standards on Review Engagements (ISREs) are to be applied in the review of historical financial information.
7. International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements other than audits or reviews of historical financial information.

8. International Standards on Related Services (ISRSs) are to be applied to compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements as specified by the IAASB.
9. ISAs, ISREs, ISAEs, and ISRSs are collectively referred to as the IAASB's Engagement Standards.
10. International Standards on Quality Control (ISQCs) are to be applied for all services falling under the IAASB's Engagement Standards.

### **International Standards on Auditing**

11. ISAs are written in the context of an audit of financial statements<sup>1</sup> by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The authority of ISAs is set out in ISA 200.<sup>2</sup>

### **International Standards on Quality Control**

12. ISQCs are written to apply to firms in respect of all their services falling under the IAASB's Engagement Standards. The authority of ISQCs is set out in the introduction to the ISQCs.

### **Other International Standards**

13. Some International Standards identified in paragraphs 6–8 contain: objectives, requirements, application and other explanatory material, introductory material and definitions. These terms are to be interpreted in a directly analogous way to how they are explained in the context of ISA and financial statement audits in ISA 200.
14. Other International Standards identified in paragraphs 6–8 contain basic principles and essential procedures (identified in bold type lettering and by the word “should”) together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. It is therefore necessary to consider the entire text of a Standard to understand and apply the basic principles and essential procedures.
15. The basic principles and essential procedures of a Standard are to be applied in all cases where they are relevant in the circumstances of the engagement. In exceptional circumstances, however, a professional accountant may judge it necessary to depart from a relevant essential procedure in order to achieve the purpose of that procedure. When such a situation arises, the professional

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<sup>1</sup> Unless otherwise stated, “financial statements” mean financial statements comprising historical financial information.

<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

accountant is required to document how alternative procedures performed achieve the purpose of the procedure and, unless otherwise clear, the reasons for the departure. The need for the professional accountant to depart from a relevant essential procedure is expected to arise only where, in the specific circumstances of the engagement, that procedure would be ineffective.

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

### **Professional Judgment**

17. The nature of the International Standards requires the professional accountant to exercise professional judgment in applying them.

### **Applicability of the International Standards**

18. The scope, effective date and any specific limitation of the applicability of a specific International Standard is made clear in the Standard. Unless otherwise stated in the International Standard, the professional accountant is permitted to apply an International Standard before the effective date specified therein.
19. International Standards are relevant to engagements in the public sector. When appropriate, additional considerations specific to public sector entities are included:
  - (a) Within the body of an International Standard in the case of ISAs and ISQCs; or
  - (b) In a Public Sector Perspective (PSP) appearing at the end of other International Standards.

### **Non-Authoritative Material**

20. Non-authoritative material includes Practice Notes issued by the IAASB and staff publications. Non-authoritative material is not part of the IAASB's International Standards.

### **International Auditing Practice Notes**

21. International Auditing Practice Notes (IAPNs) do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor's responsibility to comply with all ISA relevant to the audit. IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance.

22. Depending on the nature of the topic(s) covered, an IAPN may assist the auditor in:
- Obtaining an understanding of the circumstances of the entity, and in making judgments about the identification and assessment of risks of material misstatement;
  - Making judgments about how to respond to assessed risks, including judgments about procedures that may be appropriate in the circumstances; or
  - Addressing reporting considerations, including forming an opinion on the financial statements and communicating with those charged with governance.

### **Practice Notes Relating to Other International Standards**

23. The IAASB may also issue International Review Engagement Practice Notes (IREPNs), International Assurance Engagement Practice Notes (IAEPNs), and International Related Services Practice Notes (IRSPNs) to serve the same purpose for ISREs, ISAEs, and ISRSs respectively.

### **Staff Publications**

24. Staff publications are used to help raise practitioners' awareness of significant new or emerging issues by referring to existing requirements and application material, or to direct their attention to relevant provisions of IAASB pronouncements.

### **Language**

25. The sole official text of an IAASB International Standard, Practice Note, exposure draft or other publication is that published by the IAASB in the English language.

# GLOSSARY OF TERMS<sup>1</sup>

(January 2020)

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

- Unauthorized access to on-line terminal devices, programs and data;
- Entry of unauthorized transactions;
- Unauthorized changes to data files;
- The use of computer programs by unauthorized personnel; and
- The use of computer programs that have not been authorized.

\**Accounting estimate*—A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.

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

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

\**Analytical procedures*—Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations

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\* Denotes a term defined in the ISAs

† Denotes a term defined in ISQC 1

<sup>1</sup> In the case of public sector engagements, the terms in this glossary should be read as referring to their public sector equivalents.

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

or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

*Annual report*—A document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom, the purpose of which is to provide owners (or similar stakeholders) with information on the entity’s operations and the entity’s financial results and financial position as set out in the financial statements. An annual report contains or accompanies the financial statements and the auditor’s report thereon and usually includes information about the entity’s developments, its future outlook and risks and uncertainties, a statement by the entity’s governing body, and reports covering governance matters.

\**Anomaly*—A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

*Applicable criteria (in the context of ISAE 3410<sup>2</sup>)*—The criteria used by the entity to quantify and report its emissions in the GHG statement.

*Applicable criteria (in the context of ISAE 3420<sup>3</sup>)*—The criteria used by the responsible party when compiling the pro forma financial information. Criteria may be established by an authorized or recognized standard-setting organization or by law or regulation. Where established criteria do not exist, they will be developed by the responsible party.

\**Applicable financial reporting framework*—The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. In the context of ISRS 4410 (Revised),<sup>4</sup> reference is to the financial information, rather than to the financial statements.

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (a) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (b) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

<sup>2</sup> ISAE 3410, *Assurance Engagements on Greenhouse Gas Statements*

<sup>3</sup> ISAE 3420, *Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus*

<sup>4</sup> ISRS 4410 (Revised), *Compilation Engagements*

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (a) or (b) above.

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

\**Applied criteria (in the context of ISA 810 (Revised))*<sup>5</sup>—The criteria applied by management in the preparation of the summary financial statements.

\**Appropriateness (of audit evidence)*—The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.

\**Arm’s length transaction*—A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

\**Assertions*—Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur. In the context of ISAE 3410, assertions are defined as representations by the entity, explicit or otherwise, that are embodied in the GHG statement, as used by the practitioner to consider the different types of potential misstatements that may occur.

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

*Association*—(see *Auditor association with financial information*)

\*†*Assurance*—(see *Reasonable assurance*)

*Assurance engagement*—An engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria). Each assurance engagement is classified on two dimensions:

- (i) Either a reasonable assurance engagement or a limited assurance engagement:
  - a. Reasonable assurance engagement—An assurance engagement in which the practitioner reduces engagement risk to an acceptably low level in the circumstances of the engagement as the basis for the practitioner’s conclusion. The practitioner’s conclusion is expressed in a form that

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<sup>5</sup> ISA 810 (Revised), *Engagements to Report on Summary Financial Statements*

conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria.

- b. Limited assurance engagement—An assurance engagement in which the practitioner reduces 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 expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated. The nature, timing and extent of procedures performed in a limited assurance engagement is limited compared with that necessary in a reasonable assurance engagement but is planned to obtain a level of assurance that is, in the practitioner's professional judgment, meaningful. 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.
- (ii) Either an attestation engagement or a direct engagement:
- a. Attestation engagement—An assurance engagement in which a party other than the practitioner measures or evaluates the underlying subject matter against the criteria. A party other than the practitioner also often presents the resulting subject matter information in a report or statement. In some cases, however, the subject matter information may be presented by the practitioner in the assurance report. In an attestation engagement, the practitioner's conclusion addresses whether the subject matter information is free from material misstatement. The practitioner's conclusion may be phrased in terms of:
    - i. The underlying subject matter and the applicable criteria;
    - ii. The subject matter information and the applicable criteria; or
    - iii. A statement made by the appropriate party(ies).
  - b. Direct engagement—An assurance engagement in which the practitioner measures or evaluates the underlying subject matter against the applicable criteria and the practitioner presents the resulting subject matter information as part of, or accompanying, the assurance report. In a direct engagement, the practitioner's conclusion addresses the reported outcome of the measurement or evaluation of the underlying subject matter against the criteria.

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

*Assurance skills and techniques*—Those planning, evidence gathering, evidence evaluation, communication and reporting skills and techniques demonstrated by an

assurance practitioner that are distinct from expertise in the underlying subject matter of any particular assurance engagement or its measurement or evaluation.

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

*\*Audit evidence*—Information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. (See *Sufficiency of audit evidence* and *Appropriateness of audit evidence*.)

*\*Audit file*— One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

*\*†Audit firm*—(see *Firm*)

*\*Audit opinion*—(see *Modified opinion* and *Unmodified opinion*)

*\*Audit risk*—The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

*\*Audit sampling (sampling)*—The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

*\*Audited financial statements (in the context of ISA 810 (Revised))*—Financial statements<sup>6</sup> audited by the auditor in accordance with ISAs, and from which the summary financial statements are derived.

*\*Auditor*—“Auditor” is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an ISA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “auditor” is used. “Engagement partner” and “firm” are to be read as referring to their public sector equivalents where relevant.

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

*\*Auditor’s expert*—An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor’s expert may be

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<sup>6</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(f), defines the term “financial statements.”

either an auditor's internal expert (who is a partner<sup>7</sup> or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

\**Auditor's point estimate or auditor's range*—An amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate.

\**Auditor's range*—(see *Auditor's point estimate*)

*Base year*—A specific year or an average over multiple years against which an entity's emissions are compared over time.

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

*Cap and trade*—A system that sets overall emissions limits, allocates emissions allowances to participants, and allows them to trade allowances and emission credits with each other.

*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.

\**Comparative financial statements*—Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

\**Comparative information*—The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework. In the context of ISAE 3410, comparative information is defined as the amounts and disclosures included in the GHG statement in respect of one or more prior periods.

*Compilation engagement*—An engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework, and reports as required by this ISRS. Throughout ISRS

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<sup>7</sup> "Partner" and "firm" should be read as referring to their public sector equivalents where relevant.

4410 (Revised), the words “compile”, “compiling” and “compiled” are used in this context.

\**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, are identified in the description of its system.

\**Compliance framework*—(see *Applicable financial reporting framework* and *General purpose framework*)

\**Component*—An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

\**Component auditor*—An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

\**Component management*—Management responsible for the preparation of the financial information of a component.

\**Component materiality*—The materiality for a component determined by the group engagement team.

*Computer-assisted audit techniques*—Applications of auditing procedures using the computer as an audit tool (also known as CAATs).

*Control activities*—Those policies and procedures that help ensure that management directives are carried out. Control activities are a component of internal control.

*Control environment*—Includes the governance and management functions and the attitudes, awareness and actions of those charged with governance and management concerning the entity’s internal control and its importance in the entity. The control environment is a component of internal control.

*Control objective*—The aim or purpose of a particular aspect of controls. Control objectives relate to risks that controls seek to mitigate.

\**Control risk*—(see *Risk of material misstatement*)

*Controls at the service organization*—Controls over the achievement of a control objective that is covered by the service auditor’s assurance report.

*Controls at a subservice organization*—Controls at a subservice organization to provide reasonable assurance about the achievement of a control objective.

*Corporate governance*—(see *Governance*)

\**Corresponding figures*—Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

*Criteria*—The benchmarks used to measure or evaluate the underlying subject matter. The “applicable criteria” are the criteria used for the particular engagement.

\**Date of approval of the financial statements*—The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognized authority have asserted that they have taken responsibility for those financial statements.

†*Date of report (in relation to quality control)*—The date selected by the practitioner to date the report.

\**Date of the auditor’s report*—The date the auditor dates the report on the financial statements in accordance with ISA 700 (Revised).<sup>8</sup>

\**Date of the financial statements*—The date of the end of the latest period covered by the financial statements.

\**Date the financial statements are issued*—The date that the auditor’s report and audited financial statements are made available to third parties.

\**Deficiency in internal control*—This exists when:

- (a) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
- (b) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

\**Detection risk*—The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

\**Direct assistance*—The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

\**Element*—(see *Element of a financial statement*)

\**Element of a financial statement (in the context of ISA 805 (Revised))<sup>9</sup>*—An element, account or item of a financial statement.

*Emissions*—The GHGs that, during the relevant period, have been emitted to the atmosphere or would have been emitted to the atmosphere had they not been captured and channeled to a sink. Emissions can be categorized as:

- Direct emissions (also known as Scope 1 emissions), which are emissions from sources that are owned or controlled by the entity.

<sup>8</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

<sup>9</sup> ISA 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*

- Indirect emissions, which are emissions that are a consequence of the activities of the entity, but which occur at sources that are owned or controlled by another entity. Indirect emissions can be further categorized as:
  - Scope 2 emissions, which are emissions associated with energy that is transferred to and consumed by the entity.
  - Scope 3 emissions, which are all other indirect emissions.

*Emissions deduction*—Any item included in the entity’s GHG statement that is deducted from the total reported emissions, but which is not a removal; it commonly includes purchased offsets, but can also include a variety of other instruments or mechanisms such as performance credits and allowances that are recognized by a regulatory or other scheme of which the entity is a part.

*Emissions factor*—A mathematical factor or ratio for converting the measure of an activity (for example, liters of fuel consumed, kilometers travelled, the number of animals in husbandry, or tonnes of product produced) into an estimate of the quantity of GHGs associated with that activity.

*Emissions trading scheme*—A market-based approach used to control greenhouse gases by providing economic incentives for achieving reductions in the emissions of such gases.

*\*Emphasis of Matter paragraph*—A paragraph included in the auditor’s report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor’s judgment, is of such importance that it is fundamental to users’ understanding of the financial statements.

*Engagement circumstances*—The broad context defining the particular engagement, which includes: the terms of the engagement; whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the underlying subject matter; the measurement or evaluation criteria; the information needs of the intended users; relevant characteristics of the responsible party, the measurer or evaluator, and the engaging party and their environment; and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

*†Engagement documentation*—The record of work performed, results obtained, and conclusions the practitioner reached (terms such as “working papers” or “workpapers” are sometimes used).

*Engagement letter*—Written terms of an engagement in the form of a letter.

*\*†Engagement partner<sup>10</sup>*—The partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional,

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<sup>10</sup> “Engagement partner,” “partner,” and “firm” should be read as referring to their public sector equivalents where relevant.

*legal or regulatory body. “Engagement partner” should be read as referring to its public sector equivalents where relevant.*

*\*†Engagement quality control review—A process designed to provide an objective evaluation, on or before the date of the report, of the significant judgments the engagement team made and the conclusions it reached in formulating the report. The engagement quality control review process is for audits of financial statements of listed entities and those other engagements, if any, for which the firm has determined an engagement quality control review is required.*

*\*†Engagement quality control reviewer—A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the report.*

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

*\*†Engagement team—All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform procedures on the engagement. This excludes an auditor’s external expert engaged by the firm or by a network firm. The term “engagement team” also excludes individuals within the client’s internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of ISA 610 (Revised 2013).<sup>11</sup>*

*\*†Engagement team (in the context of ISAE 3000 (Revised))<sup>12</sup>— All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform procedures on the engagement. This excludes a practitioner’s external expert engaged by the firm or a network firm.*

*Engaging party—The party(ies) that engages the practitioner to perform the assurance engagement.*

*Entity (in the context of ISAE 3410)—The legal entity, economic entity, or the identifiable portion of a legal or economic entity (for example, a single factory or other form of facility, such as a land fill site), or combination of legal or other entities or portions of those entities (for example, a joint venture) to which the emissions in the GHG statement relate.*

*Entity’s risk assessment process—A component of internal control that is the entity’s process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.*

<sup>11</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, establishes limits on the use of direct assistance. It also acknowledges that the external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. Therefore, the use of direct assistances is restricted to situations where it is permitted.

<sup>12</sup> ISAE 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*

*Environmental risk*—In certain circumstances, factors relevant to the assessment of inherent risk for the development of the overall audit plan may include the risk of material misstatement of the financial statements due to environmental matters.

*Error*—An unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

*\*Estimation uncertainty*—Susceptibility to an inherent lack of precision in measurement.

*Evaluate*—Identify and analyze the relevant issues, including performing further procedures as necessary, to come to a specific conclusion on a matter. “Evaluation,” by convention, is used only in relation to a range of matters, including evidence, the results of procedures and the effectiveness of management’s response to a risk. (also see *Assess*)

*Evidence*—Information used by the practitioner in arriving at the practitioner’s conclusion. Evidence includes both information contained in relevant information systems, if any, and other information. For purposes of the ISAEs:

(i) Sufficiency of evidence is the measure of the quantity of evidence.

(ii) Appropriateness of evidence is the measure of the quality of evidence.

*\*Exception*—A response that indicates a difference between information requested to be confirmed, or contained in the entity’s records, and information provided by the confirming party.

*\*Experienced auditor*—An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

(a) Audit processes;

(b) ISAs and applicable legal and regulatory requirements;

(c) The business environment in which the entity operates; and

(d) Auditing and financial reporting issues relevant to the entity’s industry.

*\*Expert*—(see *Auditor’s expert* and *Management’s expert*)

*\*Expertise*—Skills, knowledge and experience in a particular field.

*\*External confirmation*—Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

*\*Fair presentation framework* —(see *Applicable financial reporting framework* and *General purpose framework*)

*\*Financial statements*—A structured representation of historical financial information, including disclosures, intended to communicate an entity’s economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with a financial reporting framework. The term “financial statements” ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable

financial reporting framework, but can also refer to a single financial statement. Disclosures comprise explanatory or descriptive information, set out as required, expressly permitted or otherwise allowed by the applicable financial reporting framework, on the face of a financial statement, or in the notes, or incorporated therein by cross-reference.

\*†*Firm*—A sole practitioner, partnership or corporation or other entity of professional accountants. “Firm” should be read as referring to its public sector equivalents where relevant.

*Forecast*—Prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).

\**Fraud*—An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

\**Fraud risk factors*—Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

*Fraudulent financial reporting*—Involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users.

*Further procedures*—Procedures performed in response to assessed risks of *material* misstatement, including tests of controls (if any), tests of details and analytical procedures.

*General IT controls*—Policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General IT controls commonly include controls over data center and network operations; system software acquisition, change and maintenance; access security; and application system acquisition, development, and maintenance.

\**General purpose financial statements*—Financial statements prepared in accordance with a general purpose framework.

\**General purpose framework* – A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.<sup>13</sup>

*GHG statement*—A statement setting out constituent elements and quantifying an entity’s GHG emissions for a period (sometimes known as an emissions inventory) and, where applicable, comparative information and explanatory notes including a summary of significant quantification and reporting policies. An entity’s GHG statement may also include a categorized listing of removals or emissions deductions. Where the engagement does not cover the entire GHG statement, the term “GHG statement” is to be read as that portion that is covered by the engagement. The GHG statement is the “subject matter information” of the engagement.<sup>14</sup>

*Greenhouse gases (GHGs)*—Carbon dioxide (CO<sub>2</sub>) and any other gases required by the applicable criteria to be included in the GHG statement, such as: methane; nitrous oxide; sulfur hexafluoride; hydrofluorocarbons; perfluorocarbons; and chlorofluorocarbons. Gases other than carbon dioxide are often expressed in terms of carbon dioxide equivalents (CO<sub>2</sub>-e).

*Governance*—Describes the role of person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

\**Group*—All the components whose financial information is included in the group financial statements. A group always has more than one component.

\**Group audit*—The audit of group financial statements.

\**Group audit opinion*—The audit opinion on the group financial statements.

\**Group engagement partner*—The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor’s report on the group financial statements that is issued on behalf of the firm. Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team.

\**Group engagement team*—Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

\**Group financial statements*—Financial statements that include the financial information of more than one component. The term “group financial statements” also refers to combined financial statements aggregating the financial information prepared by components that have no parent but are under common control.

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<sup>13</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(a)

<sup>14</sup> ISAE 3000 (Revised), paragraph 12(x)

*\*Group management*—Management responsible for the preparation of the group financial statements.

*\*Group-wide controls*—Controls designed, implemented and maintained by group management over group financial reporting.

*\*Historical financial information*—Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

*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.

*Independence<sup>15</sup>*—Comprises:

- (a) Independence of mind—the state of mind that permits the expression of an opinion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional skepticism.
- (b) Independence in appearance—the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude that a firm's or an audit or assurance team member's integrity, objectivity or professional skepticism has been compromised.

*Information system relevant to financial reporting*—A component of internal control that includes the financial reporting system, and consists of the procedures and records established to initiate, record, process and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity.

*\*Inherent risk*—(see *Risk of material misstatement*)

*\*Initial audit engagement*—An engagement in which either:

- (a) The financial statements for the prior period were not audited; or
- (b) The financial statements for the prior period were audited by a predecessor auditor.

*Inquiry*—Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity.

*Inquiry (in the context of ISRE 2400 (Revised))*—Inquiry consists of seeking information of knowledgeable persons from within or outside the entity.

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<sup>15</sup> As defined in the IESBA *Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code)

*Inspection (as an audit procedure)*—Examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

\*†*Inspection (in relation to quality control)*—In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm’s quality control policies and procedures.

*Intended users*— The individual(s) or organization(s), or group(s) thereof that the practitioner expects will use the assurance report. In some cases, there may be intended users other than those to whom the assurance report is addressed.

*Interim financial information or statements*—Financial information (which may be less than a complete set of financial statements as defined above) issued at interim dates (usually half-yearly or quarterly) in respect of a financial period.

\**Internal audit function*—A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity’s governance, risk management and internal control processes.

*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.

\**Internal control*—The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term “controls” refers to any aspects of one or more of the components of internal control.

\**International Financial Reporting Standards*—The International Financial Reporting Standards issued by the International Accounting Standards Board.

*Investigate*—Inquire into matters arising from other procedures to resolve them.

*IT environment*—The policies and procedures that the entity implements and the IT infrastructure (hardware, operating systems, etc.) and application software that it uses to support business operations and achieve business strategies.

*Key audit matters*—Those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

*Limited assurance (in the context of ISRE 2400 (Revised))*—The level of assurance obtained where engagement risk is reduced 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 expressing a conclusion in accordance with this ISRE. 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. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the financial statements.

*Limited assurance engagement*—(see *Assurance engagement*)

\*†*Listed entity*—An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.

\**Management*—The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

\**Management bias*—A lack of neutrality by management in the preparation of information.

\**Management's expert*—An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

\**Management's point estimate*—The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

*Measurer or evaluator*—The party(ies) who measures or evaluates the underlying subject matter against the criteria. The measurer or evaluator possesses expertise in the underlying subject matter.

*Misappropriation of assets*—Involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more capable of disguising or concealing misappropriations in ways that are difficult to detect.

\**Misstatement*—A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

In the context of ISAE 3000 (Revised), a misstatement is defined as a difference between the subject matter information and the appropriate measurement or evaluation of the underlying subject matter in accordance with the criteria. Misstatements can be intentional or unintentional, qualitative or quantitative, and include omissions

In the context of ISRS 4410 (Revised), a misstatement is defined as a difference between the amount, classification, presentation, or disclosure of a reported item in the financial information, and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Where the financial information is prepared in accordance with a fair presentation framework, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the practitioner's judgment, are necessary for the financial information to be presented fairly, in all material respects, or to give a true and fair view.

*Misstatement of fact (with respect to other information)*(in the context of ISAE 3000 (Revised))—Other information that is unrelated to matters appearing in the subject matter information or the assurance report that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing the subject matter information.

*Misstatement of the other information*—A misstatement of the other information exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information).

\**Modified opinion*—A qualified opinion, an adverse opinion or a disclaimer of opinion on the financial statements.

\*†*Monitoring (in relation to quality control)*—A process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to provide the firm with reasonable assurance that its system of quality control is operating effectively.

*Monitoring of controls*—A process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions. Monitoring of controls is a component of internal control.

\**Negative confirmation request*—A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

\*†*Network*—A larger structure:

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

\*†*Network firm*—A firm or entity that belongs to a network.

\**Non-compliance (in the context of ISA 250<sup>16</sup>)*—Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

\**Non-response*—A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

\**Non-sampling risk*—The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

*Observation*—Consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.

\**Opening balances*—Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

*Organizational boundary*—The boundary that determines which operations to include in the entity's GHG statement.

\**Other information*— Financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report.

*Other information (in the context of ISAE 3000 (Revised))* —Information (other than the subject matter information and the assurance report thereon) which is included, either by law, regulation or custom, in a document containing the subject matter information and the assurance report thereon.

\**Other Matter paragraph*—A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

\**Outcome of an accounting estimate*—The actual monetary amount that results from the resolution of the transaction(s), event(s) or condition(s) addressed by an accounting estimate.

*Overall audit strategy*—Sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

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<sup>16</sup> ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

\*†*Partner*—Any individual with authority to bind the firm with respect to the performance of a professional services engagement.

\**Performance materiality*—The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures. In the context of ISAE 3410, performance materiality is defined as the amount or amounts set by the practitioner at less than materiality for the GHG statement to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the GHG statement. If applicable, performance materiality also refers to the amount or amounts set by the practitioner at less than the materiality level or levels for particular types of emissions or disclosures.

\*†*Personnel*—Partners and staff.

\**Pervasive*—A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor’s judgment:

- (a) Are not confined to specific elements, accounts or items of the financial statements;
- (b) If so confined, represent or could represent a substantial proportion of the financial statements; or
- (c) In relation to disclosures, are fundamental to users’ understanding of the financial statements.

\**Population*—The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

\**Positive confirmation request*—A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

*Practitioner*—A professional accountant in public practice.

*Practitioner (in the context of ISAE 3000 (Revised))*—The individual(s) conducting the engagement (usually the engagement partner or other members of the engagement team, or, as applicable, the firm). Where this ISAE expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “practitioner” is used.

*Practitioner (in the context of ISRE 2400 (Revised))*—A professional accountant in public practice. The term includes the engagement partner or other members of the

engagement team, or, as applicable, the firm. Where ISRE 2400 (Revised) expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “practitioner” is used. “Engagement partner” and “firm” are to be read as referring to their public sector equivalents where relevant.

*Practitioner (in the context of ISRS 4410 (Revised))*—A professional accountant in public practice who conducts the compilation engagement. The term includes the engagement partner or other members of the engagement team, or, as applicable, the firm. Where ISRS 4410 (Revised) expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “practitioner” is used. “Engagement partner” and “firm” are to be read as referring to their public sector equivalents where relevant.

*Practitioner’s expert*—An individual or organization possessing expertise in a field other than assurance, whose work in that field is used by the practitioner to assist the practitioner in obtaining sufficient appropriate evidence. A practitioner’s expert may be either a practitioner’s internal expert (who is a partner or staff, including temporary staff, of the practitioner’s firm or a network firm), or a practitioner’s external expert.

*\*Preconditions for an audit*—The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise<sup>17</sup> on which an audit is conducted.

*\*Predecessor auditor*—The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

*\*Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted*—That management and, where appropriate, those charged with governance have acknowledged and understand that they have the following responsibilities that are fundamental to the conduct of an audit in accordance with ISAs. That is, responsibility:

- (a) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
- (b) For such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide the auditor with:
  - (i) Access to all information of which management and, where appropriate, those charged with governance are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

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<sup>17</sup> ISA 200, paragraph 13

- (ii) Additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and
- (iii) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, (a) above may be restated as “for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework,” or “for the preparation of financial statements *that give a true and fair view* in accordance with the financial reporting framework.”

The “premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted” may also be referred to as the “premise.”

*Pro forma adjustments*—In relation to unadjusted financial information, these include:

- (a) Adjustments to unadjusted financial information that illustrate the impact of a significant event or transaction (“event” or “transaction”) as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration; and
- (b) Adjustments to unadjusted financial information that are necessary for the pro forma financial information to be compiled on a basis consistent with the applicable financial reporting framework of the reporting entity (“entity”) and its accounting policies under that framework.

Pro forma adjustments include the relevant financial information of a business that has been, or is to be, acquired (“acquiree”), or a business that has been, or is to be, divested (“divestee”), to the extent that such information is used in compiling the pro forma financial information (“acquiree or divestee financial information”).

*Pro forma financial information*—Financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been *undertaken* at an earlier date selected for purposes of the illustration. In this ISAE, it is presumed that pro forma financial information is presented in columnar format consisting of (a) the unadjusted financial information; (b) the pro forma adjustments; and (c) the resulting pro forma column.

*Professional accountant*<sup>18</sup>—An individual who is a member of an IFAC member body.

*Professional accountant in public practice*<sup>19</sup>—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.

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<sup>18</sup> As defined in the IESBA Code

<sup>19</sup> As defined in the IESBA Code

*\*Professional judgment*—The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

*Professional judgment (in the context of ISAE 3000 (Revised))*—The application of relevant training, knowledge and experience, within the context provided by assurance and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the engagement.

*Professional judgment (in the context of ISRE 2400 (Revised))*—The application of relevant training, knowledge and experience, within the context provided by assurance, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the review engagement.

*\*Professional skepticism*—An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.

*Professional skepticism (in the context of ISAE 3000 (Revised))*—An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement, and a critical assessment of evidence.

*\*Professional standards*—International Standards on Auditing (ISAs) and relevant ethical requirements

*†Professional standards (in the context of ISQC 1<sup>20</sup>)*—IAASB Engagement Standards, as defined in the IAASB’s *Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*, and relevant ethical requirements.

*Projection*—Prospective financial information prepared on the basis of:

- (a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or
- (b) A mixture of best-estimate and hypothetical assumptions.

*Prospective financial information*—Financial information based on assumptions about events that may occur in the future and possible actions by an entity. Prospective financial information can be in the form of a forecast, a projection or a combination of both. (see *Forecast* and *Projection*)

*Prospectus*—A document issued pursuant to legal or regulatory requirements relating to the entity’s securities on which it is intended that a third party should make an investment decision.

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<sup>20</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

*Public sector*—National governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises).

*Published financial information*—Financial information of the entity or of an acquiree or a divestee that is made available publicly.

*Purchased offset*—An emissions deduction in which the entity pays for the lowering of another entity’s emissions (emissions reductions) or the increasing of another entity’s removals (removal enhancements), compared to a hypothetical baseline.

*Quantification*—The process of determining the quantity of GHGs that relate to the entity, either directly or indirectly, as emitted (or removed) by particular sources (or sinks).

\*†*Reasonable assurance (in the context of audit engagements, and in quality control)*—A high, but not absolute, level of assurance.

*Reasonable assurance engagement*—(see *Assurance engagement*)

*Recalculation*—Consists of checking the mathematical accuracy of documents or records.

\**Related party*—A party that is either:

- (a) A related party as defined in the applicable financial reporting framework; or
- (b) Where the applicable financial reporting framework establishes minimal or no related party requirements:
  - (i) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
  - (ii) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
  - (iii) Another entity that is under common control with the reporting entity through having:
    - a. Common controlling ownership;
    - b. Owners who are close family members; or
    - c. Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

*Related services*—Comprise agreed-upon procedures and compilations.

\*† *Relevant ethical requirements (in the context of ISQC 1)*—Ethical requirements to which the engagement team and engagement quality control reviewer are subject when undertaking audits or reviews of financial statements, or other assurance or related services engagements, which ordinarily comprise the provisions of the International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) together with national requirements that are more restrictive.

*Relevant ethical requirements (in the context of the ISAs)*—Ethical requirements to which the engagement team and engagement quality control reviewer are subject when undertaking an audit engagement, which ordinarily comprise the provisions of the International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) related to an audit of financial statements, together with national requirements that are more restrictive.

*Relevant ethical requirements (in the context of ISRE 2400 (Revised))*—Ethical requirements to which the engagement team is subject when undertaking a review engagement, which ordinarily comprise the provisions of the International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code), related to a review of financial statements, together with national requirements that are more restrictive.

*Relevant ethical requirements (in the context of ISRS 4410 (Revised))*—Ethical requirements to which the engagement team is subject when undertaking a compilation engagement, which ordinarily comprise the provisions of the International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) related to compilation engagements, together with national requirements that are more restrictive.

*Removal*—The GHGs that the entity has, during the period, removed from the atmosphere, or that would have been emitted to the atmosphere had they not been captured and channeled to a sink.

*Reperformance*—The auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal controls.

\* *Report on the description and design of controls at a service organization (referred to in ISA 402<sup>21</sup> as a type 1 report)*—A report that comprises:

- (a) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls that have been designed and implemented as at a specified date; and

<sup>21</sup> ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

- (b) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor’s opinion on the description of the service organization’s system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

*Report on the description and design of controls at a service organization (referred to in ISAE 3402<sup>22</sup> as a “type 1 report”)(in the context of ISAE 3402)*—A report that comprises:

- (a) The service organization’s description of its system;
- (b) A written statement by the service organization that, in all material respects, and based on suitable criteria:
- (i) The description fairly presents the service organization’s system as designed and implemented as at the specified date;
  - (ii) 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
- (c) A service auditor’s assurance report that conveys a reasonable assurance conclusion about the matters in (b)(i)–(ii) above.

*\*Report on the description, design, and operating effectiveness of controls at a service organization (referred to in ISA 402 as a type 2 report)*—A report that comprises:

- (a) A description, prepared by management of the service organization, of the service organization’s system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and
- (b) A report by the service auditor with the objective of conveying reasonable assurance that includes:
- (i) The service auditor’s opinion on the description of the service organization’s system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
  - (ii) A description of the service auditor’s tests of the controls and the results thereof.

*Report on the description, design and operating effectiveness of controls at a service organization (referred to in ISAE 3402 as a “type 2 report”)(in the context of ISAE 3402)*—A report that comprises:

- (a) The service organization’s description of its system;

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<sup>22</sup> ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

- (b) A written statement by the service organization that, in all material respects, and based on suitable criteria:
  - (i) The description fairly presents the service organization's system as designed and implemented throughout the specified period;
  - (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; and
  - (iii) The controls related to the control objectives stated in the service organization's description of its system operated effectively throughout the specified period; and
- (c) A service auditor's assurance report that:
  - (i) Conveys a reasonable assurance conclusion about the matters in (b)(i)–(iii) above; and
  - (ii) Includes a description of the tests of controls and the results thereof.

*Responsible party*—The party(ies) responsible for the underlying subject matter.

*Review (in relation to quality control)*—Appraising the quality of the work performed and conclusions reached by others.

*Review engagement*—The objective of a review engagement is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

*Review procedures*—The procedures deemed necessary to meet the objective of a review engagement, primarily inquiries of entity personnel and analytical procedures applied to financial data.

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

*\*Risk of material misstatement*—The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

- (a) *Inherent risk*—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
- (b) *Control risk*—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either

individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

*Risk of material misstatement (in the context of ISAE 3000 (Revised))*—The risk that the subject matter information is materially misstated prior to the engagement.

\**Sampling*—(see *Audit sampling*)

\**Sampling risk*—The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

- (a) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (b) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

\**Sampling unit*—The individual items constituting a population.

*Scope of a review*—The review procedures deemed necessary in the circumstances to achieve the objective of the review.

\**Service auditor*—An auditor who, at the request of the service organization, provides an assurance report on the controls of a service organization.

*Service auditor (in the context of ISAE 3402)*—A practitioner who, at the request of the service organization, provides an assurance report on controls of a service organization.

\**Service organization*—A third-party organization (or segment of a third-party organization) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

*Service organization (in the context of ISAE 3402)*—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.

*Service organization's statement*—The written statement about the matters referred to in (b) of the definition of a report on the description, design and operating effectiveness of controls at a service organization (in the case of a type 2 report) or (b) of the definition of a report on the description and design of controls at a service organization (in the case of a type 1 report).

\**Service organization's system*—The policies and procedures designed, implemented and maintained by the service organization to provide user entities with the services covered by the service auditor's report.

*Service organization's system (or the system)(in the context of ISAE 3402)*—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.

*Significance*—The relative importance of a matter, taken in context. The significance of a matter is judged by the practitioner in the context in which it is being considered. This might include, for example, the reasonable prospect of its changing or influencing the decisions of intended users of the practitioner's report; or, as another example, where the context is a judgment about whether to report a matter to those charged with governance, whether the matter would be regarded as important by them in relation to their duties. Significance can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and effect on the subject matter and the expressed interests of intended users or recipients.

*\*Significant component*—A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

*\*Significant deficiency in internal control*—A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

*Significant facility*—A facility that is of individual significance due to the size of its emissions relative to the aggregate emissions included in the GHG statement or its specific nature or circumstances which give rise to particular risks of material misstatement.

*\*Significant risk*—An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

*Sink*—A physical unit or process that removes GHGs from the atmosphere.

*Smaller entity*—An entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
  - (i) Straightforward or uncomplicated transactions;
  - (ii) Simple record-keeping;
  - (iii) Few lines of business and few products within business lines;
  - (iv) Few internal controls;
  - (v) Few levels of management with responsibility for a broad range of controls; or

(vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

*Source*—A physical unit or process that releases GHGs into the atmosphere.

\**Special purpose financial statements*—Financial statements prepared in accordance with a special purpose framework.

\**Special purpose framework*—A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.<sup>23</sup>

\*†*Staff*—Professionals, other than partners, including any experts the firm employs.

\**Statistical sampling*—An approach to sampling that has the following characteristics:

- (a) Random selection of the sample items; and
- (b) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (a) and (b) is considered non-statistical sampling.

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

*Subject matter information*—The outcome of the measurement or evaluation of the underlying subject matter against the criteria, that is, the information that results from applying the criteria to the underlying subject matter.

\**Subsequent events*—Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

\**Subservice organization*—A service organization used by another service organization to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.

*Subservice organization (in the context of ISAE 3402)*—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.

\**Substantive procedure*—An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

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<sup>23</sup> ISA 200, paragraph 13(a)

- (a) Tests of details (of classes of transactions, account balances, and disclosures); and
- (b) Substantive analytical procedures.

*\*Sufficiency (of audit evidence)*—The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence.

*Suitable criteria*—(see *Criteria*)

*\*†Suitably qualified external person*—An individual outside the firm with the competence and capabilities to act as an engagement partner, for example a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organization that provides relevant quality control services.

*\*Summary financial statements (in the context of ISA 810 (Revised))*—Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity’s economic resources or obligations at a point in time or the changes therein for a period of time.<sup>24</sup> Different jurisdictions may use different terminology to describe such historical financial information.

*Supplementary information*—Information that is presented together with the financial statements that is not required by the applicable financial reporting framework used to prepare the financial statements, normally presented in either supplementary schedules or as additional notes.

*Test*—The application of procedures to some or all items in a population.

*Test of controls (in the context of ISAE 3402)*—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.

*\*Tests of controls*—An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

*\*Those charged with governance*—The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.<sup>25</sup>

<sup>24</sup> ISA 200, paragraph 13(f)

<sup>25</sup> For discussion of the diversity of governance structures, see paragraphs A1–A8 of ISA 260 (Revised), *Communication with Those Charged with Governance*.

*\*Tolerable misstatement*—A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

*\*Tolerable rate of deviation*—A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

*Type of emission*—A grouping of emissions based on, for example, source of emission, type of gas, region, or facility.

*Unadjusted financial information*—Financial information of the entity to which pro forma adjustments are applied by the responsible party.

*Uncertainty*—A matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

*\*Uncorrected misstatements*—Misstatements that the auditor has accumulated during the audit and that have not been corrected.

*Underlying subject matter*—The phenomenon that is measured or evaluated by applying criteria.

*\*Unmodified opinion*—The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.<sup>26</sup>

*\*User auditor*—An auditor who audits and reports on the financial statements of a user entity.

*User auditor (in the context of ISAE 3402)*—An auditor who audits and reports on the financial statements of a user entity.<sup>27</sup>

*\*User entity*—An entity that uses a service organization and whose financial statements are being audited.

*User entity (in the context of ISAE 3402)*—An entity that uses a service organization.

*Walk-through test*—Involves tracing a few transactions through the financial reporting system.

*\*Written representation*—A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

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<sup>26</sup> Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

<sup>27</sup> 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.

# INTERNATIONAL STANDARD ON QUALITY CONTROL 1 QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF FINANCIAL STATEMENTS, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS

(Effective as of December 15, 2009)

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International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISQC

1. This International Standard on Quality Control (ISQC) deals with a firm's responsibilities for its system of quality control for audits and reviews of financial statements, and other assurance and related services engagements. This ISQC is to be read in conjunction with relevant ethical requirements.
2. Other pronouncements of the International Auditing and Assurance Standards Board (IAASB) set out additional standards and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements. ISA 220,<sup>1</sup> for example, deals with quality control procedures for audits of financial statements.
3. A system of quality control consists of policies designed to achieve the objective set out in paragraph 11 and the procedures necessary to implement and monitor compliance with those policies.

### Authority of this ISQC

4. This ISQC applies to all firms of professional accountants in respect of audits and reviews of financial statements, and other assurance and related services engagements. The nature and extent of the policies and procedures developed by an individual firm to comply with this ISQC will depend on various factors such as the size and operating characteristics of the firm, and whether it is part of a network.
5. This ISQC contains the objective of the firm in following the ISQC, and requirements designed to enable the firm to meet that stated objective. In addition, it contains related guidance in the form of application and other explanatory material, as discussed further in paragraph 8, and introductory material that provides context relevant to a proper understanding of the ISQC, and definitions.
6. The objective provides the context in which the requirements of this ISQC are set, and is intended to assist the firm in:
  - Understanding what needs to be accomplished; and
  - Deciding whether more needs to be done to achieve the objective.
7. The requirements of this ISQC are expressed using "shall."
8. Where necessary, the application and other explanatory material provides further explanation of the requirements and guidance for carrying them out. In particular, it may:

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<sup>1</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

- Explain more precisely what a requirement means or is intended to cover; and
- Include examples of policies and procedures that may be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements. The application and other explanatory material may also provide background information on matters addressed in this ISQC. Where appropriate, additional considerations specific to public sector audit organizations or smaller firms are included within the application and other explanatory material. These additional considerations assist in the application of the requirements in this ISQC. They do not, however, limit or reduce the responsibility of the firm to apply and comply with the requirements in this ISQC.

9. This ISQC includes, under the heading “Definitions,” a description of the meanings attributed to certain terms for purposes of this ISQC. These are provided to assist in the consistent application and interpretation of this ISQC, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. The Glossary of Terms relating to International Standards issued by the IAASB in the *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements* published by IFAC includes the terms defined in this ISQC. It also includes descriptions of other terms found in this ISQC to assist in common and consistent interpretation and translation.

### **Effective Date**

10. Systems of quality control in compliance with this ISQC are required to be established by December 15, 2009.

### **Objective**

11. The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that:
- (a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
  - (b) Reports issued by the firm or engagement partners are appropriate in the circumstances.

### **Definitions**

12. In this ISQC, the following terms have the meanings attributed below:
- (a) Date of report – The date selected by the practitioner to date the report.
  - (b) Engagement documentation – The record of work performed, results obtained, and conclusions the practitioner reached (terms such as “working papers” or “workpapers” are sometimes used).

- (c) Engagement partner<sup>2</sup> – The partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
- (d) Engagement quality control review – A process designed to provide an objective evaluation, on or before the date of the report, of the significant judgments the engagement team made and the conclusions it reached in formulating the report. The engagement quality control review process is for audits of financial statements of listed entities, and those other engagements, if any, for which the firm has determined an engagement quality control review is required.
- (e) Engagement quality control reviewer – A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the report.
- (f) Engagement team – All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform procedures on the engagement. This excludes an auditor’s external expert engaged by the firm or by a network firm. The term “engagement team” also excludes individuals within the client’s internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of ISA 610 (Revised 2013).<sup>3</sup>
- (g) Firm – A sole practitioner, partnership or corporation or other entity of professional accountants.
- (h) Inspection – In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm’s quality control policies and procedures.
- (i) Listed entity – An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.
- (j) Monitoring – A process comprising an ongoing consideration and evaluation of the firm’s system of quality control, including a periodic

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<sup>2</sup> “Engagement partner,” “partner,” and “firm” should be read as referring to their public sector equivalents where relevant.

<sup>3</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, establishes limits on the use of direct assistance. It also acknowledges that the external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. Therefore, the use of direct assistances is restricted to situations where it is permitted.

inspection of a selection of completed engagements, designed to provide the firm with reasonable assurance that its system of quality control is operating effectively.

- (k) Network firm – A firm or entity that belongs to a network.
- (l) Network – A larger structure:
  - (i) That is aimed at cooperation, and
  - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
- (m) Partner – Any individual with authority to bind the firm with respect to the performance of a professional services engagement.
- (n) Personnel – Partners and staff.
- (o) Professional standards – IAASB Engagement Standards, as defined in the IAASB’s *Preface to the International Quality Control, Auditing, Review, Other Assurance and Related Services Pronouncements*, and relevant ethical requirements.
- (p) Reasonable assurance – In the context of this ISQC, a high, but not absolute, level of assurance.
- (q) Relevant ethical requirements – Ethical requirements to which the engagement team and engagement quality control reviewer are subject when undertaking audits or reviews of financial statements, or other assurance or related services engagements, which ordinarily comprise the provisions of the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code), together with national requirements that are more restrictive.
- (r) Staff – Professionals, other than partners, including any experts the firm employs.
- (s) Suitably qualified external person – An individual outside the firm with the competence and capabilities to act as an engagement partner, for example, a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organization that provides relevant quality control services.

## Requirements

### Applying, and Complying with, Relevant Requirements

13. Personnel within the firm responsible for establishing and maintaining the firm's system of quality control shall have an understanding of the entire text of this ISQC, including its application and other explanatory material, to understand its objective and to apply its requirements properly.
14. The firm shall comply with each requirement of this ISQC unless, in the circumstances of the firm, the requirement is not relevant to the services provided in respect of audits and reviews of financial statements, and other assurance and related services engagements. (Ref: Para. A1)
15. The requirements are designed to enable the firm to achieve the objective stated in this ISQC. The proper application of the requirements is therefore expected to provide a sufficient basis for the achievement of the objective. However, because circumstances vary widely and all such circumstances cannot be anticipated, the firm shall consider whether there are particular matters or circumstances that require the firm to establish policies and procedures in addition to those required by this ISQC to meet the stated objective.

### Elements of a System of Quality Control

16. The firm shall establish and maintain a system of quality control that includes policies and procedures that address each of the following elements:
  - (a) Leadership responsibilities for quality within the firm.
  - (b) Relevant ethical requirements.
  - (c) Acceptance and continuance of client relationships and specific engagements.
  - (d) Human resources.
  - (e) Engagement performance.
  - (f) Monitoring.
17. The firm shall document its policies and procedures and communicate them to the firm's personnel. (Ref: Para. A2–A3)

### Leadership Responsibilities for Quality within the Firm

18. The firm shall establish policies and procedures designed to promote an internal culture recognizing that quality is essential in performing engagements. Such policies and procedures shall require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent) to assume ultimate responsibility for the firm's system of quality control. (Ref: Para. A4–A5)

19. The firm shall establish policies and procedures such that any person or persons assigned operational responsibility for the firm's system of quality control by the firm's chief executive officer or managing board of partners has sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility. (Ref: Para. A6)

### **Relevant Ethical Requirements**

20. The firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements. (Ref: Para. A7–A10)

### *Independence*

21. The firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including network firm personnel) maintain independence where required by relevant ethical requirements. Such policies and procedures shall enable the firm to: (Ref: Para. A10)
- (a) Communicate its independence requirements to its personnel and, where applicable, others subject to them; and
  - (b) Identify threats to independence, evaluate whether the identified threats are at an acceptable level, and if not address them by eliminating the circumstances that create the threats, applying safeguards to reduce the threats to an acceptable level, or withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.
22. Such policies and procedures shall require: (Ref: Para. A10)
- (a) Engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements;
  - (b) Personnel to promptly notify the firm of circumstances and relationships that create threats to independence so that appropriate action can be taken; and
  - (c) The accumulation and communication of relevant information to appropriate personnel so that:
    - (i) The firm and its personnel can readily determine whether they satisfy independence requirements;
    - (ii) The firm can maintain and update its records relating to independence; and
    - (iii) The firm can take appropriate action regarding identified threats to independence that are not at an acceptable level.

23. The firm shall establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures shall include requirements for: (Ref: Para. A10)
- (a) Personnel to promptly notify the firm of independence breaches of which they become aware;
  - (b) The firm to promptly communicate identified breaches of these policies and procedures to:
    - (i) The engagement partner who, with the firm, needs to address the breach; and
    - (ii) Other relevant personnel in the firm and, where appropriate, the network, and those subject to the independence requirements who need to take appropriate action; and
  - (c) Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph 23(b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.
24. At least annually, the firm shall obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant ethical requirements. (Ref: Para. A10–A11)
25. The firm shall establish policies and procedures: (Ref: Para. A10)
- (a) Setting out criteria for determining the need to eliminate the circumstances that create a threat of long association with an entity to an acceptable level, when using the same senior personnel on an assurance engagement over a long period of time or criteria for applying safeguards to reduce the threat; and
  - (b) Requiring, for audits of financial statements of listed entities, the rotation of the engagement partner and the individuals responsible for engagement quality control review, and, where applicable, others subject to rotation requirements, after a specified period in compliance with relevant ethical requirements. (Ref: Para. A12–A17)

### **Acceptance and Continuance of Client Relationships and Specific Engagements**

26. The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm:
- (a) Is competent to perform the engagement and has the capabilities, including time and resources, to do so; (Ref: Para. A18, A23)

- (b) Can comply with relevant ethical requirements; and
  - (c) Has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity. (Ref: Para. A19–A20, A23)
27. Such policies and procedures shall require:
- (a) The firm to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. (Ref: Para. A21, A23)
  - (b) If a potential conflict of interest is identified in accepting an engagement from a new or an existing client, the firm to determine whether it is appropriate to accept the engagement.
  - (c) If issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, the firm to document how the issues were resolved.
28. The firm shall establish policies and procedures on continuing an engagement and the client relationship, addressing the circumstances where the firm obtains information that would have caused it to decline the engagement had that information been available earlier. Such policies and procedures shall include consideration of:
- (a) The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and
  - (b) The possibility of withdrawing from the engagement or from both the engagement and the client relationship. (Ref: Para. A22–A23)

## **Human Resources**

29. The firm shall establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the competence, capabilities, and commitment to ethical principles necessary to:
- (a) Perform engagements in accordance with professional standards and applicable legal and regulatory requirements; and
  - (b) Enable the firm or engagement partners to issue reports that are appropriate in the circumstances. (Ref: Para. A24–A29)

### *Assignment of Engagement Teams*

30. The firm shall assign responsibility for each engagement to an engagement partner and shall establish policies and procedures requiring that:

- (a) The identity and role of the engagement partner are communicated to key members of client management and those charged with governance;
  - (b) The engagement partner has the appropriate competence, capabilities, and authority to perform the role; and
  - (c) The responsibilities of the engagement partner are clearly defined and communicated to that partner. (Ref: Para. A30)
31. The firm shall also establish policies and procedures to assign appropriate personnel with the necessary competence, and capabilities to:
- (a) Perform engagements in accordance with professional standards and applicable legal and regulatory requirements; and
  - (b) Enable the firm or engagement partners to issue reports that are appropriate in the circumstances. (Ref: Para. A31)

### **Engagement Performance**

32. The firm shall establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances. Such policies and procedures shall include:
- (a) Matters relevant to promoting consistency in the quality of engagement performance; (Ref: Para. A32–A33)
  - (b) Supervision responsibilities; and (Ref: Para. A34)
  - (c) Review responsibilities. (Ref: Para. A35)
33. The firm’s review responsibility policies and procedures shall be determined on the basis that work of less experienced team members is reviewed by more experienced engagement team members.

### *Consultation*

34. The firm shall establish policies and procedures designed to provide it with reasonable assurance that:
- (a) Appropriate consultation takes place on difficult or contentious matters;
  - (b) Sufficient resources are available to enable appropriate consultation to take place;
  - (c) The nature and scope of, and conclusions resulting from, such consultations are documented and are agreed by both the individual seeking consultation and the individual consulted; and
  - (d) Conclusions resulting from consultations are implemented. (Ref: Para. A36–A40)

*Engagement Quality Control Review*

35. The firm shall establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. Such policies and procedures shall:
- (a) Require an engagement quality control review for all audits of financial statements of listed entities;
  - (b) Set out criteria against which all other audits and reviews of historical financial information and other assurance and related services engagements shall be evaluated to determine whether an engagement quality control review should be performed; and (Ref: Para. A41)
  - (c) Require an engagement quality control review for all engagements, if any, meeting the criteria established in compliance with subparagraph 35(b).
36. The firm shall establish policies and procedures setting out the nature, timing and extent of an engagement quality control review. Such policies and procedures shall require that the engagement report not be dated until the completion of the engagement quality control review. (Ref: Para. A42–A43)
37. The firm shall establish policies and procedures to require the engagement quality control review to include:
- (a) Discussion of significant matters with the engagement partner;
  - (b) Review of the financial statements or other subject matter information and the proposed report;
  - (c) Review of selected engagement documentation relating to significant judgments the engagement team made and the conclusions it reached; and
  - (d) Evaluation of the conclusions reached in formulating the report and consideration of whether the proposed report is appropriate. (Ref: Para. A44)
38. For audits of financial statements of listed entities, the firm shall establish policies and procedures to require the engagement quality control review to also include consideration of the following:
- (a) The engagement team’s evaluation of the firm’s independence in relation to the specific engagement;
  - (b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and

- (c) Whether documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached. (Ref: Para. A45–A46)

#### Criteria for the Eligibility of Engagement Quality Control Reviewers

- 39. The firm shall establish policies and procedures to address the appointment of engagement quality control reviewers and establish their eligibility through:
  - (a) The technical qualifications required to perform the role, including the necessary experience and authority; and (Ref: Para. A47)
  - (b) The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer’s objectivity. (Ref: Para. A48)
- 40. The firm shall establish policies and procedures designed to maintain the objectivity of the engagement quality control reviewer. (Ref: Para. A49–A51)
- 41. The firm’s policies and procedures shall provide for the replacement of the engagement quality control reviewer where the reviewer’s ability to perform an objective review may be impaired.

#### Documentation of the Engagement Quality Control Review

- 42. The firm shall establish policies and procedures on documentation of the engagement quality control review which require documentation that:
  - (a) The procedures required by the firm’s policies on engagement quality control review have been performed;
  - (b) The engagement quality control review has been completed on or before the date of the report; and
  - (c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

#### Differences of Opinion

- 43. The firm shall establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer. (Ref: Para. A52–A53)
- 44. Such policies and procedures shall require that:
  - (a) Conclusions reached be documented and implemented; and
  - (b) The report not be dated until the matter is resolved.

## Engagement Documentation

### Completion of the assembly of final engagement files

45. The firm shall establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. (Ref: Para. A54–A55)

### Confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation

46. The firm shall establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation. (Ref: Para. A56–A59)

### Retention of engagement documentation

47. The firm shall establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation. (Ref: Para. A60–A63)

## Monitoring

### Monitoring the firm's quality control policies and procedures

48. The firm shall establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. This process shall:
- (a) Include an ongoing consideration and evaluation of the firm's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner;
  - (b) Require responsibility for the monitoring process to be assigned to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility; and
  - (c) Require that those performing the engagement or the engagement quality control review are not involved in inspecting the engagement. (Ref: Para. A64–A68)

### *Evaluating, Communicating and Remediating Identified Deficiencies*

49. The firm shall evaluate the effect of deficiencies noted as a result of the monitoring process and determine whether they are either:
- (a) Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and applicable legal and regulatory requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or

- (b) Systemic, repetitive or other significant deficiencies that require prompt corrective action.
50. The firm shall communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action. (Ref: Para. A69)
51. Recommendations for appropriate remedial actions for deficiencies noted shall include one or more of the following:
- (a) Taking appropriate remedial action in relation to an individual engagement or member of personnel;
  - (b) The communication of the findings to those responsible for training and professional development;
  - (c) Changes to the quality control policies and procedures; and
  - (d) Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.
52. The firm shall establish policies and procedures to address cases where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement. Such policies and procedures shall require the firm to determine what further action is appropriate to comply with relevant professional standards and applicable legal and regulatory requirements and to consider whether to obtain legal advice.
53. The firm shall communicate at least annually the results of the monitoring of its system of quality control to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing board of partners. This communication shall be sufficient to enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities. Information communicated shall include the following:
- (a) A description of the monitoring procedures performed.
  - (b) The conclusions drawn from the monitoring procedures.
  - (c) Where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.
54. Some firms operate as part of a network and, for consistency, may implement some of their monitoring procedures on a network basis. Where firms within a network operate under common monitoring policies and procedures designed to comply with this ISQC, and these firms place reliance on such a monitoring system, the firm's policies and procedures shall require that:

- (a) At least annually, the network communicate the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms; and
  - (b) The network communicate promptly any identified deficiencies in the system of quality control to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken,
- in order that engagement partners in the network firms can rely on the results of the monitoring process implemented within the network, unless the firms or the network advise otherwise.

### *Complaints and Allegations*

55. The firm shall establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:
- (a) Complaints and allegations that the work performed by the firm fails to comply with professional standards and applicable legal and regulatory requirements; and
  - (b) Allegations of non-compliance with the firm’s system of quality control.
- As part of this process, the firm shall establish clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals. (Ref: Para. A70)
56. If during the investigations into complaints and allegations, deficiencies in the design or operation of the firm’s quality control policies and procedures or non-compliance with the firm’s system of quality control by an individual or individuals are identified, the firm shall take appropriate actions as set out in paragraph 51. (Ref: Para. A71–A72)

### **Documentation of the System of Quality Control**

57. The firm shall establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control. (Ref: Para. A73–A75)
58. The firm shall establish policies and procedures that require retention of documentation for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm’s compliance with its system of quality control, or for a longer period if required by law or regulation.
59. The firm shall establish policies and procedures requiring documentation of complaints and allegations and the responses to them.

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## **Application and Other Explanatory Material**

### **Applying, and Complying with, Relevant Requirements**

#### *Considerations Specific to Smaller Firms* (Ref: Para. 14)

- A1. This ISQC does not call for compliance with requirements that are not relevant, for example, in the circumstances of a sole practitioner with no staff. Requirements in this ISQC such as those for policies and procedures for the assignment of appropriate personnel to the engagement team (see paragraph 31), for review responsibilities (see paragraph 33), and for the annual communication of the results of monitoring to engagement partners within the firm (see paragraph 53) are not relevant in the absence of staff.

#### **Elements of a System of Quality Control** (Ref: Para. 17)

- A2. In general, communication of quality control policies and procedures to firm personnel includes a description of the quality control policies and procedures and the objectives they are designed to achieve, and the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. Encouraging firm personnel to communicate their views or concerns on quality control matters recognizes the importance of obtaining feedback on the firm's system of quality control.

#### *Considerations Specific to Smaller Firms*

- A3. Documentation and communication of policies and procedures for smaller firms may be less formal and extensive than for larger firms.

### **Leadership Responsibilities for Quality within the Firm**

#### *Promoting an Internal Culture of Quality* (Ref: Para. 18)

- A4. The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management that emphasize the firm's quality control policies and procedures, and the requirement to:
- (a) perform work that complies with professional standards and applicable legal and regulatory requirements; and
  - (b) issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards high quality work. These actions and messages may be communicated by, but are not limited to, training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They may be incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

- A5. Of particular importance in promoting an internal culture based on quality is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs. Promoting such an internal culture includes:
- (a) Establishment of policies and procedures that address performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel, in order to demonstrate the firm's overriding commitment to quality;
  - (b) Assignment of management responsibilities so that commercial considerations do not override the quality of work performed; and
  - (c) Provision of sufficient resources for the development, documentation and support of its quality control policies and procedures.

*Assigning Operational Responsibility for the Firm's System of Quality Control*  
(Ref: Para. 19)

- A6. Sufficient and appropriate experience and ability enables the person or persons responsible for the firm's system of quality control to identify and understand quality control issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

**Relevant Ethical Requirements**

*Compliance with Relevant Ethical Requirements* (Ref: Para. 20)

- A7. The IESBA Code establishes the fundamental principles of ethics, which are:
- (a) Integrity;
  - (b) Objectivity;
  - (c) Professional competence and due care;
  - (d) Confidentiality; and
  - (e) Professional behavior.

The fundamental principles of ethics establish the standard of behavior expected of a professional accountant.

- A8. The IESBA Code provides a conceptual framework that establishes the approach which a professional accountant is required to apply when identifying, evaluating and addressing threats to compliance with the fundamental principles. In the case of audits, reviews and other assurance engagements, the IESBA Code sets out *International Independence Standards*, established by the application of the conceptual framework to threats to independence in relation to those engagements.

A9. The fundamental principles are reinforced in particular by:

- The leadership of the firm;
- Education and training;
- Monitoring; and
- A process for dealing with breaches.

Definition of “Firm,” “Network” and “Network Firm” (Ref: Para. 20–25)

A10. The definitions of “firm,” “network” or “network firm” in relevant ethical requirements may differ from those set out in this ISQC. For example, the IESBA Code defines the “firm” as:

- (a) A sole practitioner, partnership or corporation of professional accountants;
- (b) An entity that controls such parties through ownership, management or other means; and
- (c) An entity controlled by such parties through ownership, management or other means.

The IESBA Code also provides guidance in relation to the terms “network” and “network firm.”

In complying with the requirements in paragraphs 20–25, the definitions used in the relevant ethical requirements apply in so far as is necessary to interpret those ethical requirements.

Written Confirmation (Ref: Para. 24)

A11. Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating a breach, the firm demonstrates the importance that it attaches to independence and makes the issue current for, and visible to, its personnel.

Long Association with an Entity (Ref: Para. 25)

A12. The IESBA Code discusses the threats that may be created as a result of an individual’s long association with:

- The entity and its operations;
- The entity’s senior management; or
- The underlining subject matter and subject matter information of the assurance engagement

A13. The IESBA Code includes examples of factors that are relevant to evaluating the level of a threat that may arise when an individual is involved in an assurance

engagement over a long period of time. The IESBA Code also provides examples of actions to address threats, including:

- Eliminating the threat, by rotating the individual off the engagement team; or
- Applying safeguards to reduce the threat to an acceptable level, for example by performing regular independent internal or external quality reviews of the engagement.

A14. The IESBA Code requires the rotation of the engagement partner, the engagement quality reviewer, and other key audit partners<sup>4</sup> in respect of certain engagements. National requirements may establish shorter rotation periods.

#### Considerations specific to public sector audit organizations

A15. Statutory measures may provide safeguards for the independence of public sector auditors. However, threats to independence may still exist regardless of any statutory measures designed to protect it. Therefore, in establishing the policies and procedures required by paragraphs 20–25, the public sector auditor may have regard to the public sector mandate and address any threats to independence in that context.

A16. Listed entities as referred to in paragraphs 25 and A14 are not common in the public sector. However, there may be other public sector entities that are significant due to size, complexity or public interest aspects, and which consequently have a wide range of stakeholders. Therefore, there may be instances when a firm determines, based on its quality control policies and procedures, that a public sector entity is significant for the purposes of expanded quality control procedures.

A17. In the public sector, legislation may establish the appointments and terms of office of the auditor with engagement partner responsibility. As a result, it may not be possible to comply strictly with the engagement partner rotation requirements envisaged for listed entities. Nonetheless, for public sector entities considered significant, as noted in paragraph A16, it may be in the public interest for public sector audit organizations to establish policies and procedures to promote compliance with the spirit of rotation of engagement partner responsibility.

#### **Acceptance and Continuance of Client Relationships and Specific Engagements**

##### *Competence, Capabilities, and Resources* (Ref: Para. 26(a))

A18. Consideration of whether the firm has the competence, capabilities, and resources to undertake a new engagement from a new or an existing client involves reviewing the specific requirements of the engagement and the existing partner and staff profiles at all relevant levels, and including whether:

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<sup>4</sup> As defined in the IESBA Code

- Firm personnel have knowledge of relevant industries or subject matters;
- Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
- The firm has sufficient personnel with the necessary competence and capabilities;
- Experts are available, if needed;
- Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; and
- The firm is able to complete the engagement within the reporting deadline.

*Integrity of Client* (Ref: Para. 26(c))

A19. With regard to the integrity of a client, matters to consider include, for example:

- The identity and business reputation of the client's principal owners, key management, and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.
- The identity and business reputation of related parties.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

A20. Sources of information on such matters obtained by the firm may include the following:

- Communications with existing or previous providers of professional accountancy services to the client in accordance with relevant ethical requirements, and discussions with other third parties.

- Inquiry of other firm personnel or third parties such as bankers, legal counsel and industry peers.
- Background searches of relevant databases.

*Continuance of Client Relationship* (Ref: Para. 27(a))

21. Deciding whether to continue a client relationship includes consideration of significant matters that have arisen during the current or previous engagements, and their implications for continuing the relationship. For example, a client may have started to expand its business operations into an area where the firm does not possess the necessary expertise.

*Withdrawal* (Ref: Para. 28)

A22. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.
- Considering whether there is a professional, legal or regulatory requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- Documenting significant matters, consultations, conclusions and the basis for the conclusions.

*Considerations Specific to Public Sector Audit Organizations* (Ref: Para. 26–28)

A23. In the public sector, auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and specific engagements as set out paragraphs 26–28 and A18–A22 may not be relevant. Nonetheless, establishing policies and procedures as described may provide valuable information to public sector auditors in performing risk assessments and in carrying out reporting responsibilities.

**Human Resources** (Ref: Para. 29)

A24. Personnel issues relevant to the firm's policies and procedures related to human resources include, for example:

- Recruitment.
- Performance evaluation.
- Capabilities, including time to perform assignments.
- Competence.
- Career development.
- Promotion.
- Compensation.
- The estimation of personnel needs.

Effective recruitment processes and procedures help the firm select individuals of integrity who have the capacity to develop the competence and capabilities necessary to perform the firm's work and possess the appropriate characteristics to enable them to perform competently.

A25. Competence can be developed through a variety of methods, including the following:

- Professional education.
- Continuing professional development, including training.
- Work experience.
- Coaching by more experienced staff, for example, other members of the engagement team.
- Independence education for personnel who are required to be independent.

A26. The continuing competence of the firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain their knowledge and capabilities. Effective policies and procedures emphasize the need for continuing training for all levels of firm personnel, and provide the necessary training resources and assistance to enable personnel to develop and maintain the required competence and capabilities.

A27. The firm may use a suitably qualified external person, for example, when internal technical and training resources are unavailable.

A28. Performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. Steps a firm may take in developing and maintaining competence and commitment to ethical principles include:

- Making personnel aware of the firm's expectations regarding performance and ethical principles;

- Providing personnel with evaluation of, and counseling on, performance, progress and career development; and
- Helping personnel understand that advancement to positions of greater responsibility depends, among other things, upon performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

*Considerations Specific to Smaller Firms*

A29. The size and circumstances of the firm will influence the structure of the firm's performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

*Assignment of Engagement Teams*

Engagement Partners (Ref: Para. 30)

A30. Policies and procedures may include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

Engagement Teams (Ref: Para. 31)

A31. The firm's assignment of engagement teams and the determination of the level of supervision required, include for example, consideration of the engagement team's:

- Understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation;
- Understanding of professional standards and applicable legal and regulatory requirements;
- Technical knowledge and expertise, including knowledge of relevant information technology;
- Knowledge of relevant industries in which the clients operate;
- Ability to apply professional judgment; and
- Understanding of the firm's quality control policies and procedures.

**Engagement Performance**

*Consistency in the Quality of Engagement Performance* (Ref: Para. 32(a))

A32. The firm promotes consistency in the quality of engagement performance through its policies and procedures. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed may include:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.
- Processes of engagement supervision, staff training and coaching.
- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

A33. Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

*Supervision* (Ref: Para. 32(b))

A34. Engagement supervision includes the following:

- Tracking the progress of the engagement;
- Considering the competence and capabilities of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement;
- Addressing significant matters arising during the engagement, considering their significance and modifying the planned approach appropriately; and
- Identifying matters for consultation or consideration by more experienced engagement team members during the engagement.

*Review* (Ref: Para. 32(c))

A35. A review consists of consideration of whether:

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;

- The evidence obtained is sufficient and appropriate to support the report; and
- The objectives of the engagement procedures have been achieved.

*Consultation* (Ref: Para. 34)

- A36. Consultation includes discussion at the appropriate professional level, with individuals within or outside the firm who have specialized expertise.
- A37. Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. Appropriate recognition of consultation in the firm's policies and procedures helps to promote a culture in which consultation is recognized as a strength and encourages personnel to consult on difficult or contentious matters.
- A38. Effective consultation on significant technical, ethical and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:
- Are given all the relevant facts that will enable them to provide informed advice; and
  - Have appropriate knowledge, seniority and experience,
- and when conclusions resulting from consultations are appropriately documented and implemented.
- A39. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:
- The issue on which consultation was sought; and
  - The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

*Considerations Specific to Smaller Firms*

- A40. A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by:
- Other firms;
  - Professional and regulatory bodies; or
  - Commercial organizations that provide relevant quality control services.
- Before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm to determine whether the external provider is suitably qualified for that purpose.

### *Engagement Quality Control Review*

#### Criteria for an Engagement Quality Control Review (Ref: Para. 35(b))

A41. Criteria for determining which engagements, other than audits of financial statements of listed entities, are to be subject to an engagement quality control review may include, for example:

- The nature of the engagement, including the extent to which it involves a matter of public interest.
- The identification of unusual circumstances or risks in an engagement or class of engagements.
- Whether laws or regulations require an engagement quality control review.

#### Nature, Timing and Extent of the Engagement Quality Control Review (Ref: Para. 36–37)

A42. The engagement report is not dated until the completion of the engagement quality control review. However, documentation of the engagement quality control review may be completed after the date of the report.

A43. Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the report.

A44. The extent of the engagement quality control review may depend, among other things, on the complexity of the engagement, whether the entity is a listed entity, and the risk that the report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner.

#### Engagement Quality Control Review of a Listed Entity (Ref: Para. 38)

A45. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of an audit of financial statements of a listed entity include:

- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

- These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of the financial statements of other entities as well as reviews of financial statements and other assurance and related services engagements.

#### Considerations specific to public sector audit organizations

A46. Although not referred to as listed entities, as described in paragraph A16, certain public sector entities may be of sufficient significance to warrant performance of an engagement quality control review.

#### *Criteria for the Eligibility of Engagement Quality Control Reviewers*

##### Sufficient and Appropriate Technical Expertise, Experience and Authority (Ref: Para. 39(a))

A47. What constitutes sufficient and appropriate technical expertise, experience and authority depends on the circumstances of the engagement. For example, the engagement quality control reviewer for an audit of the financial statements of a listed entity is likely to be an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities.

##### Consultation with the Engagement Quality Control Reviewer (Ref: Para. 39(b))

A48. The engagement partner may consult the engagement quality control reviewer during the engagement, for example, to establish that a judgment made by the engagement partner will be acceptable to the engagement quality control reviewer. Such consultation avoids identification of differences of opinion at a late stage of the engagement and need not compromise the engagement quality control reviewer's eligibility to perform the role. Where the nature and extent of the consultations become significant the reviewer's objectivity may be compromised unless care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person may be appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement.

##### Objectivity of the Engagement Quality Control Reviewer (Ref: Para. 40)

A49. The firm is required to establish policies and procedures designed to maintain objectivity of the engagement quality control reviewer. Accordingly, such policies and procedures provide that the engagement quality control reviewer:

- Where practicable, is not selected by the engagement partner;
- Does not otherwise participate in the engagement during the period of review;

- Does not make decisions for the engagement team; and
- Is not subject to other considerations that would threaten the reviewer's objectivity.

#### Considerations specific to smaller firms

A50. It may not be practicable, in the case of firms with few partners, for the engagement partner not to be involved in selecting the engagement quality control reviewer. Suitably qualified external persons may be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. Where the firm contracts suitably qualified external persons, the requirements in paragraphs 39–41 and guidance in paragraphs A47–A48 apply.

#### Considerations specific to public sector audit organizations

A51. In the public sector, a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General) may act in a role equivalent to that of engagement partner with overall responsibility for public sector audits. In such circumstances, where applicable, the selection of the engagement quality control reviewer includes consideration of the need for independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.

#### *Differences of Opinion* (Ref: Para. 43)

- A52. Effective procedures encourage identification of differences of opinion at an early stage, provide clear guidelines as to the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached.
- A53. Procedures to resolve such differences may include consulting with another practitioner or firm, or a professional or regulatory body.

#### *Engagement Documentation*

##### Completion of the Assembly of Final Engagement Files (Ref: Para. 45)

- A54. Law or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagement is to be completed. Where no such time limits are prescribed in law or regulation, paragraph 45 requires the firm to establish time limits that reflect the need to complete the assembly of final engagement files on a timely basis. In the case of an audit, for example, such a time limit would ordinarily not be more than 60 days after the date of the auditor's report.
- A55. Where two or more different reports are issued in respect of the same subject matter information of an entity, the firm's policies and procedures relating to

time limits for the assembly of final engagement files address each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on a component's financial information for group consolidation purposes and, at a subsequent date, an auditor's report on the same financial information for statutory purposes.

Confidentiality, Safe Custody, Integrity, Accessibility and Retrievability of Engagement Documentation (Ref: Para. 46)

- A56. Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information, or there are responsibilities under law, regulation or relevant ethical requirements to do so.<sup>5</sup> Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.
- A57. Whether engagement documentation is in paper, electronic or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. Accordingly, controls that the firm designs and implements to avoid unauthorized alteration or loss of engagement documentation may include those that:
- Enable the determination of when and by whom engagement documentation was created, changed or reviewed;
  - Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via the Internet;
  - Prevent unauthorized changes to the engagement documentation; and
  - Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.
- A58. Controls that the firm designs and implements to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation may include the following:
- The use of a password among engagement team members to restrict access to electronic engagement documentation to authorized users.
  - Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.

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<sup>5</sup> See, for example, paragraphs R114.1, 114.1 A1 and R360.26 of the IESBA Code

- Procedures for properly distributing engagement documentation to the team members at the start of the engagement, processing it during engagement, and collating it at the end of engagement.
- Procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.

A59. For practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In such cases, the firm's procedures designed to maintain the integrity, accessibility, and retrievability of the documentation may include requiring the engagement teams to:

- Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;
- Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and
- Enable the scanned copies to be retrieved and printed as necessary.

There may be legal, regulatory or other reasons for a firm to retain original paper documentation that has been scanned.

#### Retention of Engagement Documentation (Ref: Para. 47)

A60. The needs of the firm for retention of engagement documentation, and the period of such retention, will vary with the nature of the engagement and the firm's circumstances, for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether local law or regulation prescribes specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the jurisdiction in the absence of specific legal or regulatory requirements.

A61. In the specific case of audit engagements, the retention period would ordinarily be no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report.

A62. Procedures that the firm adopts for retention of engagement documentation include those that enable the requirements of paragraph 47 to be met during the retention period, for example to:

- Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time;
- Provide, where necessary, a record of changes made to engagement documentation after the engagement files have been completed; and
- Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

## Ownership of engagement documentation

A63. Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

## Monitoring

### *Monitoring the Firm's Quality Control Policies and Procedures* (Ref: Para. 48)

A64. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- Adherence to professional standards and applicable legal and regulatory requirements;
- Whether the system of quality control has been appropriately designed and effectively implemented; and
- Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

A65. Ongoing consideration and evaluation of the system of quality control include matters such as the following:

- Analysis of:
  - New developments in professional standards and applicable legal and regulatory requirements, and how they are reflected in the firm's policies and procedures where appropriate;
  - Written confirmation of compliance with policies and procedures on independence;
  - Continuing professional development, including training; and
  - Decisions related to acceptance and continuance of client relationships and specific engagements.
- Determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.
- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.
- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

A66. Inspection cycle policies and procedures may, for example, specify a cycle that spans three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, such as the following:

- The size of the firm.
- The number and geographic location of offices.
- The results of previous monitoring procedures.
- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
- The nature and complexity of the firm's practice and organization.
- The risks associated with the firm's clients and specific engagements.

A67. The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an independent external inspection program does not act as a substitute for the firm's own internal monitoring program.

#### Considerations Specific to Smaller Firms

A68. In the case of small firms, monitoring procedures may need to be performed by individuals who are responsible for design and implementation of the firm's quality control policies and procedures, or who may be involved in performing the engagement quality control review. A firm with a limited number of persons may choose to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, the firm may establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

#### *Communicating Deficiencies* (Ref: Para. 50)

A69. The reporting of identified deficiencies to individuals other than the relevant engagement partners need not include an identification of the specific engagements concerned, although there may be cases where such identification may be necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

#### *Complaints and Allegations*

##### Source of Complaints and Allegations (Ref: Para. 55)

A70. Complaints and allegations (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made

by firm personnel, clients or other third parties. They may be received by engagement team members or other firm personnel.

**Investigation Policies and Procedures (Ref: Para. 56)**

A71. Policies and procedures established for the investigation of complaints and allegations may include for example, that the partner supervising the investigation:

- Has sufficient and appropriate experience;
- Has authority within the firm; and
- Is otherwise not involved in the engagement.

The partner supervising the investigation may involve legal counsel as necessary.

**Considerations specific to smaller firms**

A72. It may not be practicable, in the case of firms with few partners, for the partner supervising the investigation not to be involved in the engagement. These small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation into complaints and allegations.

**Documentation of the System of Quality Control (Ref: Para. 57)**

A73. The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following:

- The size of the firm and the number of offices.
- The nature and complexity of the firm's practice and organization.

For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections.

A74. Appropriate documentation relating to monitoring includes, for example:

- Monitoring procedures, including the procedure for selecting completed engagements to be inspected.
- A record of the evaluation of:
  - Adherence to professional standards and applicable legal and regulatory requirements;
  - Whether the system of quality control has been appropriately designed and effectively implemented; and

- Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.
- Identification of the deficiencies noted, an evaluation of their effect, and the basis for determining whether and what further action is necessary.

*Considerations Specific to Smaller Firms*

A75. Smaller firms may use more informal methods in the documentation of their systems of quality control such as manual notes, checklists and forms.

**INTERNATIONAL STANDARD ON AUDITING 200**  
**OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR**  
**AND THE CONDUCT OF AN AUDIT IN ACCORDANCE**  
**WITH INTERNATIONAL STANDARDS ON AUDITING**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with ISAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the ISAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the ISAs. The independent auditor is referred to as "the auditor" hereafter.
2. ISAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. ISAs do not address the responsibilities of the auditor that may exist in legislation, regulation or otherwise in connection with, for example, the offering of securities to the public. Such responsibilities may differ from those established in the ISAs. Accordingly, while the auditor may find aspects of the ISAs helpful in such circumstances, it is the responsibility of the auditor to ensure compliance with all relevant legal, regulatory or professional obligations.

### An Audit of Financial Statements

3. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with ISAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1)
4. The financial statements subject to audit are those of the entity, prepared by management of the entity with oversight from those charged with governance. ISAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A2–A11)
5. As the basis for the auditor's opinion, ISAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are

free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. (Ref: Para. A30–A54)

6. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.<sup>1</sup> In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.
7. The ISAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The ISAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:
  - Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
  - Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
  - Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.
8. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable law or regulation. (Ref: Para. A12–A13)
9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or

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<sup>1</sup> ISA 320, *Materiality in Planning and Performing an Audit* and ISA 450, *Evaluation of Misstatements Identified during the Audit*

parties outside the entity, in relation to matters arising from the audit. These may be established by the ISAs or by applicable law or regulation.<sup>2</sup>

### Effective Date

10. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Overall Objectives of the Auditor

11. In conducting an audit of financial statements, the overall objectives of the auditor are:
  - (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
  - (b) To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.
12. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the ISAs require that the auditor disclaim an opinion or withdraw (or resign)<sup>3</sup> from the engagement, where withdrawal is possible under applicable law or regulation.

### Definitions

13. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Applicable financial reporting framework – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for

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<sup>2</sup> See, for example, ISA 260 (Revised), *Communication with Those Charged with Governance*; and ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 44.

<sup>3</sup> In the ISAs, only the term “withdrawal” is used.

management to provide disclosures beyond those specifically required by the framework; or

- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

- (b) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the ISAs:
  - (i) Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence.
  - (ii) Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.
- (c) Audit risk – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.
- (d) Auditor – The person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an ISA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “auditor” is used. “Engagement partner” and “firm” are to be read as referring to their public sector equivalents where relevant.
- (e) Detection risk – The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.
- (f) Financial statements – A structured representation of historical financial information, including disclosures, intended to communicate an entity’s economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with a financial reporting framework. The term “financial statements” ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable

financial reporting framework, but can also refer to a single financial statement. Disclosures comprise explanatory or descriptive information, set out as required, expressly permitted or otherwise allowed by the applicable financial reporting framework, on the face of a financial statement, or in the notes, or incorporated therein by cross-reference. (Ref: Para. A14–A15)

- (g) Historical financial information – Information expressed in financial terms in relation to a particular entity, derived primarily from that entity’s accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.
- (h) Management – The person(s) with executive responsibility for the conduct of the entity’s operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.
- (i) Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor’s judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

- (j) Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted – That management and, where appropriate, those charged with governance have acknowledged and understand that they have the following responsibilities that are fundamental to the conduct of an audit in accordance with ISAs. That is, responsibility:
  - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation;
  - (ii) For such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

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- (iii) To provide the auditor with:
- a. Access to all information of which management and, where appropriate, those charged with governance are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
  - b. Additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and
  - c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, (i) above may be restated as “for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework,” or “for the preparation of financial statements *that give a true and fair view* in accordance with the financial reporting framework.”

The “premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted” may also be referred to as the “premise.”

- (k) Professional judgment – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.
- (l) Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
- (m) Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.
- (n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:
  - (i) Inherent risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - (ii) Control risk – The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or

detected and corrected, on a timely basis by the entity's internal control.

- (o) Those charged with governance – The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

## Requirements

### Ethical Requirements Relating to an Audit of Financial Statements

- 14. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. (Ref: Para. A16–A19)

### Professional Skepticism

- 15. The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A20–A24)

### Professional Judgment

- 16. The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A25–A29)

### Sufficient Appropriate Audit Evidence and Audit Risk

- 17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A30–A54)

### Conduct of an Audit in Accordance with ISAs

#### *Complying with ISAs Relevant to the Audit*

- 18. The auditor shall comply with all ISAs relevant to the audit. An ISA is relevant to the audit when the ISA is in effect and the circumstances addressed by the ISA exist. (Ref: Para. A55–A59)
- 19. The auditor shall have an understanding of the entire text of an ISA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A60–A68)

20. The auditor shall not represent compliance with ISAs in the auditor's report unless the auditor has complied with the requirements of this ISA and all other ISAs relevant to the audit.

*Objectives Stated in Individual ISAs*

21. To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant ISAs in planning and performing the audit, having regard to the interrelationships among the ISAs, to: (Ref: Para. A69–A71)
- (a) Determine whether any audit procedures in addition to those required by the ISAs are necessary in pursuance of the objectives stated in the ISAs; and (Ref: Para. A72)
  - (b) Evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: Para. A73)

*Complying with Relevant Requirements*

22. Subject to paragraph 23, the auditor shall comply with each requirement of an ISA unless, in the circumstances of the audit:
- (a) The entire ISA is not relevant; or
  - (b) The requirement is not relevant because it is conditional and the condition does not exist. (Ref: Para. A74–A75)
23. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an ISA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Ref: Para. A76)

*Failure to Achieve an Objective*

24. If an objective in a relevant ISA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the ISAs, to modify the auditor's opinion or withdraw from the engagement (where withdrawal is possible under applicable law or regulation). Failure to achieve an objective represents a significant matter requiring documentation in accordance with ISA 230.<sup>4</sup> (Ref: Para. A77–A78)

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<sup>4</sup> ISA 230, *Audit Documentation*, paragraph 8(c)

## Application and Other Explanatory Material

### An Audit of Financial Statements

#### *Scope of the Audit* (Ref: Para. 3)

- A1. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some jurisdictions, however, applicable law or regulation may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the ISAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

#### *Preparation of the Financial Statements* (Ref: Para. 4)

- A2. Law or regulation may establish the responsibilities of management and, where appropriate, those charged with governance in relation to financial reporting. However, the extent of these responsibilities, or the way in which they are described, may differ across jurisdictions. Despite these differences, an audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged and understand that they have responsibility:
- (a) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation;
  - (b) For such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
  - (c) To provide the auditor with:
    - (i) Access to all information of which management and, where appropriate, those charged with governance are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
    - (ii) Additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and

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- (iii) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

A3. The preparation of the financial statements by management and, where appropriate, those charged with governance requires:

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- The preparation of the financial statements in accordance with that framework.
- The inclusion of an adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

A4. The financial statements may be prepared in accordance with a financial reporting framework designed to meet:

- The common financial information needs of a wide range of users (that is, “general purpose financial statements”); or
- The financial information needs of specific users (that is, “special purpose financial statements”).

A5. The applicable financial reporting framework often encompasses financial reporting standards established by an authorized or recognized standards setting organization, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorized or recognized standards setting organization and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include:

- The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- Published accounting interpretations of varying authority issued by standards setting, professional or regulatory organizations;
- Published views of varying authority on emerging accounting issues issued by standards setting, professional or regulatory organizations;

- General and industry practices widely recognized and prevalent; and
- Accounting literature.

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

- A6. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.
- A7. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. Financial reporting frameworks that encompass primarily the financial reporting standards established by an organization that is authorized or recognized to promulgate standards to be used by entities for preparing general purpose financial statements are often designed to achieve fair presentation, for example, International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB).
- A8. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the financial position, financial performance and cash flows of an entity. For such frameworks, a complete set of financial statements would include a balance sheet; an income statement; a statement of changes in equity; a cash flow statement; and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements:
- For example, the International Public Sector Accounting Standard (IPSAS), *Financial Reporting under the Cash Basis of Accounting*, issued by the International Public Sector Accounting Standards Board states that the primary financial statement is a statement of cash receipts and payments when a public sector entity prepares its financial statements in accordance with that IPSAS.
  - Other examples of a single financial statement, each of which would include related notes, are:
    - Balance sheet.
    - Statement of income or statement of operations.
    - Statement of retained earnings.

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- Statement of cash flows.
  - Statement of assets and liabilities that does not include owner's equity.
  - Statement of changes in owners' equity.
  - Statement of revenue and expenses.
  - Statement of operations by product lines.
- A9. ISA 210 establishes requirements and provides guidance on determining the acceptability of the applicable financial reporting framework.<sup>5</sup> ISA 800 (Revised) deals with special considerations when financial statements are prepared in accordance with a special purpose framework.<sup>6</sup>
- A10. Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain the agreement of management and, where appropriate, those charged with governance that they acknowledge and understand that they have the responsibilities set out in paragraph A2 as a precondition for accepting the audit engagement.<sup>7</sup>

Considerations Specific to Audits in the Public Sector

- A11. The mandates for audits of the financial statements of public sector entities may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of a public sector entity is conducted may include additional responsibilities, such as the responsibility for the execution of transactions and events in accordance with law, regulation or other authority.<sup>8</sup>

*Form of the Auditor's Opinion* (Ref: Para. 8)

- A12. The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor's opinion, however, will depend upon the applicable financial reporting framework and any applicable law or regulation. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, *preparation* of the financial statements in accordance with the applicable financial reporting framework includes *presentation*.
- A13. Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the ISAs is on whether the financial statements are presented fairly, in all

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<sup>5</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

<sup>6</sup> ISA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, paragraph 8

<sup>7</sup> ISA 210, paragraph 6(b)

<sup>8</sup> See paragraph A59.

material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the ISAs to the auditor's opinion cover both forms of opinion.

## Definitions

*Financial Statements* (Ref: Para. 13(f))

- A14. Some financial reporting frameworks may refer to an entity's economic resources or obligations in other terms. For example, these may be referred to as the entity's assets and liabilities, and the residual difference between them may be referred to as equity or equity interests.
- A15. Explanatory or descriptive information required to be included in the financial statements by the applicable financial reporting framework may be incorporated therein by cross-reference to information in another document, such as a management report or a risk report. "Incorporated therein by cross-reference" means cross-referenced from the financial statements to the other document, but not from the other document to the financial statements. Where the applicable financial reporting framework does not expressly prohibit the cross-referencing of where explanatory or descriptive information may be found, and the information has been appropriately cross-referenced, the information will form part of the financial statements.

## Ethical Requirements Relating to an Audit of Financial Statements (Ref: Para. 14)

- A16. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the provisions of the International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) related to an audit of financial statements, together with national requirements that are more restrictive.
- A17. The IESBA Code establishes the fundamental principles of ethics, which are:
- (a) Integrity;
  - (b) Objectivity;
  - (c) Professional competence and due care;
  - (d) Confidentiality; and
  - (e) Professional behavior.

The fundamental principles of ethics establish the standard of behavior expected of a professional accountant.

The IESBA Code provides a conceptual framework that establishes the approach which a professional accountant is required to apply when identifying, evaluating and addressing threats to compliance with the fundamental principles. In the case of audits, reviews and other assurance engagements, the IESBA Code sets out *International Independence Standards* established by the application of the conceptual framework to threats to independence in relation to those engagements.

- A18. In the case of an audit engagement it is in the public interest and, therefore, required by the IESBA Code, that the auditor be independent of the entity subject to the audit. The IESBA Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.
- A19. International Standard on Quality Control (ISQC) 1,<sup>9</sup> or national requirements that are at least as demanding,<sup>10</sup> deal with the firm's responsibilities to establish and maintain its system of quality control for audit engagements. ISQC 1 sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence.<sup>11</sup> ISA 220 sets out the engagement partner's responsibilities with respect to relevant ethical requirements. These include remaining alert, through observation and making inquiries as necessary, for evidence of breaches of relevant ethical requirements by members of the engagement team, determining the appropriate action if matters come to the engagement partner's attention that indicate that members of the engagement team have breached relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement.<sup>12</sup> ISA 220 recognizes that the engagement team is entitled to rely on a firm's system of quality control in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise.

### **Professional Skepticism** (Ref: Para. 15)

A20. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.

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<sup>9</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

<sup>10</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 2

<sup>11</sup> ISQC 1, paragraphs 20–25

<sup>12</sup> ISA 220, paragraphs 9–12

- Conditions that may indicate possible fraud.
  - Circumstances that suggest the need for audit procedures in addition to those required by the ISAs.
- A21. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:
- Overlooking unusual circumstances.
  - Over generalizing when drawing conclusions from audit observations.
  - Using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.
- A22. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.
- A23. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence.<sup>13</sup> In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the ISAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.<sup>14</sup>
- A24. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

### **Professional Judgment (Ref: Para. 16)**

- A25. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the ISAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

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<sup>13</sup> ISA 500, *Audit Evidence*, paragraphs 7–9

<sup>14</sup> ISA 240, paragraph 14; ISA 500, paragraph 11; ISA 505, *External Confirmations*, paragraphs 10–11, and 16

- Materiality and audit risk.
- The nature, timing and extent of audit procedures used to meet the requirements of the ISAs and gather audit evidence.
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the ISAs and thereby, the overall objectives of the auditor.
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

A26. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

A27. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by ISA 220,<sup>15</sup> assist the auditor in making informed and reasonable judgments.

A28. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

A29. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit.<sup>16</sup> Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

### **Sufficient Appropriate Audit Evidence and Audit Risk (Ref: Para. 5 and 17)**

#### *Sufficiency and Appropriateness of Audit Evidence*

A30. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed

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<sup>15</sup> ISA 220, paragraph 18

<sup>16</sup> ISA 230, paragraph 8

during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit<sup>17</sup>) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

- A31. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.
- A32. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. 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.
- A33. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. ISA 500 and other relevant ISAs establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.

### *Audit Risk*

- A34. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

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<sup>17</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 9

A35. For purposes of the ISAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

#### Risks of Material Misstatement

A36. The risks of material misstatement may exist at two levels:

- The overall financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

A37. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

A38. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

A39. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

A40. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

- A41. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The ISAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.<sup>18</sup>
- A42. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made. The ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement." However, ISA 540 (Revised)<sup>19</sup> requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the assessed risks of material misstatement, including significant risks, for accounting estimates at the assertion level in accordance with ISA 330.<sup>20</sup> In identifying and assessing risks of material misstatement for significant classes of transactions, account balances or disclosures other than accounting estimates, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.
- A43. ISA 315 (Revised) establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

#### Detection Risk

- A44. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

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<sup>18</sup> ISA 330, *The Auditor's Responses to Assessed Risks*, paragraphs 7–17

<sup>19</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Disclosures*, paragraph 16

<sup>20</sup> ISA 330, paragraph 7(b)

A45. Detection risk relates to the nature, timing and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

A46. ISA 300<sup>21</sup> and ISA 330 establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

#### *Inherent Limitations of an Audit*

A47. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

- The nature of financial reporting;
- The nature of audit procedures; and
- The need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

#### The Nature of Financial Reporting

A48. The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by

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<sup>21</sup> ISA 300, *Planning an Audit of Financial Statements*

the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates. Nevertheless, the ISAs require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and related disclosures, and to the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.<sup>22</sup>

### The Nature of Audit Procedures

A49. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.
- Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

### Timeliness of Financial Reporting and the Balance between Benefit and Cost

A50. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognized in certain financial reporting frameworks (see, for example, the IASB's *Framework for the Preparation and Presentation of Financial Statements*).

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<sup>22</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, and ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 12

Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognizing that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

A51. Consequently, it is necessary for the auditor to:

- Plan the audit so that it will be performed in an effective manner;
- Direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- Use testing and other means of examining populations for misstatements.

A52. In light of the approaches described in paragraph A51, the ISAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities;<sup>23</sup> and
- Use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population.<sup>24</sup>

#### Other Matters that Affect the Inherent Limitations of an Audit

A53. In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion. See ISA 240 for further discussion.
- The existence and completeness of related party relationships and transactions. See ISA 550<sup>25</sup> for further discussion.
- The occurrence of non-compliance with laws and regulations. See ISA 250 (Revised)<sup>26</sup> for further discussion.
- Future events or conditions that may cause an entity to cease to continue as a going concern. See ISA 570 (Revised)<sup>27</sup> for further discussion.

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<sup>23</sup> ISA 315 (Revised), paragraphs 5–10

<sup>24</sup> ISA 330; ISA 500; ISA 520, *Analytical Procedures*; ISA 530, *Audit Sampling*

<sup>25</sup> ISA 550, *Related Parties*

<sup>26</sup> ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*

<sup>27</sup> ISA 570 (Revised), *Going Concern*

Relevant ISAs identify specific audit procedures to assist in mitigating the effect of the inherent limitations.

- A54. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with ISAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with ISAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less than persuasive audit evidence. Whether the auditor has performed an audit in accordance with ISAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

### **Conduct of an Audit in Accordance with ISAs**

#### *Nature of the ISAs (Ref: Para. 18)*

- A55. The ISAs, taken together, provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. The ISAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics.
- A56. The scope, effective date and any specific limitation of the applicability of a specific ISA is made clear in the ISA. Unless otherwise stated in the ISA, the auditor is permitted to apply an ISA before the effective date specified therein.
- A57. In performing an audit, the auditor may be required to comply with legal or regulatory requirements in addition to the ISAs. The ISAs do not override law or regulation that governs an audit of financial statements. In the event that such law or regulation differs from the ISAs, an audit conducted only in accordance with law or regulation will not automatically comply with ISAs.
- A58. The auditor may also conduct the audit in accordance with both ISAs and auditing standards of a specific jurisdiction or country. In such cases, in addition to complying with each of the ISAs relevant to the audit, it may be necessary for the auditor to perform additional audit procedures in order to comply with the relevant standards of that jurisdiction or country.

#### **Considerations Specific to Audits in the Public Sector**

- A59. The ISAs are relevant to engagements in the public sector. The public sector auditor's responsibilities, however, may be affected by the audit mandate, or by obligations on public sector entities arising from law, regulation or other authority (such as ministerial directives, government policy requirements, or resolutions of the legislature), which may encompass a broader scope than an

audit of financial statements in accordance with the ISAs. These additional responsibilities are not dealt with in the ISAs. They may be dealt with in the pronouncements of the International Organization of Supreme Audit Institutions or national standard setters, or in guidance developed by government audit agencies.

*Contents of the ISAs* (Ref: Para. 19)

A60. In addition to objectives and requirements (requirements are expressed in the ISAs using “shall”), an ISA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the ISA, and definitions. The entire text of an ISA, therefore, is relevant to an understanding of the objectives stated in an ISA and the proper application of the requirements of an ISA.

A61. Where necessary, the application and other explanatory material provides further explanation of the requirements of an ISA and guidance for carrying them out. In particular, it may:

- Explain more precisely what a requirement means or is intended to cover.
- Include examples of procedures that may be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an ISA. The application and other explanatory material may also provide background information on matters addressed in an ISA.

A62. Appendices form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related ISAs or within the title and introduction of the appendix itself.

A63. Introductory material may include, as needed, such matters as explanation of:

- The purpose and scope of the ISA, including how the ISA relates to other ISAs.
- The subject matter of the ISA.
- The respective responsibilities of the auditor and others in relation to the subject matter of the ISA.
- The context in which the ISA is set.

A64. An ISA may include, in a separate section under the heading “Definitions,” a description of the meanings attributed to certain terms for purposes of the ISAs. These are provided to assist in the consistent application and interpretation of the ISAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the ISAs.

The Glossary of Terms relating to International Standards issued by the International Auditing and Assurance Standards Board in the *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements* published by IFAC contains a complete listing of terms defined in the ISAs. It also includes descriptions of other terms found in ISAs to assist in common and consistent interpretation and translation.

- A65. When appropriate, additional considerations specific to audits of smaller entities and public sector entities are included within the application and other explanatory material of an ISA. These additional considerations assist in the application of the requirements of the ISA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the ISAs.

#### Considerations Specific to Smaller Entities

- A66. For purposes of specifying additional considerations to audits of smaller entities, a “smaller entity” refers to an entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
  - (i) Straightforward or uncomplicated transactions;
  - (ii) Simple record-keeping;
  - (iii) Few lines of business and few products within business lines;
  - (iv) Few internal controls;
  - (v) Few levels of management with responsibility for a broad range of controls; or
  - (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

- A67. The considerations specific to smaller entities included in the ISAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.
- A68. The ISAs refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the “owner-manager.”

*Objectives Stated in Individual ISAs (Ref: Para. 21)*

A69. Each ISA contains one or more objectives which provide a link between the requirements and the overall objectives of the auditor. The objectives in individual ISAs serve to focus the auditor on the desired outcome of the ISAs while being specific enough to assist the auditor in:

- Understanding what needs to be accomplished and, where necessary, the appropriate means of doing so; and
- Deciding whether more needs to be done to achieve them in the particular circumstances of the audit.

A70. Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph 11 of this ISA. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

A71. In using the objectives, the auditor is required to have regard to the interrelationships among the ISAs. This is because, as indicated in paragraph A55, the ISAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this ISA requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each ISA. At a more detailed level, ISA 315 (Revised) and ISA 330 contain, among other things, objectives and requirements that deal with the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An ISA dealing with specific aspects of the audit (for example, ISA 540 (Revised)) may expand on how the objectives and requirements of such ISAs as ISA 315 (Revised) and ISA 330 are to be applied in relation to the subject of the ISA but does not repeat them. Thus, in achieving the objective stated in ISA 540 (Revised), the auditor has regard to the objectives and requirements of other relevant ISAs.

*Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 21(a))*

A72. The requirements of the ISAs are designed to enable the auditor to achieve the objectives specified in the ISAs, and thereby the overall objectives of the auditor. The proper application of the requirements of the ISAs by the auditor is therefore expected to provide a sufficient basis for the auditor's achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the ISAs, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of the ISAs and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by the ISAs to meet the objectives specified in the ISAs.

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has  
Been Obtained (Ref: Para. 21(b))

A73. The auditor is required to use the objectives to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If as a result the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph 21(b):

- Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other ISAs;
- Extend the work performed in applying one or more requirements; or
- Perform other procedures judged by the auditor to be necessary in the circumstances.

Where none of the above is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and is required by the ISAs to determine the effect on the auditor's report or on the auditor's ability to complete the engagement.

*Complying with Relevant Requirements*

Relevant Requirements (Ref: Para. 22)

A74. In some cases, an ISA (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in ISA 610 (Revised 2013)<sup>28</sup> is relevant.

A75. Within a relevant ISA, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- The requirement to modify the auditor's opinion if there is a limitation of scope<sup>29</sup> represents an explicit conditional requirement.
- The requirement to communicate significant deficiencies in internal control identified during the audit to those charged with governance,<sup>30</sup> which depends on the existence of such identified significant deficiencies; and the requirement to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in

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<sup>28</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 2

<sup>29</sup> ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*, paragraph 13

<sup>30</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph 9

accordance with the applicable financial reporting framework,<sup>31</sup> which depends on that framework requiring or permitting such disclosure, represent implicit conditional requirements.

In some cases, a requirement may be expressed as being conditional on applicable law or regulation. For example, the auditor may be required to withdraw from the audit engagement, *where withdrawal is possible under applicable law or regulation*, or the auditor may be required to do something, *unless prohibited by law or regulation*. Depending on the jurisdiction, the legal or regulatory permission or prohibition may be explicit or implicit.

#### Departure from a Requirement (Ref: Para. 23)

A76. ISA 230 establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement.<sup>32</sup> The ISAs do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

#### Failure to Achieve an Objective (Ref: Para. 24)

A77. Whether an objective has been achieved is a matter for the auditor's professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of the ISAs, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in the ISAs. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that:

- Prevent the auditor from complying with the relevant requirements of an ISA.
- Result in its not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph 21, for example, due to a limitation in the available audit evidence.

A78. Audit documentation that meets the requirements of ISA 230 and the specific documentation requirements of other relevant ISAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

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<sup>31</sup> ISA 501, *Audit Evidence—Specific Considerations for Selected Items*, paragraph 13

<sup>32</sup> ISA 230, paragraph 12

# INTERNATIONAL STANDARD ON AUDITING 210

## AGREEING THE TERMS OF AUDIT ENGAGEMENTS

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present. ISA 220<sup>1</sup> deals with those aspects of engagement acceptance that are within the control of the auditor. (Ref: Para. A1)

### Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objective

3. The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:
  - (a) Establishing whether the preconditions for an audit are present; and
  - (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

### Definitions

4. For purposes of the ISAs, the following term has the meaning attributed below:  
 Preconditions for an audit – The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise<sup>2</sup> on which an audit is conducted.
5. For the purposes of this ISA, references to “management” should be read hereafter as “management and, where appropriate, those charged with governance.”

### Requirements

#### Preconditions for an Audit

6. In order to establish whether the preconditions for an audit are present, the auditor shall:

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<sup>1</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13

- (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2–A10)
- (b) Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para. A11–A14, A21)
  - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A15)
  - (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (Ref: Para. A16–A19)
  - (iii) To provide the auditor with:
    - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
    - b. Additional information that the auditor may request from management for the purpose of the audit; and
    - c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

*Limitation on Scope Prior to Audit Engagement Acceptance*

7. If management or those charged with governance impose a limitation on the scope of the auditor’s work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

*Other Factors Affecting Audit Engagement Acceptance*

8. If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:
  - (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable, except as provided in paragraph 19; or
  - (b) If the agreement referred to in paragraph 6(b) has not been obtained.

**Agreement on Audit Engagement Terms**

9. The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: Para. A22)

10. Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include: (Ref: Para. A23–A27)
- (a) The objective and scope of the audit of the financial statements;
  - (b) The responsibilities of the auditor;
  - (c) The responsibilities of management;
  - (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
  - (e) Reference to the expected form and content of any reports to be issued by the auditor; and (Ref: Para. A24)
  - (f) A statement that there may be circumstances in which a report may differ from its expected form and content.
11. If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (Ref: Para. A23, A28–A29)
12. If law or regulation prescribes responsibilities of management similar to those described in paragraph 6(b), the auditor may determine that the law or regulation includes responsibilities that, in the auditor’s judgment, are equivalent in effect to those set out in that paragraph. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the written agreement. For those responsibilities that are not prescribed by law or regulation such that their effect is equivalent, the written agreement shall use the description in paragraph 6(b). (Ref: Para. A28)

## Recurring Audits

13. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (Ref: Para. A30)

## Acceptance of a Change in the Terms of the Audit Engagement

14. The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. (Ref: Para. A31–A33)
15. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so. (Ref: Para. A34–A35)

16. If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.
17. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:
  - (a) Withdraw from the audit engagement where possible under applicable law or regulation; and
  - (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

### **Additional Considerations in Engagement Acceptance**

#### *Financial Reporting Standards Supplemented by Law or Regulation*

18. If financial reporting standards established by an authorized or recognized standards setting organization are supplemented by law or regulation, the auditor shall determine whether there are any conflicts between the financial reporting standards and the additional requirements. If such conflicts exist, the auditor shall discuss with management the nature of the additional requirements and shall agree whether:
  - (a) The additional requirements can be met through additional disclosures in the financial statements; or
  - (b) The description of the applicable financial reporting framework in the financial statements can be amended accordingly.

If neither of the above actions is possible, the auditor shall determine whether it will be necessary to modify the auditor's opinion in accordance with ISA 705.<sup>3</sup> (Ref: Para. A36)

#### *Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance*

19. If the auditor has determined that the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, the auditor shall accept the audit engagement only if the following conditions are present: (Ref: Para. A37)
  - (a) Management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and
  - (b) It is recognized in the terms of the audit engagement that:

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<sup>3</sup> ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*

- (i) The auditor’s report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users’ attention to the additional disclosures, in accordance with ISA 706 (Revised);<sup>4</sup> and
  - (ii) Unless the auditor is required by law or regulation to express the auditor’s opinion on the financial statements by using the phrases “present fairly, in all material respects,” or “give a true and fair view” in accordance with the applicable financial reporting framework, the auditor’s opinion on the financial statements will not include such phrases.
20. If the conditions outlined in paragraph 19 are not present and the auditor is required by law or regulation to undertake the audit engagement, the auditor shall:
- (a) Evaluate the effect of the misleading nature of the financial statements on the auditor’s report; and
  - (b) Include appropriate reference to this matter in the terms of the audit engagement.

*Auditor’s Report Prescribed by Law or Regulation*

21. In some cases, law or regulation of the relevant jurisdiction prescribes the layout or wording of the auditor’s report in a form or in terms that are significantly different from the requirements of ISAs. In these circumstances, the auditor shall evaluate:
- (a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,
  - (b) Whether additional explanation in the auditor’s report can mitigate possible misunderstanding.<sup>5</sup>
22. If the auditor concludes that additional explanation in the auditor’s report cannot mitigate possible misunderstanding, the auditor shall not accept the audit engagement, unless required by law or regulation to do so. An audit conducted in accordance with such law or regulation does not comply with ISAs. Accordingly, the auditor shall not include any reference within the auditor’s report to the audit having been conducted in accordance with ISAs.<sup>6</sup> (Ref: Para. A38–A39)

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<sup>4</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report*

<sup>5</sup> ISA 706 (Revised)

<sup>6</sup> See also ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 43.

## Application and Other Explanatory Material

### Scope of this ISA (Ref: Para. 1)

A1. Assurance engagements, which include audit engagements, may only be accepted when the practitioner considers that relevant ethical requirements such as independence and professional competence will be satisfied, and when the engagement exhibits certain characteristics.<sup>7</sup> The auditor's responsibilities in respect of ethical requirements in the context of the acceptance of an audit engagement and in so far as they are within the control of the auditor are dealt with in ISA 220.<sup>8</sup> This ISA deals with those matters (or preconditions) that are within the control of the entity and upon which it is necessary for the auditor and the entity's management to agree.

### Preconditions for an Audit

#### *The Financial Reporting Framework* (Ref: Para. 6(a))

- A2. A condition for acceptance of an assurance engagement is that the criteria referred to in the definition of an assurance engagement are suitable and available to intended users.<sup>9</sup> Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Suitable criteria enable reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. For purposes of the ISAs, the applicable financial reporting framework provides the criteria the auditor uses to audit the financial statements, including where relevant their fair presentation.
- A3. Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and the auditor does not have suitable criteria for auditing the financial statements. In many cases the auditor may presume that the applicable financial reporting framework is acceptable, as described in paragraphs A8–A9.

#### Determining the Acceptability of the Financial Reporting Framework

- A4. Factors that are relevant to the auditor's determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include:
- The nature of the entity (for example, whether it is a business enterprise, a public sector entity or a not-for-profit organization);
  - The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users);

<sup>7</sup> *International Framework for Assurance Engagements*, paragraph 22

<sup>8</sup> ISA 220, paragraphs 9–11

<sup>9</sup> *International Framework for Assurance Engagements*, paragraph 22(b)(ii)

- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement); and
  - Whether law or regulation prescribes the applicable financial reporting framework.
5. Many users of financial statements are not in a position to demand financial statements tailored to meet their specific information needs. While all the information needs of specific users cannot be met, there are financial information needs that are common to a wide range of users. Financial statements prepared in accordance with a financial reporting framework designed to meet the common financial information needs of a wide range of users are referred to as general purpose financial statements.
6. In some cases, the financial statements will be prepared in accordance with a financial reporting framework designed to meet the financial information needs of specific users. Such financial statements are referred to as special purpose financial statements. The financial information needs of the intended users will determine the applicable financial reporting framework in these circumstances. ISA 800 discusses the acceptability of financial reporting frameworks designed to meet the financial information needs of specific users.<sup>10</sup>
7. Deficiencies in the applicable financial reporting framework that indicate that the framework is not acceptable may be encountered after the audit engagement has been accepted. When use of that framework is prescribed by law or regulation, the requirements of paragraphs 19–20 apply. When use of that framework is not prescribed by law or regulation, management may decide to adopt another framework that is acceptable. When management does so, as required by paragraph 16, new terms of the audit engagement are agreed to reflect the change in the framework as the previously agreed terms will no longer be accurate.

#### General purpose frameworks

- A8. At present, there is no objective and authoritative basis that has been generally recognized globally for judging the acceptability of general purpose frameworks. In the absence of such a basis, financial reporting standards established by organizations that are authorized or recognized to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities, provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting standards include:

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<sup>10</sup> ISA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, paragraph 8

- International Financial Reporting Standards (IFRSs) promulgated by the International Accounting Standards Board;
- International Public Sector Accounting Standards (IPSASs) promulgated by the International Public Sector Accounting Standards Board; and
- Accounting principles promulgated by an authorized or recognized standards setting organization in a particular jurisdiction, provided the organization follows an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders.

These financial reporting standards are often identified as the applicable financial reporting framework in law or regulation governing the preparation of general purpose financial statements.

#### Financial reporting frameworks prescribed by law or regulation

- A9. In accordance with paragraph 6(a), the auditor is required to determine whether the financial reporting framework, to be applied in the preparation of the financial statements, is acceptable. In some jurisdictions, law or regulation may prescribe the financial reporting framework to be used in the preparation of general purpose financial statements for certain types of entities. In the absence of indications to the contrary, such a financial reporting framework is presumed to be acceptable for general purpose financial statements prepared by such entities. In the event that the framework is not considered to be acceptable, paragraphs 19–20 apply.

#### Jurisdictions that do not have standards setting organizations or prescribed financial reporting frameworks

- A10. When an entity is registered or operating in a jurisdiction that does not have an authorized or recognized standards setting organization, or where use of the financial reporting framework is not prescribed by law or regulation, management identifies a financial reporting framework to be applied in the preparation of the financial statements. Appendix 2 contains guidance on determining the acceptability of financial reporting frameworks in such circumstances.

#### *Agreement of the Responsibilities of Management* (Ref: Para. 6(b))

- A11. An audit in accordance with ISAs is conducted on the premise that management has acknowledged and understands that it has the responsibilities set out in paragraph 6(b).<sup>11</sup> In certain jurisdictions, such responsibilities may be specified in law or regulation. In others, there may be little or no legal or regulatory definition of such responsibilities. ISAs do not override law or regulation in such matters. However, the concept of an independent audit

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<sup>11</sup> ISA 200, paragraph A4

requires that the auditor’s role does not involve taking responsibility for the preparation of the financial statements or for the entity’s related internal control, and that the auditor has a reasonable expectation of obtaining the information necessary for the audit (including information obtained from outside of the general and subsidiary ledgers) in so far as management is able to provide or procure it. Accordingly, the premise is fundamental to the conduct of an independent audit. To avoid misunderstanding, agreement is reached with management that it acknowledges and understands that it has such responsibilities as part of agreeing and recording the terms of the audit engagement in paragraphs 9–12.

- A12. The way in which the responsibilities for financial reporting are divided between management and those charged with governance will vary according to the resources and structure of the entity and any relevant law or regulation, and the respective roles of management and those charged with governance within the entity. In most cases, management is responsible for execution while those charged with governance have oversight of management. In some cases, those charged with governance will have, or will assume, responsibility for approving the financial statements or monitoring the entity’s internal control related to financial reporting. In larger or public entities, a subgroup of those charged with governance, such as an audit committee, may be charged with certain oversight responsibilities.
- A13. ISA 580 requires the auditor to request management to provide written representations that it has fulfilled certain of its responsibilities.<sup>12</sup> It may therefore be appropriate to make management aware that receipt of such written representations will be expected, together with written representations required by other ISAs and, where necessary, written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.
- A14. Where management will not acknowledge its responsibilities, or agree to provide the written representations, the auditor will be unable to obtain sufficient appropriate audit evidence.<sup>13</sup> In such circumstances, it would not be appropriate for the auditor to accept the audit engagement, unless law or regulation requires the auditor to do so. In cases where the auditor is required to accept the audit engagement, the auditor may need to explain to management the importance of these matters, and the implications for the auditor’s report.

#### Preparation of the Financial Statements (Ref: Para. 6(b)(i))

- A15. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, *preparation* of the financial statements in accordance with the financial reporting

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<sup>12</sup> ISA 580, *Written Representations*, paragraphs 10–11

<sup>13</sup> ISA 580, paragraph A26

framework includes *presentation*. In the case of a fair presentation framework the importance of the reporting objective of fair presentation is such that the premise agreed with management includes specific reference to fair presentation, or to the responsibility to ensure that the financial statements will “give a true and fair view” in accordance with the financial reporting framework.

Internal Control (Ref: Para. 6(b)(ii))

- A16. Management maintains such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity’s financial reporting objectives due to the inherent limitations of internal control.<sup>14</sup>
- A17. An independent audit conducted in accordance with the ISAs does not act as a substitute for the maintenance of internal control necessary for the preparation of financial statements by management. Accordingly, the auditor is required to obtain the agreement of management that it acknowledges and understands its responsibility for internal control. However, the agreement required by paragraph 6(b)(ii) does not imply that the auditor will find that internal control maintained by management has achieved its purpose or will be free of deficiencies.
- A18. It is for management to determine what internal control is necessary to enable the preparation of the financial statements. The term “internal control” encompasses a wide range of activities within components that may be described as the control environment; the entity’s risk assessment process; the information system, including the related business processes relevant to financial reporting, and communication; control activities; and monitoring of controls. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component.<sup>15</sup> An entity’s internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.
- A19. In some jurisdictions, law or regulation may refer to the responsibility of management for the adequacy of accounting books and records, or accounting systems. In some cases, general practice may assume a distinction between accounting books and records or accounting systems on the one hand, and internal control or controls on the other. As accounting books and records, or accounting systems, are an integral part of internal control as referred to in

<sup>14</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph A54

<sup>15</sup> ISA 315 (Revised), paragraph A59 and Appendix 1

paragraph A18, no specific reference is made to them in paragraph 6(b)(ii) for the description of the responsibility of management. To avoid misunderstanding, it may be appropriate for the auditor to explain to management the scope of this responsibility.

Additional Information (Ref: Para. 6(b)(iii)b)

A20. Additional information that the auditor may request from management for the purpose of the audit may include when applicable, matters related to other information in accordance with ISA 720 (Revised). When the auditor expects to obtain other information after the date of the auditor’s report, the terms of the audit engagement may also acknowledge the auditor’s responsibilities relating to such other information including, if applicable, the actions that may be appropriate or necessary if the auditor concludes that a material misstatement of the other information exists in other information obtained after the date of the auditor’s report.

Considerations Relevant to Smaller Entities (Ref: Para. 6(b))

A21. One of the purposes of agreeing the terms of the audit engagement is to avoid misunderstanding about the respective responsibilities of management and the auditor. For example, when a third party has assisted with the preparation of the financial statements, it may be useful to remind management that the preparation of the financial statements in accordance with the applicable financial reporting framework remains its responsibility.

**Agreement on Audit Engagement Terms**

*Agreeing the Terms of the Audit Engagement* (Ref: Para. 9)

A22. The roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation.

*Audit Engagement Letter or Other Form of Written Agreement*<sup>16</sup> (Ref: Para. 10–11)

A23. It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some countries, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law, that is, they prescribe the matters described in paragraph 10. Although in these circumstances paragraph 11 permits the auditor to include in the engagement letter only reference to the fact that relevant law or regulation applies and that management acknowledges and understands its responsibilities as set

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<sup>16</sup> In the paragraphs that follow, any reference to an audit engagement letter is to be taken as a reference to an audit engagement letter or other suitable form of written agreement.

out in paragraph 6(b), the auditor may nevertheless consider it appropriate to include the matters described in paragraph 10 in an engagement letter for the information of management.

#### Form and Content of the Audit Engagement Letter

A24. The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor's responsibilities may be based on ISA 200.<sup>17</sup> Paragraphs 6(b) and 12 of this ISA deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, ISAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.
- The form of any other communication of results of the audit engagement.
- The requirement for the auditor to communicate key audit matters in the auditor's report in accordance with ISA 701.<sup>18</sup>
- The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.
- Arrangements regarding the planning and performance of the audit, including the composition of the engagement team.
- The expectation that management will provide written representations (see also paragraph A13).
- The expectation that management will provide access to all information of which management is aware that is relevant to the preparation of the financial statements, including an expectation that management will provide access to information relevant to disclosures.
- The agreement of management to make available to the auditor draft financial statements, including all information relevant to their preparation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation of disclosures), and the other information,<sup>19</sup> if any, in time to allow the auditor to complete the audit in accordance with the proposed timetable.

<sup>17</sup> ISA 200, paragraphs 3–9

<sup>18</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

<sup>19</sup> As defined in ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.

A25. When the auditor is not required to communicate key audit matters, it may be helpful for the auditor to make reference in the terms of the audit engagement to the possibility of communicating key audit matters in the auditor's report and, in certain jurisdictions, it may be necessary for the auditor to include a reference to such possibility in order to retain the ability to do so.

A26. When relevant, the following points could also be made in the audit engagement letter:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other staff of the entity.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- A reference to, and description of, the auditor's responsibilities under law, regulation or relevant ethical requirements that address reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the entity.
- Any obligations to provide audit working papers to other parties.

An example of an audit engagement letter is set out in Appendix 1.

#### Audits of Components

A27. When the auditor of a parent entity is also the auditor of a component, the factors that may influence the decision whether to send a separate audit engagement letter to the component include the following:

- Who appoints the component auditor;
- Whether a separate auditor's report is to be issued on the component;
- Legal requirements in relation to audit appointments;

- Degree of ownership by parent; and
- Degree of independence of the component management from the parent entity.

**Responsibilities of Management Prescribed by Law or Regulation (Ref: Para. 11–12)**

A28. If, in the circumstances described in paragraphs A23 and A29, the auditor concludes that it is not necessary to record certain terms of the audit engagement in an audit engagement letter, the auditor is still required by paragraph 11 to seek the written agreement from management that it acknowledges and understands that it has the responsibilities set out in paragraph 6(b). However, in accordance with paragraph 12, such written agreement may use the wording of the law or regulation if such law or regulation establishes responsibilities for management that are equivalent in effect to those described in paragraph 6(b). The accounting profession, audit standards setter, or audit regulator in a jurisdiction may have provided guidance as to whether the description in law or regulation is equivalent.

**Considerations specific to public sector entities**

A29. Law or regulation governing the operations of public sector audits generally mandate the appointment of a public sector auditor and commonly set out the public sector auditor’s responsibilities and powers, including the power to access an entity’s records and other information. When law or regulation prescribes in sufficient detail the terms of the audit engagement, the public sector auditor may nonetheless consider that there are benefits in issuing a fuller audit engagement letter than permitted by paragraph 11.

**Recurring Audits (Ref: Para. 13)**

A30. The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity’s business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

## Acceptance of a Change in the Terms of the Audit Engagement

### *Request to Change the Terms of the Audit Engagement (Ref: Para. 14)*

- A31. A request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances. The auditor, as required by paragraph 14, considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.
- A32. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.
- A33. In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

### *Request to Change to a Review or a Related Service (Ref: Para. 15)*

- A34. Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with ISAs may need to assess, in addition to the matters referred to in paragraphs A31–A33 above, any legal or contractual implications of the change.
- A35. If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement; however, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:
- (a) The original audit engagement; or
  - (b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

## Additional Considerations in Engagement Acceptance

### *Financial Reporting Standards Supplemented by Law or Regulation (Ref: Para. 18)*

- A36. In some jurisdictions, law or regulation may supplement the financial reporting standards established by an authorized or recognized standards setting

organization with additional requirements relating to the preparation of financial statements. In those jurisdictions, the applicable financial reporting framework for the purposes of applying the ISAs encompasses both the identified financial reporting framework and such additional requirements provided they do not conflict with the identified financial reporting framework. This may, for example, be the case when law or regulation prescribes disclosures in addition to those required by the financial reporting standards or when they narrow the range of acceptable choices that can be made within the financial reporting standards.<sup>20</sup>

*Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance* (Ref: Para. 19)

A37. Law or regulation may prescribe that the wording of the auditor’s opinion use the phrases “present fairly, in all material respects” or “give a true and fair view” in a case where the auditor concludes that the applicable financial reporting framework prescribed by law or regulation would otherwise have been unacceptable. In this case, the terms of the prescribed wording of the auditor’s report are significantly different from the requirements of ISAs (see paragraph 21).

*Auditor’s Report Prescribed by Law or Regulation* (Ref: Para. 21)

A38. ISAs require that the auditor shall not represent compliance with ISAs unless the auditor has complied with all of the ISAs relevant to the audit.<sup>21</sup> When law or regulation prescribes the layout or wording of the auditor’s report in a form or in terms that are significantly different from the requirements of ISAs and the auditor concludes that additional explanation in the auditor’s report cannot mitigate possible misunderstanding, the auditor may consider including a statement in the auditor’s report that the audit is not conducted in accordance with ISAs. The auditor is, however, encouraged to apply ISAs, including the ISAs that address the auditor’s report, to the extent practicable, notwithstanding that the auditor is not permitted to refer to the audit being conducted in accordance with ISAs.

Considerations Specific to Public Sector Entities

A39. In the public sector, specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a minister, the legislature or the public if the entity attempts to limit the scope of the audit.

<sup>20</sup> ISA 700 (Revised), paragraph 15, includes a requirement regarding the evaluation of whether the financial statements adequately refer to or describe the applicable financial reporting framework.

<sup>21</sup> ISA 200, paragraph 20

## Appendix 1

(Ref: Para. A24–A26)

### Example of an Audit Engagement Letter

The following is an example of an audit engagement letter for an audit of general purpose financial statements prepared in accordance with International Financial Reporting Standards. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this ISA. It will need to be varied according to individual requirements and circumstances. It is drafted to refer to the audit of financial statements for a single reporting period and would require adaptation if intended or expected to apply to recurring audits (see paragraph 13). It may be appropriate to seek legal advice that any proposed letter is suitable.

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To the appropriate representative of management or those charged with governance of ABC Company:<sup>1</sup>

*[The objective and scope of the audit]*

You<sup>2</sup> have requested that we audit the financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

*[The responsibilities of the auditor]*

We will conduct our audit in accordance with ISAs. Those standards require that we comply with ethical requirements. As part of an audit in accordance with ISAs, we

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<sup>1</sup> The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons – see paragraph A22.

<sup>2</sup> Throughout this letter, references to “you,” “we,” “us,” “management,” “those charged with governance” and “auditor” would be used or amended as appropriate in the circumstances.

exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.<sup>3</sup> However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

*[The responsibilities of management and identification of the applicable financial reporting framework (for purposes of this example it is assumed that the auditor has*

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<sup>3</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

*not determined that the law or regulation prescribes those responsibilities in appropriate terms; the descriptions in paragraph 6(b) of this ISA are therefore used).]*

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance]<sup>4</sup> acknowledge and understand that they have responsibility:

- (a) For the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards;<sup>5</sup>
- (b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide us with:<sup>6</sup>
  - (i) Access to all information of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
  - (ii) Additional information that we may request from [management] for the purpose of the audit; and
  - (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation from your staff during our audit.

*[Other relevant information]*

*[Insert other information, such as fee arrangements, billings and other specific terms, as appropriate.]*

*[Reporting]*

*[Insert appropriate reference to the expected form and content of the auditor's report including, if applicable, the reporting on other information in accordance with ISA 720 (Revised).]*

The form and content of our report may need to be amended in the light of our audit findings.

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<sup>4</sup> Use terminology as appropriate in the circumstances.

<sup>5</sup> Or, if appropriate, "For the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards."

<sup>6</sup> See paragraph A24 for examples of other matters relating to management's responsibilities that may be included.

AGREEING THE TERMS OF AUDIT ENGAGEMENTS

*Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.*

XYZ & Co.

Acknowledged and agreed on behalf of ABC Company by

(signed)

.....

Name and Title

Date

## Appendix 2

(Ref: Para. A10)

### **Determining the Acceptability of General Purpose Frameworks**

#### **Jurisdictions that Do Not Have Authorized or Recognized Standards Setting Organizations or Financial Reporting Frameworks Prescribed by Law or Regulation**

1. As explained in paragraph A10 of this ISA, when an entity is registered or operating in a jurisdiction that does not have an authorized or recognized standards setting organization, or where use of the financial reporting framework is not prescribed by law or regulation, management identifies an applicable financial reporting framework. Practice in such jurisdictions is often to use the financial reporting standards established by one of the organizations described in paragraph A8 of this ISA.
2. Alternatively, there may be established accounting conventions in a particular jurisdiction that are generally recognized as the financial reporting framework for general purpose financial statements prepared by certain specified entities operating in that jurisdiction. When such a financial reporting framework is adopted, the auditor is required by paragraph 6(a) of this ISA to determine whether the accounting conventions collectively can be considered to constitute an acceptable financial reporting framework for general purpose financial statements. When the accounting conventions are widely used in a particular jurisdiction, the accounting profession in that jurisdiction may have considered the acceptability of the financial reporting framework on behalf of the auditors. Alternatively, the auditor may make this determination by considering whether the accounting conventions exhibit attributes normally exhibited by acceptable financial reporting frameworks (see paragraph 3 below), or by comparing the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable (see paragraph 4 below).
3. Acceptable financial reporting frameworks normally exhibit the following attributes that result in information provided in financial statements that is useful to the intended users:
  - (a) Relevance, in that the information provided in the financial statements is relevant to the nature of the entity and the purpose of the financial statements. For example, in the case of a business enterprise that prepares general purpose financial statements, relevance is assessed in terms of the information necessary to meet the common financial information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting the financial position, financial performance and cash flows of the business enterprise.

- (b) Completeness, in that transactions and events, account balances and disclosures that could affect conclusions based on the financial statements are not omitted.
  - (c) Reliability, in that the information provided in the financial statements:
    - (i) Where applicable, reflects the economic substance of events and transactions and not merely their legal form; and
    - (ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances.
  - (d) Neutrality, in that it contributes to information in the financial statements that is free from bias.
  - (e) Understandability, in that the information in the financial statements is clear and comprehensive and not subject to significantly different interpretation.
4. The auditor may decide to compare the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable. For example, the auditor may compare the accounting conventions to IFRSs. For an audit of a small entity, the auditor may decide to compare the accounting conventions to a financial reporting framework specifically developed for such entities by an authorized or recognized standards setting organization. When the auditor makes such a comparison and differences are identified, the decision as to whether the accounting conventions adopted in the preparation of the financial statements constitute an acceptable financial reporting framework includes considering the reasons for the differences and whether application of the accounting conventions, or the description of the financial reporting framework in the financial statements, could result in financial statements that are misleading.
5. A conglomeration of accounting conventions devised to suit individual preferences is not an acceptable financial reporting framework for general purpose financial statements. Similarly, a compliance framework will not be an acceptable financial reporting framework, unless it is generally accepted in the particular jurisdictions by preparers and users.

# INTERNATIONAL STANDARD ON AUDITING 220

## QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 220, *Quality Control for an Audit of Financial Statements*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. This ISA is to be read in conjunction with relevant ethical requirements.

### System of Quality Control and Role of Engagement Teams

2. Quality control systems, policies and procedures are the responsibility of the audit firm. Under ISQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:
  - (a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
  - (b) Reports issued by the firm or engagement partners are appropriate in the circumstances.<sup>1</sup>

This ISA is premised on the basis that the firm is subject to ISQC 1 or to national requirements that are at least as demanding. (Ref: Para. A1)

3. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.
4. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise. (Ref: Para. A2)

### Effective Date

5. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objective

6. The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:
  - (a) The audit complies with professional standards and applicable legal and regulatory requirements; and
  - (b) The auditor's report issued is appropriate in the circumstances.

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<sup>1</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraph 11

## Definitions

7. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Engagement partner<sup>2</sup> – The partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor’s report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
  - (b) Engagement quality control review – A process designed to provide an objective evaluation, on or before the date of the auditor’s report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor’s report. The engagement quality control review process is for audits of financial statements of listed entities and those other audit engagements, if any, for which the firm has determined an engagement quality control review is required.
  - (c) Engagement quality control reviewer – A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the auditor’s report.
  - (d) Engagement team – All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform audit procedures on the engagement. This excludes an auditor’s external expert engaged by the firm or a network firm.<sup>3</sup> The term “engagement team” also excludes individuals within the client’s internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of ISA 610 (Revised 2013).<sup>4</sup>
  - (e) Firm – A sole practitioner, partnership or corporation or other entity of professional accountants.
  - (f) Inspection – In relation to completed audit engagements, procedures designed to provide evidence of compliance by engagement teams with the firm’s quality control policies and procedures.

<sup>2</sup> “Engagement partner,” “partner,” and “firm” should be read as referring to their public sector equivalents where relevant.

<sup>3</sup> ISA 620, *Using the Work of an Auditor’s Expert*, paragraph 6(a), defines the term “auditor’s expert.”

<sup>4</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, establishes limits on the use of direct assistance. It also acknowledges that the external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. Therefore, the use of direct assistance is restricted to situations where it is permitted.

- (g) Listed entity – An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.
- (h) Monitoring – A process comprising an ongoing consideration and evaluation of the firm’s system of quality control, including a periodic inspection of a selection of completed engagements, designed to provide the firm with reasonable assurance that its system of quality control is operating effectively.
- (i) Network firm – A firm or entity that belongs to a network.
- (j) Network – A larger structure:
  - (i) That is aimed at cooperation, and
  - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
- (k) Partner – Any individual with authority to bind the firm with respect to the performance of a professional services engagement.
- (l) Personnel – Partners and staff.
- (m) Professional standards – International Standards on Auditing (ISAs) and relevant ethical requirements.
- (n) Relevant ethical requirements – Ethical requirements to which the engagement team and engagement quality control reviewer are subject when undertaking an audit engagement, which ordinarily comprise the provisions of the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) related to an audit of financial statements, together with national requirements that are more restrictive.
- (o) Staff – Professionals, other than partners, including any experts the firm employs.
- (p) Suitably qualified external person – An individual outside the firm with the competence and capabilities to act as an engagement partner, for example, a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits of historical financial information or of an organization that provides relevant quality control services.

## Requirements

### Leadership Responsibilities for Quality on Audits

8. The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. (Ref: Para. A3)

### Relevant Ethical Requirements

9. Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of breaches of relevant ethical requirements by members of the engagement team. (Ref: Para. A4–A5)
10. If matters come to the engagement partner's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have breached relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action. (Ref: Para. A5)

### *Independence*

11. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall: (Ref: Para. A5)
  - (a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate threats to independence;
  - (b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement;
  - (c) Evaluate whether the identified threats are at an acceptable level; and
  - (d) Take appropriate action to address the threats that are not at an acceptable level by eliminating the circumstances that create the threats, applying safeguards to reduce threats to an acceptable level, or withdrawing from the engagement, where withdrawal is possible under applicable law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. (Ref: Para. A6–A7)

### Acceptance and Continuance of Client Relationships and Audit Engagements

12. The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate. (Ref: Para. A8–A10)
13. If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the

engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A10)

### **Assignment of Engagement Teams**

14. The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:
  - (a) Perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements; and
  - (b) Enable an auditor's report that is appropriate in the circumstances to be issued. (Ref: Para. A11–A13)

### **Engagement Performance**

#### *Direction, Supervision and Performance*

15. The engagement partner shall take responsibility for:
  - (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements; and (Ref: Para. A14–A16, A21)
  - (b) The auditor's report being appropriate in the circumstances.

#### *Reviews*

16. The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. (Ref: Para. A17–A18, A21)
17. On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (Ref: Para. A19–A21)

#### *Consultation*

18. The engagement partner shall:
  - (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
  - (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

- (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
- (d) Determine that conclusions resulting from such consultations have been implemented. (Ref: Para. A22–A23)

#### *Engagement Quality Control Review*

- 19. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:
  - (a) Determine that an engagement quality control reviewer has been appointed;
  - (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
  - (c) Not date the auditor's report until the completion of the engagement quality control review. (Ref: Para. A24–A26)
- 20. The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:
  - (a) Discussion of significant matters with the engagement partner;
  - (b) Review of the financial statements and the proposed auditor's report;
  - (c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and
  - (d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate. (Ref: Para. A27–A29, A31–A33)
- 21. For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:
  - (a) The engagement team's evaluation of the firm's independence in relation to the audit engagement;
  - (b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and
  - (c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached. (Ref: Para. A30–A33)

*Differences of Opinion*

22. If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm’s policies and procedures for dealing with and resolving differences of opinion.

**Monitoring**

23. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm’s monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement. (Ref: Para A34–A36)

**Documentation**

24. The auditor shall include in the audit documentation:<sup>5</sup>
- (a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.
  - (b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.
  - (c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.
  - (d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement. (Ref: Para. A37)
25. The engagement quality control reviewer shall document, for the audit engagement reviewed, that:
- (a) The procedures required by the firm’s policies on engagement quality control review have been performed;
  - (b) The engagement quality control review has been completed on or before the date of the auditor’s report; and
  - (c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

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<sup>5</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

## Application and Other Explanatory Material

### System of Quality Control and Role of Engagement Teams (Ref: Para. 2)

A1. ISQC 1, or national requirements that are at least as demanding, deals with the firm's responsibilities to establish and maintain its system of quality control for audit engagements. The system of quality control includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

National requirements that deal with the firm's responsibilities to establish and maintain a system of quality control are at least as demanding as ISQC 1 when they address all the elements referred to in this paragraph and impose obligations on the firm that achieve the aims of the requirements set out in ISQC 1.

### *Reliance on the Firm's System of Quality Control* (Ref: Para. 4)

A2. Unless information provided by the firm or other parties suggest otherwise, the engagement team may rely on the firm's system of quality control in relation to, for example:

- Competence of personnel through their recruitment and formal training.
- Independence through the accumulation and communication of relevant independence information.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to applicable legal and regulatory requirements through the monitoring process.

### Leadership Responsibilities for Quality on Audits (Ref: Para. 8)

A3. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasize:

- (a) The importance to audit quality of:
  - (i) Performing work that complies with professional standards and applicable legal and regulatory requirements;

- (ii) Complying with the firm’s quality control policies and procedures as applicable;
  - (iii) Issuing auditor’s reports that are appropriate in the circumstances; and
  - (iv) The engagement team’s ability to raise concerns without fear of reprisals; and
- (b) The fact that quality is essential in performing audit engagements.

### **Relevant Ethical Requirements**

*Compliance with Relevant Ethical Requirements* (Ref: Para. 9)

A4. The IESBA Code establishes the fundamental principles of ethics, which are:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behavior.

The fundamental principles of ethics establish the standard of behavior expected of a professional accountant.

Definition of “Firm,” “Network” and “Network Firm” (Ref: Para. 9–11)

A5. The definitions of “firm,” “network” or “network firm” in relevant ethical requirements may differ from those set out in this ISA. For example, the IESBA Code defines the “firm” as:

- (a) A sole practitioner, partnership or corporation of professional accountants;
- (b) An entity that controls such parties through ownership, management or other means; and
- (c) An entity controlled by such parties through ownership, management or other means.

The IESBA Code also provides guidance in relation to the terms “network” and “network firm.”

In complying with the requirements in paragraphs 9–11, the definitions used in the relevant ethical requirements apply in so far as is necessary to interpret those ethical requirements.

*Threats to Independence* (Ref: Para. 11(c))

A6. The engagement partner may identify a threat to independence regarding the audit engagement that may not be at an acceptable level. In that case, as

required by paragraph 11(d), the engagement partner reports to the relevant person(s) within the firm to determine the appropriate action, which may include eliminating the circumstance that creates the threat, applying safeguards to reduce the threat to an acceptable level or withdrawing from the audit engagement, where withdrawal is possible under applicable law or regulation.

#### Considerations Specific to Public Sector Entities

- A7. Statutory measures may provide safeguards for the independence of public sector auditors. However, public sector auditors or audit firms carrying out public sector audits on behalf of the statutory auditor may, depending on the terms of the mandate in a particular jurisdiction, need to adapt their approach in order to promote compliance with the spirit of paragraph 11. This may include, where the public sector auditor's mandate does not permit withdrawal from the engagement, disclosure through a public report, of circumstances that have arisen that would, if they were in the private sector, lead the auditor to withdraw.

#### Acceptance and Continuance of Client Relationships and Audit Engagements

(Ref: Para. 12)

- A8. ISQC 1 requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.<sup>6</sup> Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:
- The integrity of the principal owners, key management and those charged with governance of the entity;
  - Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
  - Whether the firm and the engagement team can comply with relevant ethical requirements; and
  - Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.
- A9. Law, regulation, or relevant ethical requirements<sup>7</sup> may require the auditor to request, prior to accepting the engagement, the predecessor auditor to provide known information regarding any facts or circumstances that, in the predecessor auditor's judgment, the auditor needs to be aware of before deciding whether to accept the engagement. In some circumstances, the predecessor auditor may be

<sup>6</sup> ISQC 1, paragraph 27(a)

<sup>7</sup> See, for example, paragraph R320.8 of the IESBA Code.

required, on request by the proposed successor auditor, to provide information regarding identified or suspected non-compliance with laws and regulations to the proposed successor auditor. For example, where the predecessor auditor has withdrawn from the engagement as a result of identified or suspected non-compliance with laws and regulations, the IESBA Code requires that the predecessor auditor, on request by a proposed successor auditor, provides all such facts and other information concerning such non-compliance that, in the predecessor auditor's opinion, the proposed successor auditor needs to be aware of before deciding whether to accept the audit appointment.<sup>8</sup>

*Considerations Specific to Public Sector Entities* (Ref: Para. 12–13)

A10. In the public sector, auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements as set out in paragraphs 12, 13, A8 and A9 may not be relevant. Nonetheless, information gathered as a result of the process described may be valuable to public sector auditors in performing risk assessments and in carrying out reporting responsibilities.

**Assignment of Engagement Teams** (Ref: Para. 14)

A11. An engagement team includes a person using expertise in a specialized area of accounting or auditing, whether engaged or employed by the firm, if any, who performs audit procedures on the engagement. However, a person with such expertise is not a member of the engagement team if that person's involvement with the engagement is only consultation. Consultations are addressed in paragraphs 18, A22 and A23.

A12. When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's:

- Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and applicable legal and regulatory requirements.
- Technical expertise, including expertise with relevant information technology and specialized areas of accounting or auditing.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

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<sup>8</sup> See, for example, paragraphs R360.22 and R360.23 of the IESBA Code.

*Considerations Specific to Public Sector Entities*

A13. In the public sector, additional appropriate competence may include skills that are necessary to discharge the terms of the audit mandate in a particular jurisdiction. Such competence may include an understanding of the applicable reporting arrangements, including reporting to the legislature or other governing body or in the public interest. The wider scope of a public sector audit may include, for example, some aspects of performance auditing or a comprehensive assessment of compliance with law, regulation or other authority and preventing and detecting fraud and corruption.

**Engagement Performance***Direction, Supervision and Performance* (Ref: Para. 15(a))

A14. Direction of the engagement team involves informing the members of the engagement team of matters such as:

- Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by ISA 200.<sup>9</sup>
- Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement.
- The objectives of the work to be performed.
- The nature of the entity's business.
- Risk-related issues.
- Problems that may arise.
- The detailed approach to the performance of the engagement.

Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.

A15. Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

A16. Supervision includes matters such as:

- Tracking the progress of the audit engagement.
- Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, whether they understand their instructions and

<sup>9</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 15

whether the work is being carried out in accordance with the planned approach to the audit engagement.

- Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

### *Reviews*

#### Review Responsibilities (Ref: Para. 16)

A17. Under ISQC 1, the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members.<sup>10</sup>

A18. A review consists of consideration whether, for example:

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved.

#### The Engagement Partner's Review of Work Performed (Ref: Para. 17)

A19. Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant matters to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and
- Other areas the engagement partner considers important.

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<sup>10</sup> ISQC 1, paragraph 33

The engagement partner need not review all audit documentation, but may do so. However, as required by ISA 230, the partner documents the extent and timing of the reviews.<sup>11</sup>

- A20. An engagement partner taking over an audit during the engagement may apply the review procedures as described in paragraph A19 to review the work performed to the date of a change in order to assume the responsibilities of an engagement partner.

*Considerations Relevant Where a Member of the Engagement Team with Expertise in a Specialized Area of Accounting or Auditing Is Used* (Ref: Para. 15–17)

- A21. Where a member of the engagement team with expertise in a specialized area of accounting or auditing is used, direction, supervision and review of that engagement team member's work may include matters such as:
- Agreeing with that member the nature, scope and objectives of that member's work; and the respective roles of, and the nature, timing and extent of communication between that member and other members of the engagement team.
  - Evaluating the adequacy of that member's work including the relevance and reasonableness of that member's findings or conclusions and their consistency with other audit evidence.

*Consultation* (Ref: Para. 18)

- A22. Effective consultation on significant technical, ethical and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:
- Are given all the relevant facts that will enable them to provide informed advice; and
  - Have appropriate knowledge, seniority and experience.
- A23. It may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. They may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services.

*Engagement Quality Control Review*

Completion of the Engagement Quality Control Review before Dating of the Auditor's Report (Ref: Para. 19(c))

- A24. ISA 700 (Revised) requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which

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<sup>11</sup> ISA 230, paragraph 9(c)

to base the auditor’s opinion on the financial statements.<sup>12</sup> In cases of an audit of financial statements of listed entities or when an engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

- A25. Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer’s satisfaction on or before the date of the auditor’s report.
- A26. Completion of the engagement quality control review means the completion by the engagement quality control reviewer of the requirements in paragraphs 20–21, and where applicable, compliance with paragraph 22. Documentation of the engagement quality control review may be completed after the date of the auditor’s report as part of the assembly of the final audit file. ISA 230 establishes requirements and provides guidance in this regard.<sup>13</sup>

#### Nature, Timing and Extent of Engagement Quality Control Review (Ref: Para. 20)

- A27. Remaining alert for changes in circumstances allows the engagement partner to identify situations in which an engagement quality control review is necessary, even though at the start of the engagement, such a review was not required.
- A28. The extent of the engagement quality control review may depend, among other things, on the complexity of the audit engagement, whether the entity is a listed entity, and the risk that the auditor’s report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner for the audit engagement and its performance.
- A29. When ISA 701<sup>14</sup> applies, the conclusions reached by the engagement team in formulating the auditor’s report include determining:
- The key audit matters to be included in the auditor’s report;
  - The key audit matters that will not be communicated in the auditor’s report in accordance with paragraph 14 of ISA 701, if any; and
  - If applicable, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate in the auditor’s report.

In addition, the review of the proposed auditor’s report in accordance with paragraph 20(b) includes consideration of the proposed wording to be included in the Key Audit Matters section.

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<sup>12</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 49

<sup>13</sup> ISA 230, paragraphs 14–16

<sup>14</sup> ISA 701, *Communicating Key Audit Matters in the Auditor’s Report*

## Engagement Quality Control Review of Listed Entities (Ref: Para. 21)

A30. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:

- Significant risks identified during the engagement in accordance with ISA 315 (Revised),<sup>15</sup> and the responses to those risks in accordance with ISA 330,<sup>16</sup> including the engagement team's assessment of, and response to, the risk of fraud in accordance with ISA 240.<sup>17</sup>
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of financial statements of other entities.

## Considerations Specific to Smaller Entities (Ref: Para. 20–21)

A31. In addition to the audits of financial statements of listed entities, an engagement quality control review is required for audit engagements that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm's audit engagements may meet the criteria that would subject them to such a review.

## Considerations Specific to Public Sector Entities (Ref: Para. 20–21)

A32. In the public sector, a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General), may act in a role equivalent to that of engagement partner with overall responsibility for public sector audits. In such circumstances, where applicable, the selection of the engagement quality control reviewer includes consideration of the need for independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.

A33. Listed entities as referred to in paragraphs 21 and A30 are not common in the public sector. However, there may be other public sector entities that are significant due to size, complexity or public interest aspects, and which

<sup>15</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>16</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>17</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

consequently have a wide range of stakeholders. Examples include state owned corporations and public utilities. Ongoing transformations within the public sector may also give rise to new types of significant entities. There are no fixed objective criteria on which the determination of significance is based. Nonetheless, public sector auditors evaluate which entities may be of sufficient significance to warrant performance of an engagement quality control review.

### **Monitoring** (Ref: Para. 23)

- A34. ISQC 1 requires the firm to establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate and operating effectively.<sup>18</sup>
- A35. In considering deficiencies that may affect the audit engagement, the engagement partner may have regard to measures the firm took to rectify the situation that the engagement partner considers are sufficient in the context of that audit.
- A36. A deficiency in the firm's system of quality control does not necessarily indicate that a particular audit engagement was not performed in accordance with professional standards and applicable legal and regulatory requirements, or that the auditor's report was not appropriate.

### **Documentation**

#### *Documentation of Consultations* (Ref: Para. 24(d))

- A37. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:
- The issue on which consultation was sought; and
  - The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

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<sup>18</sup> ISQC 1, paragraph 48

# INTERNATIONAL STANDARD ON AUDITING 230

## AUDIT DOCUMENTATION

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 230, *Audit Documentation*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.



## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. The Appendix lists other ISAs that contain specific documentation requirements and guidance. The specific documentation requirements of other ISAs do not limit the application of this ISA. Law or regulation may establish additional documentation requirements.

### Nature and Purposes of Audit Documentation

2. Audit documentation that meets the requirements of this ISA and the specific documentation requirements of other relevant ISAs provides:
  - (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor;<sup>1</sup> and
  - (b) Evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.
3. Audit documentation serves a number of additional purposes, including the following:
  - Assisting the engagement team to plan and perform the audit.
  - Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA 220.<sup>2</sup>
  - Enabling the engagement team to be accountable for its work.
  - Retaining a record of matters of continuing significance to future audits.
  - Enabling the conduct of quality control reviews and inspections in accordance with ISQC 1<sup>3</sup> or national requirements that are at least as demanding.<sup>4</sup>
  - Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

### Effective Date

4. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

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<sup>1</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 11

<sup>2</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraphs 15–17

<sup>3</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraphs 32–33, 35–38, and 48

<sup>4</sup> ISA 220, paragraph 2

## Objective

5. The objective of the auditor is to prepare documentation that provides:
  - (a) A sufficient and appropriate record of the basis for the auditor’s report; and
  - (b) Evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.

## Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Audit documentation – The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as “working papers” or “workpapers” are also sometimes used).
  - (b) Audit file – One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
  - (c) Experienced auditor – An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:
    - (i) Audit processes;
    - (ii) ISAs and applicable legal and regulatory requirements;
    - (iii) The business environment in which the entity operates; and
    - (iv) Auditing and financial reporting issues relevant to the entity’s industry.

## Requirements

### Timely Preparation of Audit Documentation

7. The auditor shall prepare audit documentation on a timely basis. (Ref: Para. A1)

### Documentation of the Audit Procedures Performed and Audit Evidence Obtained

#### *Form, Content and Extent of Audit Documentation*

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2–A5, A16–A17)
  - (a) The nature, timing and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements; (Ref: Para. A6–A7)
  - (b) The results of the audit procedures performed, and the audit evidence obtained; and

- (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8–A11)
9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
    - (a) The identifying characteristics of the specific items or matters tested; (Ref: Para. A12)
    - (b) Who performed the audit work and the date such work was completed; and
    - (c) Who reviewed the audit work performed and the date and extent of such review. (Ref: Para. A13)
  10. The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. (Ref: Para. A14)
  11. If the auditor identified information that is inconsistent with the auditor’s final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency. (Ref: Para. A15)

*Departure from a Relevant Requirement*

12. If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in an ISA, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure. (Ref: Para. A18–A19)

*Matters Arising after the Date of the Auditor’s Report*

13. If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor’s report, the auditor shall document: (Ref: Para. A20)
  - (a) The circumstances encountered;
  - (b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor’s report; and
  - (c) When and by whom the resulting changes to audit documentation were made and reviewed.

**Assembly of the Final Audit File**

14. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor’s report. (Ref: Para. A21–A22)

15. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period. (Ref: Para. A23)
16. In circumstances other than those envisaged in paragraph 13 where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor shall, regardless of the nature of the modifications or additions, document: (Ref: Para. A24)
  - (a) The specific reasons for making them; and
  - (b) When and by whom they were made and reviewed.

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## Application and Other Explanatory Material

### Timely Preparation of Audit Documentation (Ref: Para. 7)

- A1. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

### Documentation of the Audit Procedures Performed and Audit Evidence Obtained

#### *Form, Content and Extent of Audit Documentation* (Ref: Para. 8)

- A2. The form, content and extent of audit documentation depend on factors such as:
  - The size and complexity of the entity.
  - The nature of the audit procedures to be performed.
  - The identified risks of material misstatement.
  - The significance of the audit evidence obtained.
  - The nature and extent of exceptions identified.
  - The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
  - The audit methodology and tools used.
- A3. Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include:
  - Audit programs.
  - Analyses.

- Issues memoranda.
- Summaries of significant matters.
- Letters of confirmation and representation.
- Checklists.
- Correspondence (including e-mail) concerning significant matters.

The auditor may include abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation, however, is not a substitute for the entity's accounting records.

- A4. The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.
- A5. Oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

#### Documentation of Compliance with ISAs (Ref: Para. 8(a))

- A6. In principle, compliance with the requirements of this ISA will result in the audit documentation being sufficient and appropriate in the circumstances. Other ISAs contain specific documentation requirements that are intended to clarify the application of this ISA in the particular circumstances of those other ISAs. The specific documentation requirements of other ISAs do not limit the application of this ISA. Furthermore, the absence of a documentation requirement in any particular ISA is not intended to suggest that there is no documentation that will be prepared as a result of complying with that ISA.
- A7. Audit documentation provides evidence that the audit complies with the ISAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:
- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
  - The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management or, where appropriate, those charged with governance.
  - An auditor's report containing an appropriately qualified opinion on the financial statements demonstrates that the auditor has complied with the

requirement to express a qualified opinion under the circumstances specified in the ISAs.

- In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
  - For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with the ISAs. For example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management's assertions, documenting how the auditor evaluated that evidence, including the professional judgments made in forming a conclusion as to the sufficiency and appropriateness of the audit evidence obtained.
  - Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the ISAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussions required by ISA 315 (Revised).<sup>5</sup>

#### Documentation of Significant Matters and Related Significant Professional Judgments (Ref: Para. 8(c))

- A8. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:
- Matters that give rise to significant risks (as defined in ISA 315 (Revised)).<sup>6</sup>
  - Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
  - Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
  - Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

<sup>5</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 10

<sup>6</sup> ISA 315 (Revised), paragraph 4(e)

- A9. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).
- A10. Some examples of circumstances in which, in accordance with paragraph 8, it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:
- The rationale for the auditor's conclusion when a requirement provides that the auditor "shall consider" certain information or factors, and that consideration is significant in the context of the particular engagement.
  - The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments made by management.
  - The basis for the auditor's evaluation of whether an accounting estimate and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.
  - The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.
  - When ISA 701 applies,<sup>7</sup> the auditor's determination of the key audit matters or the determination that there are no key audit matters to be communicated.
- A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant ISA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

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<sup>7</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

*Identification of Specific Items or Matters Tested, and of the Preparer and Reviewer*  
(Ref: Para. 9)

- A12. Recording the identifying characteristics serves a number of purposes. For example, it enables the engagement team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:
- For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
  - For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).
  - For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period from April 1 to September 30, starting with report number 12345 and selecting every 125th report).
  - For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
  - For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.
- A13. ISA 220 requires the auditor to review the audit work performed through review of the audit documentation.<sup>8</sup> The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

*Documentation of Discussions of Significant Matters with Management, Those Charged with Governance, and Others* (Ref: Para. 10)

- A14. The documentation is not limited to records prepared by the auditor but may include other appropriate records such as minutes of meetings prepared by the entity's personnel and agreed by the auditor. Others with whom the auditor may

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<sup>8</sup> ISA 220, paragraph 17

discuss significant matters may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

#### Documentation of How Inconsistencies Have Been Addressed (Ref: Para. 11)

A15. The requirement to document how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.

#### Considerations Specific to Smaller Entities (Ref. Para. 8)

A16. The audit documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity. Further, in the case of an audit where the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team (for example, there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement in paragraph 8 to prepare audit documentation that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or other purposes.

A17. When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality determined in accordance with ISA 320,<sup>9</sup> assessed risks, significant matters noted during the audit, and conclusions reached.

#### *Departure from a Relevant Requirement* (Ref: Para. 12)

A18. The requirements of the ISAs are designed to enable the auditor to achieve the objectives specified in the ISAs, and thereby the overall objectives of the auditor. Accordingly, other than in exceptional circumstances, the ISAs call for compliance with each requirement that is relevant in the circumstances of the audit.

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant<sup>10</sup> only in the cases where:

- (a) The entire ISA is not relevant (for example, if an entity does not have an internal audit function, nothing in ISA 610 (Revised 2013)<sup>11</sup> is relevant); or

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<sup>9</sup> ISA 320, *Materiality in Planning and Performing an Audit*

<sup>10</sup> ISA 200, paragraph 22

<sup>11</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 2

- (b) The requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

*Matters Arising after the Date of the Auditor's Report* (Ref: Para. 13)

A20. Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report.<sup>12</sup> The resulting changes to the audit documentation are reviewed in accordance with the review responsibilities set out in ISA 220,<sup>13</sup> with the engagement partner taking final responsibility for the changes.

**Assembly of the Final Audit File** (Ref: Para. 14–16)

A21. 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 audit files.<sup>14</sup> An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.<sup>15</sup>

A22. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

A23. ISQC 1 (or national requirements that are at least as demanding) requires firms to establish policies and procedures for the retention of engagement documentation.<sup>16</sup> The retention period for audit engagements ordinarily is no

<sup>12</sup> ISA 560, *Subsequent Events*, paragraph 14

<sup>13</sup> ISA 220, paragraph 16

<sup>14</sup> ISQC 1, paragraph 45

<sup>15</sup> ISQC 1, paragraph A54

<sup>16</sup> ISQC 1, paragraph 47

shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report.<sup>17</sup>

- A24. An example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after file assembly has been completed is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.

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<sup>17</sup> ISQC 1, paragraph A61

**Appendix**

(Ref. Para. 1)

**Specific Audit Documentation Requirements in Other ISAs**

This appendix identifies paragraphs in other ISAs that contain specific documentation requirements. The list is not a substitute for considering the requirements and related application and other explanatory material in ISAs.

- ISA 210, *Agreeing the Terms of Audit Engagements* – paragraphs 10–12
- ISA 220, *Quality Control for an Audit of Financial Statements* – paragraphs 24–25
- ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraphs 45–48
- ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraph 30
- ISA 260 (Revised), *Communication with Those Charged with Governance* – paragraph 23
- ISA 300, *Planning an Audit of Financial Statements* – paragraph 12
- ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* – paragraph 32
- ISA 320, *Materiality in Planning and Performing an Audit* – paragraph 14
- ISA 330, *The Auditor’s Responses to Assessed Risks* – paragraphs 28–30
- ISA 450, *Evaluation of Misstatements Identified during the Audit* – paragraph 15
- ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* – paragraph 39
- ISA 550, *Related Parties* – paragraph 28
- ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* – paragraph 50
- ISA 610 (Revised 2013), *Using the Work of Internal Auditors* – paragraph 36–37
- ISA 720 (Revised), *The Auditor’s Responsibilities Relating to Other Information* – paragraph 25

**INTERNATIONAL STANDARD ON AUDITING 240**  
**THE AUDITOR’S RESPONSIBILITIES RELATING TO**  
**FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how ISA 315 (Revised)<sup>1</sup> and ISA 330<sup>2</sup> are to be applied in relation to risks of material misstatement due to fraud.

### Characteristics of Fraud

2. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
3. Although fraud is a broad legal concept, for the purposes of the ISAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. A1–A7)

### Responsibility for the Prevention and Detection of Fraud

4. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

### *Responsibilities of the Auditor*

5. An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing

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<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>2</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.<sup>3</sup>

6. As described in ISA 200,<sup>4</sup> the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.
7. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.
8. When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this ISA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.
9. The auditor may have additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's non-compliance with laws and regulations, including fraud, which may differ from or go beyond this and other ISAs, such as: (Ref: Para. A6)
  - (a) Responding to identified or suspected non-compliance with laws and regulations, including requirements in relation to specific communications with management and those charged with governance,

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<sup>3</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraphs A53–A54

<sup>4</sup> ISA 200, paragraph A53

assessing the appropriateness of their response to non-compliance and determining whether further action is needed;

- (b) Communicating identified or suspected non-compliance with laws and regulations to other auditors (e.g., in an audit of group financial statements); and
- (c) Documentation requirements regarding identified or suspected non-compliance with laws and regulations.

Complying with any additional responsibilities may provide further information that is relevant to the auditor's work in accordance with this and other ISAs (e.g., regarding the integrity of management or, where appropriate, those charged with governance).

### **Effective Date**

- 10. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### **Objectives**

- 11. The objectives of the auditor are:
  - (a) To identify and assess the risks of material misstatement of the financial statements due to fraud;
  - (b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
  - (c) To respond appropriately to fraud or suspected fraud identified during the audit.

### **Definitions**

- 12. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Fraud – An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
  - (b) Fraud risk factors – Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

### **Requirements**

#### **Professional Skepticism**

- 13. In accordance with ISA 200<sup>5</sup>, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due

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<sup>5</sup> ISA 200, paragraph 15

to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A8–A9)

14. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A10)
15. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

### **Discussion among the Engagement Team**

16. ISA 315 (Revised) requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion.<sup>6</sup> This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A11–A12)

### **Risk Assessment Procedures and Related Activities**

17. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by ISA 315 (Revised),<sup>7</sup> the auditor shall perform the procedures in paragraphs 18–25 to obtain information for use in identifying the risks of material misstatement due to fraud.

#### *Management and Others within the Entity*

18. The auditor shall make inquiries of management regarding:
  - (a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A13–A14)
  - (b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A15)

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<sup>6</sup> ISA 315 (Revised), paragraph 10

<sup>7</sup> ISA 315 (Revised), paragraphs 5–24

THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT  
OF FINANCIAL STATEMENTS

- (c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
  - (d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.
19. The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A16–A18)
20. For those entities that have an internal audit function, the auditor shall make inquiries of appropriate individuals within the function to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A19)

*Those Charged with Governance*

21. Unless all of those charged with governance are involved in managing the entity,<sup>8</sup> the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref: Para. A20–A22)
22. Unless all of those charged with governance are involved in managing the entity, the auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

*Unusual or Unexpected Relationships Identified*

23. The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

*Other Information*

24. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A23)

*Evaluation of Fraud Risk Factors*

25. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances

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<sup>8</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A24–A28)

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

26. In accordance with ISA 315 (Revised), the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.<sup>9</sup>
27. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 48 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A29–A31)
28. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. A32–A33)

### **Responses to the Assessed Risks of Material Misstatement Due to Fraud**

#### *Overall Responses*

29. In accordance with ISA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.<sup>10</sup> (Ref: Para. A34)
30. In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall:
  - (a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A35–A36)
  - (b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and
  - (c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. (Ref: Para. A37)

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<sup>9</sup> ISA 315 (Revised), paragraph 25

<sup>10</sup> ISA 330, paragraph 5

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

31. In accordance with ISA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.<sup>11</sup> (Ref: Para. A38–A41)

*Audit Procedures Responsive to Risks Related to Management Override of Controls*

32. Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.
33. Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:
- (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:
    - (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
    - (ii) Select journal entries and other adjustments made at the end of a reporting period; and
    - (iii) Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A42–A45)
  - (b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:
    - (i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall reevaluate the accounting estimates taken as a whole; and

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<sup>11</sup> ISA 330, paragraph 6

- (ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. (Ref: Para. A46–A48)
  - (c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A49)
- 34. The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above (that is, where there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 33).

**Evaluation of Audit Evidence** (Ref: Para. A50)

- 35. The auditor shall evaluate whether analytical procedures that are performed near the end of the audit, when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity, indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A51)
- 36. If the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. A52)
- 37. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall reevaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A53)
- 38. If the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A54)

### **Auditor Unable to Continue the Engagement**

39. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:
- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
  - (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and
  - (c) If the auditor withdraws:
    - (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
    - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: Para. A55–A58)

### **Written Representations**

40. The auditor shall obtain written representations from management and, where appropriate, those charged with governance that:
- (a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
  - (b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;
  - (c) They have disclosed to the auditor their knowledge of fraud, or suspected fraud, affecting the entity involving:
    - (i) Management;
    - (ii) Employees who have significant roles in internal control; or
    - (iii) Others where the fraud could have a material effect on the financial statements; and
  - (d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A59–A60)

### **Communications to Management and with Those Charged with Governance**

41. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters, unless prohibited by law or regulation, on a timely basis with the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A61–A62)
42. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:
- (a) management;
  - (b) employees who have significant roles in internal control; or
  - (c) others where the fraud results in a material misstatement in the financial statements,

the auditor shall communicate these matters with those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions with those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. Such communications with those charged with governance are required unless the communication is prohibited by law or regulation. (Ref: Para. A61, A63–A65)

43. The auditor shall communicate, unless prohibited by law or regulation, with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. (Ref: Para. A61, A66)

### **Reporting Fraud to an Appropriate Authority Outside the Entity**

44. If the auditor has identified or suspects a fraud, the auditor shall determine whether law, regulation or relevant ethical requirements: (Ref: Para. A67–A69)
- (a) Require the auditor to report to an appropriate authority outside the entity.
  - (b) Establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.

### **Documentation**

45. The auditor shall include the following in the audit documentation<sup>12</sup> of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by ISA 315 (Revised).<sup>13</sup>

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<sup>12</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and paragraph A6

<sup>13</sup> ISA 315 (Revised), paragraph 32

- (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and
  - (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
46. The auditor shall include the following in the audit documentation of the auditor's responses to the assessed risks of material misstatement required by ISA 330:<sup>14</sup>
- (a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
  - (b) The results of the audit procedures, including those designed to address the risk of management override of controls.
47. The auditor shall include in the audit documentation communications about fraud made to management, those charged with governance, regulators and others.
48. If the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall include in the audit documentation the reasons for that conclusion.

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## Application and Other Explanatory Material

### Characteristics of Fraud (Ref: Para. 3)

- A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:
- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.
  - A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because

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<sup>14</sup> ISA 330, paragraph 28

the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

A2. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

A3. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

A4. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as intentionally:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.

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- Omitting, obscuring or misstating disclosures required by the applicable financial reporting framework, or disclosures that are necessary to achieve fair presentation.
- Concealing facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

A5. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

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

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

## **Responsibility for the Prevention and Detection of Fraud**

*Responsibilities of the Auditor* (Ref: Para. 9)

A6. Law, regulation or relevant ethical requirements may require the auditor to perform additional procedures and take further actions. For example, the International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) requires the auditor to take steps to respond to identified or suspected non-compliance with laws and regulations and determine whether further action is needed. Such steps may include the communication of identified or suspected non-compliance with laws and regulations to other

auditors within a group, including a group engagement partner, component auditors or other auditors performing work at components of a group for purposes other than the audit of the group financial statements.<sup>15</sup>

*Considerations Specific to Public Sector Entities*

A7. The public sector auditor's responsibilities relating to fraud may be a result of law, regulation or other authority applicable to public sector entities or separately covered by the auditor's mandate. Consequently, the public sector auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.

**Professional Skepticism** (Ref: Para. 13–15)

A8. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A9. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

A10. An audit performed in accordance with ISAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication.<sup>16</sup> However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document's authenticity.

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

A11. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.

<sup>15</sup> See, for example, paragraphs R360.16–360.18 A1 of the IESBA Code.

<sup>16</sup> ISA 200, paragraph A49

THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT  
OF FINANCIAL STATEMENTS

- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention.

A12. The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements (including the individual statements and the disclosures) may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the risk that management may attempt to present disclosures in a manner that may obscure a proper understanding of the matters disclosed (for example, by including too much immaterial information or by using unclear or ambiguous language).
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material

misstatement due to fraud and whether certain types of audit procedures are more effective than others.

- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

### **Risk Assessment Procedures and Related Activities**

#### *Inquiries of Management*

Management's Assessment of the Risk of Material Misstatement Due to Fraud (Ref: Para. 18(a))

A13. Management accepts responsibility for the entity's internal control and for the preparation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

A14. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 18(b))

A15. In the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

*Inquiry of Management and Others within the Entity* (Ref: Para. 19)

A16. The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within

the entity may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.

A17. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

- Operating personnel not directly involved in the financial reporting process.
- Employees with different levels of authority.
- Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
- In-house legal counsel.
- Chief ethics officer or equivalent person.
- The person or persons charged with dealing with allegations of fraud.

A18. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

*Inquiry of Internal Audit* (Ref: Para. 20)

A19. ISA 315 (Revised) and ISA 610 (Revised 2013) establish requirements and provide guidance relevant to audits of those entities that have an internal audit function.<sup>17</sup> In carrying out the requirements of those ISAs in the context of fraud, the auditor may inquire about specific activities of the function including, for example:

- The procedures performed, if any, by the internal auditor function during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

*Obtaining an Understanding of Oversight Exercised by Those Charged with Governance* (Ref: Para. 21)

A20. Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity and by country, it is important that the auditor understands their respective

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<sup>17</sup> ISA 315 (Revised), paragraphs 6(a) and 23, and ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.<sup>18</sup>

- A21. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

#### Considerations Specific to Smaller Entities

- A22. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

#### *Consideration of Other Information* (Ref: Para. 24)

- A23. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

#### *Evaluation of Fraud Risk Factors* (Ref: Para. 25)

- A24. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:
- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
  - The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
  - A control environment that is not effective may create an opportunity to commit fraud.

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<sup>18</sup> ISA 260 (Revised), paragraphs A1–A8, discuss with whom the auditor communicates when the entity's governance structure is not well defined.

A25. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

A26. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

A27. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:

- Effective oversight by those charged with governance.
- An effective internal audit function.
- The existence and enforcement of a written code of conduct.

Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

#### Considerations Specific to Smaller Entities

A28. In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some

entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential deficiency in internal control since there is an opportunity for management override of controls.

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

### *Risks of Fraud in Revenue Recognition (Ref: Para. 27)*

- A29. Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period.
- A30. The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year over year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.
- A31. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where a there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

### *Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls (Ref: Para. 28)*

- A32. Management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.<sup>19</sup> In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.
- A33. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in

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<sup>19</sup> ISA 315 (Revised), paragraph A56

identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

## **Responses to the Assessed Risks of Material Misstatement Due to Fraud**

### *Overall Responses (Ref: Para. 29)*

A34. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 30, which are discussed below.

### *Assignment and Supervision of Personnel (Ref: Para. 30(a))*

A35. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.

A36. The extent of supervision reflects the auditor's assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work.

### *Unpredictability in the Selection of Audit Procedures (Ref: Para. 30(c))*

A37. Incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. This can be achieved by, for example:

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

*Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level (Ref: Para. 31)*

A38. The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing and extent of audit procedures in the following ways:

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

techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

- A39. If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help to identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all locations on the same date.
- A40. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions. These may include asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.
- A41. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud, including those that illustrate the incorporation of an element of unpredictability, are presented in Appendix 2. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

*Audit Procedures Responsive to Risks Related to Management Override of Controls*

Journal Entries and Other Adjustments (Ref: Para. 33(a))

- A42. Material misstatement of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or by management making adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.
- A43. Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically

passed to the general ledger or to the financial reporting system. Furthermore, where IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

- A44. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:
- *The assessment of the risks of material misstatement due to fraud* – the presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.
  - *Controls that have been implemented over journal entries and other adjustments* – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.
  - *The entity's financial reporting process and the nature of evidence that can be obtained* – for many entities routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. Where information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.
  - *The characteristics of fraudulent journal entries or other adjustments* – inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.
  - *The nature and complexity of the accounts* – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.

- *Journal entries or other adjustments processed outside the normal course of business* – non standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

A45. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. However, because fraudulent journal entries and other adjustments are often made at the end of a reporting period, paragraph 33(a)(ii) requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph 33(a)(iii) requires the auditor to consider whether there is also a need to test journal entries and other adjustments throughout the period.

*Accounting Estimates* (Ref: Para. 33(b))

- A46. The preparation of the financial statements requires management to make a number of judgments or assumptions that affect significant accounting estimates and to monitor the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
- A47. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.
- A48. A retrospective review is also required by ISA 540 (Revised).<sup>20</sup> That review is conducted as a risk assessment procedure to obtain information regarding the effectiveness of management's previous accounting estimates, audit evidence about the outcome, or where applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period, and audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements. As a practical matter, the auditor's review of management judgments and assumptions for biases that could represent a risk of material misstatement due to fraud in accordance with this ISA may be carried out in conjunction with the review required by ISA 540 (Revised).

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<sup>20</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, paragraph 14

*Business Rationale for Significant Transactions* (Ref: Para. 33(c))

A49. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include:

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

**Evaluation of Audit Evidence** (Ref: Para. 35–38)

A50. ISA 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.<sup>21</sup> This evaluation is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

*Analytical Procedures Performed Near the End of the Audit in Forming an Overall Conclusion* (Ref: Para. 35)

A51. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.

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<sup>21</sup> ISA 330, paragraph 25

*Consideration of Identified Misstatements* (Ref: Para. 36–38)

- A52. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.
- A53. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.
- A54. ISA 450<sup>22</sup> and ISA 700 (Revised)<sup>23</sup> establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

**Auditor Unable to Continue the Engagement** (Ref: Para. 39)

- A55. Examples of exceptional circumstances that may arise and that may bring into question the auditor's ability to continue performing the audit include:
- The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even where the fraud is not material to the financial statements;
  - The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
  - The auditor has significant concern about the competence or integrity of management or those charged with governance.
- A56. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.
- A57. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary by country. In some countries, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to

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<sup>22</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*

<sup>23</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others.<sup>24</sup>

### *Considerations Specific to Public Sector Entities*

A58. In many cases in the public sector, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the mandate or public interest considerations.

### **Written Representations (Ref: Para. 40)**

A59. ISA 580<sup>25</sup> establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. In addition to acknowledging that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

A60. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

- (a) The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and
- (b) Their knowledge of actual, suspected or alleged fraud affecting the entity.

### **Communications to Management and with Those Charged with Governance** (Ref: Para. 41–43)

A61. In some jurisdictions, law or regulation may restrict the auditor's communication of certain matters with management and those charged with governance. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the auditor is required to report the fraud to an appropriate authority pursuant to anti-money laundering legislation. In these circumstances, the issues considered by the auditor may be complex and the auditor may consider it appropriate to obtain legal advice.

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<sup>24</sup> The IESBA Code provides guidance on communications with an auditor replacing the existing auditor.

<sup>25</sup> ISA 580, *Written Representations*

*Communication to Management* (Ref: Para. 41)

A62. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

*Communication with Those Charged with Governance* (Ref: Para. 42)

A63. The auditor's communication with those charged with governance may be made orally or in writing. ISA 260 (Revised) identifies factors the auditor considers in determining whether to communicate orally or in writing.<sup>26</sup> Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.

A64. In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.

A65. In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

*Other Matters Related to Fraud* (Ref: Para. 43)

A66. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified significant deficiencies in internal control, or to appropriately respond to an identified fraud.

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<sup>26</sup> ISA 260 (Revised), paragraph A38

- The auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

**Reporting Fraud to an Appropriate Authority Outside the Entity** (Ref: Para. 44)

- A67. ISA 250 (Revised)<sup>27</sup> provides further guidance with respect to the auditor's determination of whether reporting identified or suspected non-compliance with laws or regulations to an appropriate authority outside the entity is required or appropriate in the circumstances, including consideration of the auditor's duty of confidentiality.
- A68. The determination required by paragraph 44 may involve complex considerations and professional judgments. Accordingly, the auditor may consider consulting internally (e.g., within the firm or a network firm) or on a confidential basis with a regulator or professional body (unless doing so is prohibited by law or regulation or would breach the duty of confidentiality). The auditor may also consider obtaining legal advice to understand the auditor's options and the professional or legal implications of taking any particular course of action.

*Considerations Specific to Public Sector Entities*

- A69. In the public sector, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related law, regulation or other authority.

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<sup>27</sup> ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraphs A28–A34

## Appendix 1

(Ref: Para. A26)

### Examples of Fraud Risk Factors

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

#### Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

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

##### *Incentives/Pressures*

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

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

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

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive – including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

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

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.<sup>1</sup>
- Personal guarantees of debts of the entity.

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

### *Opportunities*

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

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.

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<sup>1</sup> Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

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- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult “substance over form” questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

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

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

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

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of staff in accounting, information technology, or the internal audit function that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

*Attitudes/Rationalizations*

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.

- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
  - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
  - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
  - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
  - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

### **Risk Factors Arising from Misstatements Arising from Misappropriation of Assets**

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

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or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

*Incentives/Pressures*

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

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

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

*Opportunities*

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

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

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

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other re-imbursments.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.

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- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

*Attitudes/Rationalizations*

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

## Appendix 2

(Ref: Para. A41)

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

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

#### **Consideration at the Assertion Level**

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

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.

- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

### **Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting**

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

#### *Revenue Recognition*

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.

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- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

*Inventory Quantities*

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

*Management Estimates*

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

### **Specific Responses—Misstatements Due to Misappropriation of Assets**

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

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

- Counting cash or securities at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analyzing recoveries of written-off accounts.
- Analyzing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analyzing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

## Appendix 3

(Ref: Para. A50)

### Examples of Circumstances that Indicate the Possibility of Fraud

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

*Discrepancies in the accounting records, including:*

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

*Conflicting or missing evidence, including:*

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

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- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

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

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

*Other*

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

**INTERNATIONAL STANDARD ON AUDITING 250 (REVISED)**  
**CONSIDERATION OF LAWS AND REGULATIONS IN AN**  
**AUDIT OF FINANCIAL STATEMENTS**

(Effective for audits of financial statements for periods beginning  
on or after December 15, 2017)

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International Standard on Auditing (ISA) 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to consider laws and regulations in an audit of financial statements. This ISA does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

### Effect of Laws and Regulations

2. The effect on financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health, and equal employment opportunity). Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

### Responsibility for Compliance with Laws and Regulations (Ref: Para. A1–A8)

3. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

#### *Responsibility of the Auditor*

4. The requirements in this ISA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.
5. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether due to fraud or error.<sup>1</sup> In conducting an audit of financial statements, the auditor

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<sup>1</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 5

takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.<sup>2</sup> In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- There are many laws and regulations, relating principally to the operating aspects of an entity, that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body.

Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognize the non-compliance.

6. This ISA distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows: (Ref: Para. A6, A12–A13)
  - (a) The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and pension laws and regulations (see paragraph 14) (Ref: Para. A12); and
  - (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (e.g., compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements (see paragraph 15) (Ref: Para. A13).
7. In this ISA, differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in paragraph 6(a), the auditor's responsibility is to obtain sufficient appropriate audit evidence regarding

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<sup>2</sup> ISA 200, paragraphs A53–A54

compliance with the provisions of those laws and regulations. For the category referred to in paragraph 6(b), the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

8. The auditor is required by this ISA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of non-compliance to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by ISA 200,<sup>3</sup> is important in this context, given the extent of laws and regulations that affect the entity.
9. The auditor may have additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's non-compliance with laws and regulations, which may differ from or go beyond this ISA, such as: (Ref: Para. A8)
  - (a) Responding to identified or suspected non-compliance with laws and regulations, including requirements in relation to specific communications with management and those charged with governance, assessing the appropriateness of their response to non-compliance and determining whether further action is needed;
  - (b) Communicating identified or suspected non-compliance with laws and regulations to other auditors (e.g., in an audit of group financial statements); and
  - (c) Documentation requirements regarding identified or suspected non-compliance with laws and regulations.

Complying with any additional responsibilities may provide further information that is relevant to the auditor's work in accordance with this and other ISAs (e.g., regarding the integrity of management or, where appropriate, those charged with governance).

### **Effective Date**

10. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2017.

### **Objectives**

11. The objectives of the auditor are:
  - (a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements;

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<sup>3</sup> ISA 200, paragraph 15

- (b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and
- (c) To respond appropriately to identified or suspected non-compliance with laws and regulations identified during the audit.

## Definition

12. For the purposes of this ISA, the following term has the meaning attributed below:

Non-compliance – Acts of omission or commission, intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity, which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity. (Ref: Para. A9–A10)

## Requirements

### The Auditor’s Consideration of Compliance with Laws and Regulations

13. As part of obtaining an understanding of the entity and its environment in accordance with ISA 315 (Revised),<sup>4</sup> the auditor shall obtain a general understanding of:
- (a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
  - (b) How the entity is complying with that framework. (Ref: Para. A11)
14. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. (Ref: Para. A12)
15. The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements: (Ref: Para. A13–A14)
- (a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
  - (b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

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<sup>4</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 11

16. During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. (Ref: Para. A15)
17. The auditor shall request management and, where appropriate, those charged with governance, to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. (Ref: Para. A16)
18. In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations, other than those set out in paragraphs 13–17.

### **Audit Procedures When Non-Compliance Is Identified or Suspected**

19. If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: (Ref: Para. A17–A18)
  - (a) An understanding of the nature of the act and the circumstances in which it has occurred; and
  - (b) Further information to evaluate the possible effect on the financial statements. (Ref: Para. A19)
20. If the auditor suspects there may be non-compliance, the auditor shall discuss the matter, unless prohibited by law or regulation, with the appropriate level of management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. (Ref: Para. A20–A22)
21. If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.
22. The auditor shall evaluate the implications of identified or suspected non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action. (Ref: Para. A23–A25)

### **Communicating and Reporting Identified or Suspected Non-Compliance**

#### *Communicating Identified or Suspected Non-Compliance with Those Charged with Governance*

23. Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected

non-compliance already communicated by the auditor,<sup>5</sup> the auditor shall communicate, unless prohibited by law or regulation, with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

24. If, in the auditor's judgment, the non-compliance referred to in paragraph 23 is believed to be intentional and material, the auditor shall communicate the matter with those charged with governance as soon as practicable.
25. If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

*Potential Implications of Identified or Suspected Non-Compliance for the Auditor's Report* (Ref: Para. A26–A27)

26. If the auditor concludes that the identified or suspected non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with ISA 705 (Revised), express a qualified opinion or an adverse opinion on the financial statements.<sup>6</sup>
27. If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with ISA 705 (Revised).<sup>7</sup>
28. If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with ISA 705 (Revised).

*Reporting Identified or Suspected Non-Compliance to an Appropriate Authority outside the Entity*

29. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether law, regulation or relevant ethical requirements: (Ref: Para. A28–A34)

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<sup>5</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

<sup>6</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, paragraphs 7–8

<sup>7</sup> ISA 705 (Revised), paragraphs 7 and 9

- (a) Require the auditor to report to an appropriate authority outside the entity.
- (b) Establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.

### **Documentation**

30. The auditor shall include in the audit documentation<sup>8</sup> identified or suspected non-compliance with laws and regulations and: (Ref: Para. A35–A36)
  - (a) The audit procedures performed, the significant professional judgments made and the conclusions reached thereon; and
  - (b) The discussions of significant matters related to the non-compliance with management, those charged with governance and others, including how management and, where applicable, those charged with governance have responded to the matter.

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## **Application and Other Explanatory Material**

### **Responsibility for Compliance with Laws and Regulations (Ref: Para. 3–9)**

- A1. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with laws and regulations. Laws and regulations may affect an entity's financial statements in different ways: for example, most directly, they may affect specific disclosures required of the entity in the financial statements or they may prescribe the applicable financial reporting framework. They may also establish certain legal rights and obligations of the entity, some of which will be recognized in the entity's financial statements. In addition, laws and regulations may impose penalties in cases of non-compliance.
- A2. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:
  - Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
  - Instituting and operating appropriate systems of internal control.
  - Developing, publicizing and following a code of conduct.
  - Ensuring employees are properly trained and understand the code of conduct.

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<sup>8</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- An internal audit function.
- An audit committee.
- A compliance function.

### *Responsibility of the Auditor*

- A3. Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit including, for example, the auditor's consideration of the integrity of management, those charged with governance or employees.
- A4. Whether an act constitutes non-compliance with laws and regulations is a matter to be determined by a court or other appropriate adjudicative body, which is ordinarily beyond the auditor's professional competence to determine. Nevertheless, the auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognize that some acts, coming to the auditor's attention, may constitute non-compliance with laws and regulations.
- A5. In accordance with specific statutory requirements, the auditor may be specifically required to report, as part of the audit of the financial statements, on whether the entity complies with certain provisions of laws or regulations. In these circumstances, ISA 700 (Revised)<sup>9</sup> or ISA 800 (Revised)<sup>10</sup> deal with how these audit responsibilities are addressed in the auditor's report. Furthermore, where there are specific statutory reporting requirements, it may be necessary for the audit plan to include appropriate tests for compliance with these provisions of the laws and regulations.

### Categories of Laws and Regulations (Ref: Para. 6)

- A6. The nature and circumstances of the entity may impact whether relevant laws and regulations are within the categories of laws and regulations described in

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<sup>9</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 43

<sup>10</sup> ISA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, paragraph 11

paragraphs 6(a) or 6(b). Examples of laws and regulations that may be included in the categories described in paragraph 6 include those that deal with:

- Fraud, corruption and bribery.
- Money laundering, terrorist financing and proceeds of crime.
- Securities markets and trading.
- Banking and other financial products and services.
- Data protection.
- Tax and pension liabilities and payments.
- Environmental protection.
- Public health and safety.

#### Considerations Specific to Public Sector Entities

A7. In the public sector, there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations.

#### Additional Responsibilities Established by Law, Regulation or Relevant Ethical Requirements (Ref: Para. 9)

A8. Law, regulation or relevant ethical requirements may require the auditor to perform additional procedures and take further actions. For example, the International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) requires the auditor to take steps to respond to identified or suspected non-compliance with laws and regulations and determine whether further action is needed. Such steps may include the communication of identified or suspected non-compliance with laws and regulations to other auditors within a group, including a group engagement partner, component auditors or other auditors performing work at components of a group for purposes other than the audit of the group financial statements.<sup>11</sup>

#### Definition (Ref: Para. 12)

- A9. Acts of non-compliance with laws and regulations include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, by management or by other individuals working for or under the direction of the entity.
- A10. Non-compliance also includes personal misconduct related to the business activities of the entity, for example, in circumstances where an individual in a

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<sup>11</sup> See, for example, paragraphs R360.16–360.18 A1 of the IESBA Code.

key management position, in a personal capacity, has accepted a bribe from a supplier of the entity and in return secures the appointment of the supplier to provide services or contracts to the entity.

### **The Auditor's Consideration of Compliance with Laws and Regulations**

*Obtaining an Understanding of the Legal and Regulatory Framework* (Ref: Para. 13)

A11. To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example:

- Use the auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations; and
- Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

*Laws and Regulations Generally Recognized to Have a Direct Effect on the Determination of Material Amounts and Disclosures in the Financial Statements* (Ref: Para. 6 and 14)

A12. Certain laws and regulations are well-established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements (as described in paragraph 6(a)). They could include those that relate to, for example:

- The form and content of financial statements;
- Industry-specific financial reporting issues;
- Accounting for transactions under government contracts; or
- The accrual or recognition of expenses for income tax or pension costs.

Some provisions in those laws and regulations may be directly relevant to specific assertions in the financial statements (e.g., the completeness of income tax provisions), while others may be directly relevant to the financial statements as a whole (e.g., the required statements constituting a complete set of financial statements). The aim of the requirement in paragraph 14 is for the auditor to obtain sufficient appropriate audit evidence regarding the determination of amounts and disclosures in the financial statements in compliance with the relevant provisions of those laws and regulations.

Non-compliance with other provisions of such laws and regulations and other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements as described in paragraph 6(a).

*Procedures to Identify Instances of Non-Compliance—Other Laws and Regulations*  
(Ref: Para. 6 and 15)

- A13. Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity (as described in paragraph 6(b)). Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern.<sup>12</sup> For example, non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (e.g., for a bank, non-compliance with capital or investment requirements). There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- A14. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures required by paragraph 15 are directed to bringing to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

*Non-Compliance Brought to the Auditor's Attention by Other Audit Procedures*  
(Ref: Para. 16)

- A15. Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. For example, such audit procedures may include:
- Reading minutes;
  - Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and
  - Performing substantive tests of details of classes of transactions, account balances or disclosures.

*Written Representations* (Ref: Para. 17)

- A16. Because the effect on financial statements of laws and regulations can vary considerably, written representations provide necessary audit evidence

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<sup>12</sup> See ISA 570 (Revised), *Going Concern*.

about management's knowledge of identified or suspected non-compliance with laws and regulations, whose effects may have a material effect on the financial statements. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the nature and extent of other audit evidence that is to be obtained by the auditor.<sup>13</sup>

### **Audit Procedures When Non-Compliance Is Identified or Suspected**

*Indications of Non-Compliance with Laws and Regulations* (Ref: Para. 19)

A17. The auditor may become aware of information concerning an instance of non-compliance with laws and regulations other than as a result of performing the procedures in paragraphs 13–17 (e.g., when the auditor is alerted to non-compliance by a whistle blower).

A18. The following matters may be an indication of non-compliance with laws and regulations:

- Investigations by regulatory organizations and government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' checks payable to bearer or transfers to numbered bank accounts.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorized transactions or improperly recorded transactions.
- Adverse media comment.

*Matters Relevant to the Auditor's Evaluation* (Ref: Para. 19(b))

A19. Matters relevant to the auditor's evaluation of the possible effect on the financial statements include:

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<sup>13</sup> ISA 580, *Written Representations*, paragraph 4

- The potential financial consequences of identified or suspected non-compliance with laws and regulations on the financial statements including, for example, the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations, and litigation.
- Whether the potential financial consequences require disclosure.
- Whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements, or otherwise make the financial statements misleading.

*Audit Procedures and Communicating Identified or Suspected Non-Compliance with Management and Those Charged with Governance (Ref: Para. 20)*

- A20. The auditor is required to discuss the suspected non-compliance with the appropriate level of management and, where appropriate, those charged with governance, as they may be able to provide additional audit evidence. For example, the auditor may confirm that management and, where appropriate, those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the suspected non-compliance with laws and regulations.
- A21. However, in some jurisdictions, law or regulation may restrict the auditor's communication of certain matters with management and those charged with governance. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the auditor is required to report the identified or suspected non-compliance to an appropriate authority pursuant to anti-money laundering legislation. In these circumstances, the issues considered by the auditor may be complex and the auditor may consider it appropriate to obtain legal advice.
- A22. If management or, as appropriate, those charged with governance do not provide sufficient information to the auditor that the entity is in fact in compliance with laws and regulations, the auditor may consider it appropriate to consult with the entity's in-house or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible effects on the financial statements. If it is not considered appropriate to consult with the entity's legal counsel or if the auditor is not satisfied with the legal counsel's opinion, the auditor may consider it appropriate to consult on a confidential basis with others within the firm, a network firm, a professional body, or with the auditor's legal counsel as to whether a contravention of a law or regulation is involved, including the possibility of fraud, the possible legal consequences, and what further action, if any, the auditor would take.

*Evaluating the Implications of Identified or Suspected Non-Compliance*  
(Ref: Para. 22)

- A23. As required by paragraph 22, the auditor evaluates the implications of identified or suspected non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular identified or suspected non-compliance will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or individuals working for, or under the direction of, the entity involved, especially implications arising from the involvement of the highest authority within the entity. As noted in paragraph 9, the auditor's compliance with law, regulation or relevant ethical requirements may provide further information that is relevant to the auditor's responsibilities in accordance with paragraph 22.
- A24. Examples of circumstances that may cause the auditor to evaluate the implications of identified or suspected non-compliance on the reliability of written representations received from management and, where applicable, those charged with governance include when:
- The auditor suspects or has evidence of the involvement or intended involvement of management and, where applicable, those charged with governance in any identified or suspected non-compliance.
  - The auditor is aware that management and, where applicable, those charged with governance have knowledge of such non-compliance and, contrary to legal or regulatory requirements, have not reported, or authorized reporting of, the matter to an appropriate authority within a reasonable period.
- A25. In certain circumstances, the auditor may consider withdrawing from the engagement, where permitted by law or regulation, for example when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances or the identified or suspected non-compliance raises questions regarding the integrity of management or those charged with governance, even when the non-compliance is not material to the financial statements. The auditor may consider it appropriate to obtain legal advice to determine whether withdrawal from the engagement is appropriate. When the auditor determines that withdrawing from the engagement would be appropriate, doing so would not be a substitute for complying with other responsibilities under law, regulation or relevant ethical requirements to respond to identified or suspected non-compliance. Furthermore, paragraph A9 of ISA 220<sup>14</sup> indicates that some ethical requirements may require the predecessor auditor, upon request by the proposed successor auditor, to provide information regarding non-compliance with laws and regulations to the successor auditor.

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<sup>14</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

## **Communicating and Reporting Identified or Suspected Non-Compliance**

*Potential Implications of Identified or Suspected Non-Compliance for the Auditor's Report (Ref: Para. 26–28)*

A26. Identified or suspected non-compliance with laws and regulation is communicated in the auditor's report when the auditor modifies the opinion in accordance with paragraphs 26–28. In certain other circumstances, the auditor may communicate identified or suspected non-compliance in the auditor's report, for example:

- When the auditor has other reporting responsibilities, in addition to the auditor's responsibilities under the ISAs, as contemplated by paragraph 43 of ISA 700 (Revised);
- When the auditor determines that the identified or suspected non-compliance is a key audit matter and accordingly communicates the matter in accordance with ISA 701,<sup>15</sup> unless paragraph 14 of that ISA applies; or
- In exceptional cases when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances and withdrawal from the engagement is not possible (see paragraph A25), the auditor may consider describing the identified or suspected non-compliance in an Other Matter paragraph in accordance with ISA 706 (Revised).<sup>16</sup>

A27. Law or regulation may preclude public disclosure by either management, those charged with governance or the auditor about a specific matter. For example, law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including a prohibition on alerting the entity. When the auditor intends to communicate identified or suspected non-compliance in the auditor's report under the circumstances set out in paragraph A26 or otherwise, such law or regulation may have implications for the auditor's ability to describe the matter in the auditor's report, or in some circumstances to issue the auditor's report. In such cases, the auditor may consider obtaining legal advice to determine the appropriate course of action.

*Reporting Identified or Suspected Non-Compliance to an Appropriate Authority outside the Entity (Ref: Para. 29)*

A28. Reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity may be required or appropriate in the circumstances because:

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<sup>15</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

<sup>16</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF  
FINANCIAL STATEMENTS

- (a) Law, regulation or relevant ethical requirements require the auditor to report (see paragraph A29);
  - (b) The auditor has determined reporting is an appropriate action to respond to identified or suspected non-compliance in accordance with relevant ethical requirements (see paragraph A30); or
  - (c) Law, regulation or relevant ethical requirements provide the auditor with the right to do so (see paragraph A31).
- A29. In some jurisdictions, the auditor may be required by law, regulation or relevant ethical requirements to report identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity. For example, in some jurisdictions, statutory requirements exist for the auditor of a financial institution to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to a supervisory authority. Also, misstatements may arise from non-compliance with laws or regulations and, in some jurisdictions, the auditor may be required to report misstatements to an appropriate authority in cases where management or those charged with governance fail to take corrective action.
- A30. In other cases, the relevant ethical requirements may require the auditor to determine whether reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity is an appropriate action in the circumstances. For example, the IESBA Code requires the auditor to take steps to respond to identified or suspected non-compliance with laws and regulations and determine whether further action is needed, which may include reporting to an appropriate authority outside the entity.<sup>17</sup> The IESBA Code explains that such reporting would not be considered a breach of the duty of confidentiality under the IESBA Code.<sup>18</sup>
- A31. Even if law, regulation or relevant ethical requirements do not include requirements that address reporting identified or suspected non-compliance, they may provide the auditor with the right to report identified or suspected non-compliance to an appropriate authority outside the entity. For example, when auditing the financial statements of financial institutions, the auditor may have the right under law or regulation to discuss matters such as identified or suspected non-compliance with laws and regulations with a supervisory authority.
- A32. In other circumstances, the reporting of identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity may be precluded by the auditor's duty of confidentiality under law, regulation or relevant ethical requirements.

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<sup>17</sup> See, for example, paragraphs 360.21 A1 and 360.25 A1–R360.27 of the IESBA Code.

<sup>18</sup> See, for example, paragraphs R114.1–114.1 A1 and R360.26 of the IESBA Code.

A33. The determination required by paragraph 29 may involve complex considerations and professional judgments. Accordingly the auditor may consider consulting internally (e.g., within the firm or a network firm) or on a confidential basis with a regulator or professional body (unless doing so is prohibited by law or regulation or would breach the duty of confidentiality). The auditor may also consider obtaining legal advice to understand the auditor's options and the professional or legal implications of taking any particular course of action.

#### Considerations Specific to Public Sector Entities

A34. A public sector auditor may be obliged to report on identified or suspected non-compliance to the legislature or other governing body or to report them in the auditor's report.

#### **Documentation** (Ref: Para. 30)

A35. The auditor's documentation of findings regarding identified or suspected non-compliance with laws and regulations may include, for example:

- Copies of records or documents.
- Minutes of discussions held with management, those charged with governance or parties outside the entity.

A36. Law, regulation or relevant ethical requirements may also set out additional documentation requirements regarding identified or suspected non-compliance with laws and regulations.<sup>19</sup>

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<sup>19</sup> See, for example, paragraph R360.28 of the IESBA Code.

**INTERNATIONAL STANDARD ON AUDITING 260 (REVISED)**  
**COMMUNICATION WITH THOSE CHARGED  
WITH GOVERNANCE**

(Effective for audits of financial statements for periods ending  
on or after December 15, 2016)

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International Standard on Auditing (ISA) 260 (Revised), *Communication with Those Charged with Governance*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. Although this ISA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities. This ISA does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.
2. This ISA is written in the context of an audit of financial statements, but may also be applicable, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation of the other historical financial information.
3. Recognizing the importance of effective two-way communication in an audit of financial statements, this ISA provides an overarching framework for the auditor's communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the requirements of this ISA, are identified in other ISAs (see Appendix 1). In addition, ISA 265<sup>1</sup> establishes specific requirements regarding the communication of significant deficiencies in internal control the auditor has identified during the audit to those charged with governance. Further matters, not required by this or other ISAs, may be required to be communicated by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement, for example, the standards of a national professional accountancy body. Nothing in this ISA precludes the auditor from communicating any other matters to those charged with governance. (Ref: Para. A33–A36)

### The Role of Communication

4. This ISA focuses primarily on communications from the auditor to those charged with governance. Nevertheless, effective two-way communication is important in assisting:
  - (a) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity;
  - (b) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may

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<sup>1</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and

- (c) Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.
5. Although the auditor is responsible for communicating matters required by this ISA, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility. Similarly, communication by management with those charged with governance of matters that the auditor is required to communicate does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor's communication with those charged with governance.
6. Clear communication of specific matters required to be communicated by ISAs is an integral part of every audit. ISAs do not, however, require the auditor to perform procedures specifically to identify any other matters to communicate with those charged with governance.
7. In some jurisdictions, law or regulation may restrict the auditor's communication of certain matters with those charged with governance. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the auditor is required to report identified or suspected non-compliance with laws and regulations to an appropriate authority pursuant to anti-money laundering legislation. In these circumstances, the issues considered by the auditor may be complex and the auditor may consider it appropriate obtain legal advice.

### **Effective Date**

8. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2016.

### **Objectives**

9. The objectives of the auditor are:
- (a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
  - (b) To obtain from those charged with governance information relevant to the audit;

- (c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
- (d) To promote effective two-way communication between the auditor and those charged with governance.

## Definitions

10. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Those charged with governance – The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager. For discussion of the diversity of governance structures, see paragraphs A1–A8.
  - (b) Management – The person(s) with executive responsibility for the conduct of the entity’s operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

## Requirements

### Those Charged with Governance

11. The auditor shall determine the appropriate person(s) within the entity’s governance structure with whom to communicate. (Ref: Para. A1–A4)

### *Communication with a Subgroup of Those Charged with Governance*

12. If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. (Ref: Para. A5–A7)

### *When All of Those Charged with Governance Are Involved in Managing the Entity*

13. In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this ISA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role.

These matters are noted in paragraph 16(c). The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Ref: Para. A8)

## **Matters to Be Communicated**

### *The Auditor's Responsibilities in Relation to the Financial Statement Audit*

14. The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:
  - (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and
  - (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A9–A10)

### *Planned Scope and Timing of the Audit*

15. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor. (Ref: Para. A11–A16)

### *Significant Findings from the Audit*

16. The auditor shall communicate with those charged with governance: (Ref: Para. A17–A18)
  - (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A19–A20)
  - (b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A21)
  - (c) Unless all of those charged with governance are involved in managing the entity:
    - (i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and (Ref: Para. A22)
    - (ii) Written representations the auditor is requesting;

- (d) Circumstances that affect the form and content of the auditor's report, if any; and (Ref: Para. A23–A25)
- (e) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process. (Ref: Para. A26–A28)

### *Auditor Independence*

17. In the case of listed entities, the auditor shall communicate with those charged with governance:
  - (a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and
    - (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and
    - (ii) In respect of threats to independence that are not at an acceptable level, the actions taken to address the threats, including actions that were taken to eliminate the circumstances that create the threats, or applying safeguards to reduce the threats to an acceptable level. (Ref: Para. A29–A32)

## **The Communication Process**

### *Establishing the Communication Process*

18. The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. (Ref: Para. A37–A45)

### *Forms of Communication*

19. The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. (Ref: Para. A46–A48)
20. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 17.

*Timing of Communications*

21. The auditor shall communicate with those charged with governance on a timely basis. (Ref: Para. A49–A50)

*Adequacy of the Communication Process*

22. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor’s assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action. (Ref: Para. A51–A53)

**Documentation**

23. Where matters required by this ISA to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.<sup>2</sup> (Ref: Para. A54)

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**Application and Other Explanatory Material****Those Charged with Governance** (Ref: Para. 11)

- A1. Governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example:
- In some jurisdictions, a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a “two-tier board” structure). In other jurisdictions, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a “one-tier board” structure).
  - In some entities, those charged with governance hold positions that are an integral part of the entity’s legal structure, for example, company directors. In others, for example, some government entities, a body that is not part of the entity is charged with governance.
  - In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.

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<sup>2</sup> ISA 230, *Audit Documentation*, paragraphs 8–11 and A6

- In some cases, those charged with governance are responsible for approving<sup>3</sup> the entity's financial statements (in other cases management has this responsibility).
- A2. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.
- A3. Such diversity means that it is not possible for this ISA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with ISA 315 (Revised)<sup>4</sup> is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.
- A4. ISA 600 includes specific matters to be communicated by group auditors with those charged with governance.<sup>5</sup> When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (e.g., common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

<sup>3</sup> As described in paragraph A68 of ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

<sup>4</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>5</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph 49

*Communication with a Subgroup of Those Charged with Governance* (Ref: Para. 12)

- A5. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:
- The respective responsibilities of the subgroup and the governing body.
  - The nature of the matter to be communicated.
  - Relevant legal or regulatory requirements.
  - Whether the subgroup has the authority to take action in relation to the information communicated, and can provide further information and explanations the auditor may need.
- A6. When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in agreeing the terms of engagement that, unless prohibited by law or regulation, the auditor retains the right to communicate directly with the governing body.
- A7. Audit committees (or similar subgroups with different names) exist in many jurisdictions. Although their specific authority and functions may differ, communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:
- The auditor will be invited to regularly attend meetings of the audit committee.
  - The chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.
  - The audit committee will meet the auditor without management present at least annually.

*When All of Those Charged with Governance Are Involved in Managing the Entity*  
(Ref: Para.13)

- A8. In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognize this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

## Matters to Be Communicated

*The Auditor's Responsibilities in Relation to the Financial Statement Audit* (Ref: Para. 14)

A9. The auditor's responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement.<sup>6</sup> Law, regulation or the governance structure of the entity may require those charged with governance to agree the terms of the engagement with the auditor. When this is not the case, providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them regarding such matters as:

- The auditor's responsibility for performing the audit in accordance with ISAs, which is directed towards the expression of an opinion on the financial statements. The matters that ISAs require to be communicated, therefore, include significant matters arising during the audit of the financial statements that are relevant to those charged with governance in overseeing the financial reporting process.
- The fact that ISAs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- When ISA 701<sup>7</sup> applies, the auditor's responsibilities to determine and communicate key audit matters in the auditor's report.
- When applicable, the auditor's responsibility for communicating particular matters required by law or regulation, by agreement with the entity or by additional requirements applicable to the engagement, for example, the standards of a national professional accountancy body.

A10. Law or regulation, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with those charged with governance. For example, (a) an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or (b) the mandate of a public sector auditor may provide for matters to be communicated that come to the auditor's attention as a result of other work, such as performance audits.

*Planned Scope and Timing of the Audit* (Ref: Para. 15)

A11. Communication regarding the planned scope and timing of the audit may:

- (a) Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the

<sup>6</sup> See paragraph 10 of ISA 210, *Agreeing the Terms of Audit Engagements*.

<sup>7</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures; and

- (b) Assist the auditor to understand better the entity and its environment.

A12. Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they require special audit consideration. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

A13. Matters communicated may include:

- How the auditor plans to address the significant risks of material misstatement, whether due to fraud or error.
- How the auditor plans to address areas of higher assessed risks of material misstatement.
- The auditor's approach to internal control relevant to the audit.
- The application of the concept of materiality in the context of an audit.<sup>8</sup>
- The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor's expert.<sup>9</sup>
- When ISA 701 applies, the auditor's preliminary views about matters that may be areas of significant auditor attention in the audit and therefore may be key audit matters.
- The auditor's planned approach to addressing the implications on the individual statements and the disclosures of any significant changes within the applicable financial reporting framework or in the entity's environment, financial condition or activities.

A14. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, how the external auditor and internal auditors can work together in a constructive and complementary manner, including any planned use of the work of the internal audit function, and the nature and extent of any planned use of internal auditors to provide direct assistance.<sup>10</sup>
- The views of those charged with governance about:
  - The appropriate person(s) in the entity's governance structure with whom to communicate.

<sup>8</sup> ISA 320, *Materiality in Planning and Performing an Audit*

<sup>9</sup> See ISA 620, *Using the Work of an Auditor's Expert*.

<sup>10</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraphs 20 and 31

- The allocation of responsibilities between those charged with governance and management.
  - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
  - Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
  - Significant communications between the entity and regulators.
  - Other matters those charged with governance consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
  - The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters, and the effect of such developments on, for example, the overall presentation, structure and content of the financial statements, including:
    - The relevance, reliability, comparability and understandability of the information presented in the financial statements; and
    - Considering whether the financial statements are undermined by the inclusion of information that is not relevant or that obscures a proper understanding of the matters disclosed.
  - The responses of those charged with governance to previous communications with the auditor.
  - The documents comprising the other information (as defined in ISA 720 (Revised)) and the planned manner and timing of the issuance of such documents. When the auditor expects to obtain other information after the date of the auditor's report, the discussions with those charged with governance may also include the actions that may be appropriate or necessary if the auditor concludes that a material misstatement of the other information exists in other information obtained after the date of the auditor's report.
- A15. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

A16. Care is necessary when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

*Significant Findings from the Audit* (Ref: Para. 16)

A17. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

A18. When ISA 701 applies, the communications with those charged with governance required by paragraph 16, as well as the communication about the significant risks identified by the auditor required by paragraph 15, are particularly relevant to the auditor's determination of matters that required significant auditor attention and which therefore may be key audit matters.<sup>11</sup>

*Significant Qualitative Aspects of Accounting Practices* (Ref: Para. 16(a))

A19. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures, for example, in relation to the use of assumptions in the development of accounting estimates. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to "critical accounting estimates" or "critical accounting policies and practices" to identify and provide additional information to users about the most difficult, subjective or complex judgments made by management in preparing the financial statements.

A20. As a result, the auditor's views on the subjective aspects of the financial statements may be particularly relevant to those charged with governance in discharging their responsibilities for oversight of the financial reporting process. For example, in relation to the matters described in paragraph A19, those charged with governance may be interested in the auditor's views on the degree to which complexity, subjectivity or other inherent risk factors affect the selection or application of the methods, assumptions and data used in making a significant accounting estimate, as well as the auditor's evaluation of whether management's point estimate and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework. Open and constructive communication about significant qualitative aspects of the entity's accounting practices also may include comment on the acceptability of significant accounting practices and on the quality of the disclosures. When

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<sup>11</sup> ISA 701, paragraphs 9–10

applicable, this may include whether a significant accounting practice of the entity relating to accounting estimates is considered by the auditor not to be most appropriate to the particular circumstances of the entity, for example, when an alternative acceptable method for making an accounting estimate would, in the auditor's judgment, be more appropriate. Appendix 2 identifies matters that may be included in this communication.

#### Significant Difficulties Encountered during the Audit (Ref: Para. 16(b))

A21. Significant difficulties encountered during the audit may include such matters as:

- Significant delays by management, the unavailability of entity personnel, or an unwillingness by management to provide information necessary for the auditor to perform the auditor's procedures.
- An unreasonably brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- The unavailability of expected information.
- Restrictions imposed on the auditor by management.
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.<sup>12</sup>

#### Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 16(c)(i))

A22. Significant matters discussed, or subject to correspondence with management may include such matters as:

- Significant events or transactions that occurred during the year.
- Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
- Concerns about management's consultations with other accountants on accounting or auditing matters.
- Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.
- Significant matters on which there was disagreement with management, except for initial differences of opinion because of incomplete facts or

<sup>12</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

preliminary information that are later resolved by the auditor obtaining additional relevant facts or information.

#### Circumstances that Affect the Form and Content of the Auditor's Report (Ref: Para 16(d))

- A23. ISA 210 requires the auditor to agree the terms of the audit engagement with management or those charged with governance, as appropriate.<sup>13</sup> The agreed terms of the audit engagement are required to be recorded in an audit engagement letter or other suitable form of written agreement and include, among other things, reference to the expected form and content of the auditor's report.<sup>14</sup> As explained in paragraph A9, if the terms of engagement are not agreed with those charged with governance, the auditor may provide those charged with governance with a copy of the engagement letter to communicate about matters relevant to the audit. The communication required by paragraph 16(d) is intended to inform those charged with governance about circumstances in which the auditor's report may differ from its expected form and content or may include additional information about the audit that was performed.
- A24. Circumstances in which the auditor is required or may otherwise consider it necessary to include additional information in the auditor's report in accordance with the ISAs, and for which communication with those charged with governance is required, include when:
- The auditor expects to modify the opinion in the auditor's report in accordance with ISA 705 (Revised).<sup>15</sup>
  - A material uncertainty related to going concern is reported in accordance with ISA 570 (Revised).<sup>16</sup>
  - Key audit matters are communicated in accordance with ISA 701.<sup>17</sup>
  - The auditor considers it necessary to include an Emphasis of Matter paragraph or Other Matter paragraph in accordance with ISA 706 (Revised)<sup>18</sup> or is required to do so by other ISAs.
  - The auditor has concluded that there is an uncorrected material misstatement of the other information in accordance with ISA 720 (Revised).<sup>19</sup>

In such circumstances, the auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate a discussion of how such matters will be addressed in the auditor's report.

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<sup>13</sup> ISA 210, paragraph 9

<sup>14</sup> ISA 210, paragraph 10

<sup>15</sup> ISA 705 (Revised), paragraph 30

<sup>16</sup> ISA 570 (Revised), *Going Concern*, paragraph 25(d)

<sup>17</sup> ISA 701, paragraph 17

<sup>18</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, paragraph 12

<sup>19</sup> ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, paragraph 18(a)

A25. In the rare circumstances that the auditor intends not to include the name of the engagement partner in the auditor's report in accordance with ISA 700 (Revised), the auditor is required to discuss this intention with those charged with governance to inform the auditor's assessment of the likelihood and severity of a significant personal security threat.<sup>20</sup> The auditor also may communicate with those charged with governance in circumstances when the auditor elects not to include the description of the auditor's responsibilities in the body of the auditor's report as permitted by ISA 700 (Revised).<sup>21</sup>

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 16(e))

A26. ISA 300<sup>22</sup> notes that, as a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. The auditor may communicate with those charged with governance about such matters, for example, as an update to initial discussions about the planned scope and timing of the audit.

A27. Other significant matters arising during the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of the other information that have been corrected.

A28. To the extent not already addressed by the requirements in paragraphs 16(a)–(d) and related application material, the auditor may consider communicating about other matters discussed with, or considered by, the engagement quality control reviewer, if one has been appointed, in accordance with ISA 220.<sup>23</sup>

*Auditor Independence* (Ref: Para. 17)

A29. The auditor is required to comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.<sup>24</sup>

A30. The communication about relationships and other matters, and how threats to independence that are not at an acceptable level have been addressed varies with the circumstances of the engagement and generally addresses the threats to independence, safeguards to reduce the threats, and measures to eliminate the circumstances that created the threats.

A31. Relevant ethical requirements or law or regulation may also specify particular communications to those charged with governance in circumstances where breaches of independence requirements have been identified. For example, the

<sup>20</sup> ISA 700 (Revised), paragraphs 46 and A63

<sup>21</sup> ISA 700 (Revised), paragraph 41

<sup>22</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraph A15

<sup>23</sup> See paragraphs 19–22 and A24–A34 of ISA 220, *Quality Control for an Audit of Financial Statements*.

<sup>24</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 14

International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) requires the auditor to communicate with those charged with governance in writing about any breach and the action the firm has taken or proposes to take.<sup>25</sup>

- A32. The communication requirements relating to auditor independence that apply in the case of listed entities may also be appropriate in the case of some other entities, including those that may be of significant public interest, for example, because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities. On the other hand, there may be situations where communications regarding independence may not be relevant, for example, where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond a financial statement audit.

*Supplementary Matters* (Ref: Para. 3)

- A33. The oversight of management by those charged with governance includes ensuring that the entity designs, implements and maintains appropriate internal control with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.
- A34. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, for example, significant issues regarding governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorization.
- A35. In determining whether to communicate supplementary matters with those charged with governance, the auditor may discuss matters of this kind of which the auditor has become aware with the appropriate level of management, unless it is inappropriate to do so in the circumstances.
- A36. If a supplementary matter is communicated, it may be appropriate for the auditor to make those charged with governance aware that:
- (a) Identification and communication of such matters is incidental to the purpose of the audit, which is to form an opinion on the financial statements;

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<sup>25</sup> See, for example, paragraphs R400.80–R400.82 and R400.84 of the IESBA Code

- (b) No procedures were carried out with respect to the matter other than any that were necessary to form an opinion on the financial statements; and
- (c) No procedures were carried out to determine whether other such matters exist.

### **The Communication Process**

*Establishing the Communication Process* (Ref: Para. 18)

- A37. Clear communication of the auditor’s responsibilities, the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication.
- A38. Matters that may also contribute to effective two-way communication include discussion of:
- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
  - The form in which communications will be made.
  - The person(s) in the engagement team and among those charged with governance who will communicate regarding particular matters.
  - The auditor’s expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit, for example, strategic decisions that may significantly affect the nature, timing and extent of audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.
  - The process for taking action and reporting back on matters communicated by the auditor.
  - The process for taking action and reporting back on matters communicated by those charged with governance.
- A39. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor’s view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A52).

### **Considerations Specific to Smaller Entities**

- A40. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of listed or larger entities.

### Communication with Management

- A41. Many matters may be discussed with management in the ordinary course of an audit, including matters required by this ISA to be communicated with those charged with governance. Such discussions recognize management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the preparation of the financial statements.
- A42. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management's competence or integrity with management. In addition to recognizing management's executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

### Communication with Third Parties

- A43. Those charged with governance may be required by law or regulation, or may wish, to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it may be important in the circumstances that the third parties be informed that the communication was not prepared with them in mind, for example, by stating in written communications with those charged with governance:
- (a) That the communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor, and should not be relied upon by third parties;
  - (b) That no responsibility is assumed by the auditor to third parties; and
  - (c) Any restrictions on disclosure or distribution to third parties.
- A44. In some jurisdictions the auditor may be required by law or regulation to, for example:
- Notify a regulatory or enforcement body of certain matters communicated with those charged with governance. For example, in some countries the auditor has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action;

- Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies, or other bodies such as a central authority in the case of some public sector entities; or
- Make reports prepared for those charged with governance publicly available.

A45. Unless required by law or regulation to provide a third party with a copy of the auditor's written communications with those charged with governance, the auditor may need the prior consent of those charged with governance before doing so.

*Forms of Communication* (Ref: Para. 19)

A46. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The auditor may communicate matters other than those identified in paragraphs 19–20 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

A47. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

- Whether a discussion of the matter will be included in the auditor's report. For example, when key audit matters are communicated in the auditor's report, the auditor may consider it necessary to communicate in writing about the matters determined to be key audit matters.
- Whether the matter has been satisfactorily resolved.
- Whether management has previously communicated the matter.
- The size, operating structure, control environment, and legal structure of the entity.
- In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.
- Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- Whether there have been significant changes in the membership of a governing body.

A48. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

*Timing of Communications* (Ref: Para. 21)

A49. Timely communication throughout the audit contributes to the achievement of robust two-way dialogue between those charged with governance and the auditor. However, the appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

- Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.
- It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly, the auditor may communicate orally to those charged with governance as soon as practicable significant deficiencies in internal control that the auditor has identified, prior to communicating these in writing as required by ISA 265.<sup>26</sup>
- When ISA 701 applies, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit (see paragraph A13), and the auditor also may have more frequent communications to further discuss such matters when communicating about significant audit findings.
- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and how threats to independence that are not at an acceptable level will be addressed, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion.
- Communications regarding findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices, may also be made as part of the concluding discussion.
- When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.

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<sup>26</sup> ISA 265, paragraphs 9 and A14

A50. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being audited.
- Any legal obligation to communicate certain matters within a specified timeframe.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (e.g., noncompliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

*Adequacy of the Communication Process* (Ref: Para. 22)

A51. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, for example, the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed

with the auditor affect their broader governance responsibilities, as well as their management responsibilities.

- Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A52. As noted in paragraph 4, effective two-way communication assists both the auditor and those charged with governance. Further, ISA 315 (Revised) identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment.<sup>27</sup> Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatement. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A53. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor's opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g., shareholders in a general meeting), or the responsible government minister or parliament in the public sector.
- Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

### **Documentation** (Ref: Para. 23)

A54. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

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<sup>27</sup> ISA 315 (Revised), paragraph A78

**Appendix 1**

(Ref. Para. 3)

**Specific Requirements in ISQC 1 and Other ISAs that Refer to Communications with Those Charged With Governance**

This appendix identifies paragraphs in ISQC 1<sup>1</sup> and other ISAs that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in ISAs.

- ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* – paragraph 30(a)
- ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraphs 22, 39(c)(i) and 41–43
- ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraphs 15, 20 and 23–25
- ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* – paragraph 9
- ISA 450, *Evaluation of Misstatements Identified during the Audit* – paragraphs 12–13
- ISA 505, *External Confirmations* – paragraph 9
- ISA 510, *Initial Audit Engagements—Opening Balances* – paragraph 7
- ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* – paragraph 38
- ISA 550, *Related Parties* – paragraph 27
- ISA 560, *Subsequent Events* – paragraphs 7(b)–(c), 10(a), 13(b), 14(a) and 17
- ISA 570 (Revised), *Going Concern* – paragraph 25
- ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* – paragraph 49
- ISA 610 (Revised 2013), *Using the Work of Internal Auditors* – paragraphs 20 and 31
- ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements* – paragraph 46

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<sup>1</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

- ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* – paragraph 17
- ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* – paragraphs 12, 14, 23 and 30
- ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* – paragraph 12
- ISA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* – paragraph 18
- ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information* – paragraphs 17–19

## Appendix 2

(Ref: Para. 16(a), A19–A20)

### Qualitative Aspects of Accounting Practices

The communication required by paragraph 16(a), and discussed in paragraphs A19–A20, may include such matters as:

#### Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity’s financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant accounting policies as well as information on accounting policies used by similar entities.
- The initial selection of, and changes in, significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

#### Accounting Estimates and Related Disclosures

- Appendix 2 of ISA 540 (Revised) includes matters that the auditor may consider communicating with respect to significant qualitative aspects of the entity’s accounting practices related to accounting estimates and related disclosures.

#### Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (e.g., disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).
- The overall neutrality, consistency and clarity of the disclosures in the financial statements.

**Related Matters**

- The potential effect on the financial statements of significant risks, exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. This communication may highlight:
  - The non-recurring amounts recognized during the period.
  - The extent to which such transactions are separately disclosed in the financial statements.
  - Whether such transactions appear to have been designed to achieve a particular accounting or tax treatment, or a particular legal or regulatory objective.
  - Whether the form of such transactions appears overly complex or where extensive advice regarding the structuring of the transaction has been taken.
  - Where management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.

**INTERNATIONAL STANDARD ON AUDITING 265**  
**COMMUNICATING DEFICIENCIES IN INTERNAL**  
**CONTROL TO THOSE CHARGED WITH GOVERNANCE**  
**AND MANAGEMENT**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

ISA

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control<sup>1</sup> that the auditor has identified in an audit of financial statements. This ISA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of ISA 315 (Revised) and ISA 330.<sup>2</sup> ISA 260 (Revised)<sup>3</sup> establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance in relation to the audit.
2. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement.<sup>4</sup> In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This ISA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.
3. Nothing in this ISA precludes the auditor from communicating to those charged with governance and management other internal control matters that the auditor has identified during the audit.

### Effective Date

4. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.\*

### Objective

5. The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

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<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraphs 4 and 12

<sup>2</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>3</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

<sup>4</sup> ISA 315 (Revised), paragraph 12. Paragraphs A68–A73 provide guidance on controls relevant to the audit.

## Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Deficiency in internal control – This exists when:
    - (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
    - (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.
  - (b) Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor’s professional judgment, is of sufficient importance to merit the attention of those charged with governance. (Ref: Para. A5)

## Requirements

7. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1–A4)
8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5–A11)
9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12–A18, A27)
10. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27)
  - (a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A20–A21)
  - (b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor’s professional judgment, are of sufficient importance to merit management’s attention. (Ref: Para. A22–A26)
11. The auditor shall include in the written communication of significant deficiencies in internal control:
  - (a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A28)

- (b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29–A30)
- (i) The purpose of the audit was for the auditor to express an opinion on the financial statements;
  - (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
  - (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

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## **Application and Other Explanatory Material**

### **Determination of Whether Deficiencies in Internal Control Have Been Identified**

(Ref: Para. 7)

- A1. In determining whether the auditor has identified one or more deficiencies in internal control, the auditor may discuss the relevant facts and circumstances of the auditor's findings with the appropriate level of management. This discussion provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control. In some circumstances, it may not be appropriate for the auditor to discuss the auditor's findings directly with management, for example, if the findings appear to call management's integrity or competence into question (see paragraph A20).
- A2. In discussing the facts and circumstances of the auditor's findings with management, the auditor may obtain other relevant information for further consideration, such as:
- Management's understanding of the actual or suspected causes of the deficiencies.
  - Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant information technology (IT) controls.
  - A preliminary indication from management of its response to the findings.

*Considerations Specific to Smaller Entities*

- A3. While the concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of control activities are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed control activities.
- A4. Also, smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This higher level of management oversight needs to be balanced against the greater potential for management override of controls.

**Significant Deficiencies in Internal Control** (Ref: Para. 6(b), 8)

- A5. The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may therefore exist even though the auditor has not identified misstatements during the audit.
- A6. Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:
- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
  - The susceptibility to loss or fraud of the related asset or liability.
  - The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
  - The financial statement amounts exposed to the deficiencies.
  - The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
  - The importance of the controls to the financial reporting process; for example:
    - General monitoring controls (such as oversight of management).
    - Controls over the prevention and detection of fraud.
    - Controls over the selection and application of significant accounting policies.

- Controls over significant transactions with related parties.
- Controls over significant transactions outside the entity's normal course of business.
- Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.

A7. Indicators of significant deficiencies in internal control include, for example:

- Evidence of ineffective aspects of the control environment, such as:
  - Indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance.
  - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
  - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (for example, absence of controls over such a risk).
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.
- Evidence of management's inability to oversee the preparation of the financial statements.

A8. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements.<sup>5</sup> For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently

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<sup>5</sup> ISA 315, paragraph A74

important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account balance or disclosure, relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

- A9. Law or regulation in some jurisdictions may establish a requirement (particularly for audits of listed entities) for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) one or more specific types of deficiency in internal control that the auditor has identified during the audit. Where law or regulation has established specific terms and definitions for these types of deficiency and requires the auditor to use these terms and definitions for the purpose of the communication, the auditor uses such terms and definitions when communicating in accordance with the legal or regulatory requirement.
- A10. Where the jurisdiction has established specific terms for the types of deficiency in internal control to be communicated but has not defined such terms, it may be necessary for the auditor to use judgment to determine the matters to be communicated further to the legal or regulatory requirement. In doing so, the auditor may consider it appropriate to have regard to the requirements and guidance in this ISA. For example, if the purpose of the legal or regulatory requirement is to bring to the attention of those charged with governance certain internal control matters of which they should be aware, it may be appropriate to regard such matters as being generally equivalent to the significant deficiencies required by this ISA to be communicated to those charged with governance.
- A11. The requirements of this ISA remain applicable notwithstanding that law or regulation may require the auditor to use specific terms or definitions.

### **Communication of Deficiencies in Internal Control**

#### *Communication of Significant Deficiencies in Internal Control to Those Charged with Governance (Ref: Para. 9)*

- A12. Communicating significant deficiencies in writing to those charged with governance reflects the importance of these matters, and assists those charged with governance in fulfilling their oversight responsibilities. ISA 260 (Revised) establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.<sup>6</sup>
- A13. In determining when to issue the written communication, the auditor may consider whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. In addition, for listed entities in certain jurisdictions, those charged with governance may need to receive the auditor's written communication before the date of approval of the financial statements in

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<sup>6</sup> ISA 260 (Revised), paragraph 13

order to discharge specific responsibilities in relation to internal control for regulatory or other purposes. For other entities, the auditor may issue the written communication at a later date. Nevertheless, in the latter case, as the auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement<sup>7</sup> for the auditor to complete the assembly of the final audit file on a timely basis. ISA 230 states that an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.<sup>8</sup>

- A14. Regardless of the timing of the written communication of significant deficiencies, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing, as this ISA requires.
- A15. The level of detail at which to communicate significant deficiencies is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:
- The nature of the entity. For example, the communication required for a public interest entity may be different from that for a non-public interest entity.
  - The size and complexity of the entity. For example, the communication required for a complex entity may be different from that for an entity operating a simple business.
  - The nature of significant deficiencies that the auditor has identified.
  - The entity's governance composition. For example, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.
  - Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.
- A16. Management and those charged with governance may already be aware of significant deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirement in paragraph 9 applies regardless of cost or other considerations

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<sup>7</sup> ISA 230, *Audit Documentation*, paragraph 14

<sup>8</sup> ISA 230, paragraph A21

that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

- A17. The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

#### Considerations Specific to Smaller Entities

- A18. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of larger entities.

#### *Communication of Deficiencies in Internal Control to Management* (Ref: Para. 10)

- A19. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies, the appropriate level is likely to be the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

#### Communication of Significant Deficiencies in Internal Control to Management (Ref: Para. 10(a))

- A20. Certain identified significant deficiencies in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management, or management may exhibit an inability to oversee the preparation of adequate financial statements that may raise doubt about management's competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.
- A21. ISA 250 (Revised) establishes requirements and provides guidance on the reporting of identified or suspected non-compliance with laws and regulations, including when those charged with governance are themselves involved in such non-compliance.<sup>9</sup> ISA 240 establishes requirements and provides guidance

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<sup>9</sup> ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraphs 23–29

regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management.<sup>10</sup>

Communication of Other Deficiencies in Internal Control to Management  
(Ref: Para. 10(b))

- A22. During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies but that may be of sufficient importance to merit management's attention. The determination as to which other deficiencies in internal control merit management's attention is a matter of professional judgment in the circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.
- A23. The communication of other deficiencies in internal control that merit management's attention need not be in writing but may be oral. Where the auditor has discussed the facts and circumstances of the auditor's findings with management, the auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently.
- A24. If the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor is also not required to repeat information about such deficiencies if it has been previously communicated to management by other parties, such as the internal audit function or regulators. It may, however, be appropriate for the auditor to re-communicate these other deficiencies if there has been a change of management, or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor's judgment in the circumstances.
- A25. In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control the auditor has communicated to management, or be briefly informed of the nature of the other deficiencies. Alternatively, the auditor may consider it appropriate to inform those charged with governance of the communication of the other deficiencies to management. In either case, the auditor may report orally or in writing to those charged with governance as appropriate.

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<sup>10</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 42

A26. ISA 260 (Revised) establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.<sup>11</sup>

*Considerations Specific to Public Sector Entities* (Ref: Para. 9–10)

A27. Public sector auditors may have additional responsibilities to communicate deficiencies in internal control that the auditor has identified during the audit, in ways, at a level of detail and to parties not envisaged in this ISA. For example, significant deficiencies may have to be communicated to the legislature or other governing body. Law, regulation or other authority may also mandate that public sector auditors report deficiencies in internal control, irrespective of the significance of the potential effects of those deficiencies. Further, legislation may require public sector auditors to report on broader internal control-related matters than the deficiencies in internal control required to be communicated by this ISA, for example, controls related to compliance with legislative authorities, regulations, or provisions of contracts or grant agreements.

*Content of Written Communication of Significant Deficiencies in Internal Control*  
(Ref: Para. 11)

A28. In explaining the potential effects of the significant deficiencies, the auditor need not quantify those effects. The significant deficiencies may be grouped together for reporting purposes where it is appropriate to do so. The auditor may also include in the written communication suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented.

A29. The auditor may consider it appropriate to include the following information as additional context for the communication:

- An indication that if the auditor had performed more extensive procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.
- An indication that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

A30. Law or regulation may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor's written communication may identify such regulatory authorities.

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<sup>11</sup> ISA 260 (Revised), paragraph 13

**INTERNATIONAL STANDARD ON AUDITING 300**  
**PLANNING AN AUDIT OF FINANCIAL STATEMENTS**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 300, *Planning an Audit of Financial Statements*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to plan an audit of financial statements. This ISA is written in the context of recurring audits. Additional considerations in an initial audit engagement are separately identified.

### The Role and Timing of Planning

2. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following: (Ref: Para. A1–A3)
  - Helping the auditor to devote appropriate attention to important areas of the audit.
  - Helping the auditor identify and resolve potential problems on a timely basis.
  - Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
  - Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
  - Facilitating the direction and supervision of engagement team members and the review of their work.
  - Assisting, where applicable, in coordination of work done by auditors of components and experts.

### Effective Date

3. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

## Objective

4. The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

## Requirements

### Involvement of Key Engagement Team Members

5. The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (Ref: Para. A4)

### Preliminary Engagement Activities

6. The auditor shall undertake the following activities at the beginning of the current audit engagement:
  - (a) Performing procedures required by ISA 220 regarding the continuance of the client relationship and the specific audit engagement;<sup>1</sup>
  - (b) Evaluating compliance with relevant ethical requirements, including independence, in accordance with ISA 220,<sup>2</sup> and
  - (c) Establishing an understanding of the terms of the engagement, as required by ISA 210.<sup>3</sup> (Ref: Para. A5–A7)

### Planning Activities

7. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
8. In establishing the overall audit strategy, the auditor shall:
  - (a) Identify the characteristics of the engagement that define its scope;
  - (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
  - (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
  - (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
  - (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement. (Ref: Para. A8–A11)
9. The auditor shall develop an audit plan that shall include a description of:
  - (a) The nature, timing and extent of planned risk assessment procedures, as determined under ISA 315 (Revised).<sup>4</sup>
  - (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA 330.<sup>5</sup>
  - (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs. (Ref: Para. A12-A14)

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<sup>1</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraphs 12–13

<sup>2</sup> ISA 220, paragraphs 9–11

<sup>3</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraphs 9–13

<sup>4</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>5</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

10. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A15)
11. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A16–A17)

### Documentation

12. The auditor shall include in the audit documentation:<sup>6</sup>
  - (a) The overall audit strategy;
  - (b) The audit plan; and
  - (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A18–A21)

### Additional Considerations in Initial Audit Engagements

13. The auditor shall undertake the following activities prior to starting an initial audit:
  - (a) Performing procedures required by ISA 220 regarding the acceptance of the client relationship and the specific audit engagement;<sup>7</sup> and
  - (b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A22)

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## Application and Other Explanatory Material

### The Role and Timing of Planning (Ref: Para. 2)

- A1. The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement.
- A2. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the

<sup>6</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

<sup>7</sup> ISA 220, paragraphs 12–13

performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

A3. The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

#### **Involvement of Key Engagement Team Members (Ref: Para. 5)**

A4. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process.<sup>8</sup>

#### **Preliminary Engagement Activities (Ref: Para. 6)**

A5. Performing the preliminary engagement activities specified in paragraph 6 at the beginning of the current audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

A6. Performing these preliminary engagement activities enables the auditor to plan an audit engagement for which, for example:

- The auditor maintains the necessary independence and ability to perform the engagement.

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<sup>8</sup> ISA 315 (Revised), paragraph 10, establishes requirements and provides guidance on the engagement team's discussion of the susceptibility of the entity to material misstatements of the financial statements. ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 16, provides guidance on the emphasis given during this discussion to the susceptibility of the entity's financial statements to material misstatement due to fraud.

- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
  - There is no misunderstanding with the client as to the terms of the engagement.
- A7. The auditor's consideration of client continuance and relevant ethical requirements, including independence, occurs throughout the audit engagement as conditions and changes in circumstances occur. Performing initial procedures on both client continuance and evaluation of relevant ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.

### Planning Activities

#### *The Overall Audit Strategy* (Ref: Para. 7–8)

- A8. The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:
- The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
  - The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
  - When these resources are to be deployed, such as whether at an interim audit stage or at key cutoff dates; and
  - How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.
- A9. The Appendix lists examples of considerations in establishing the overall audit strategy.
- A10. Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy

and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

### Considerations Specific to Smaller Entities

A11. In audits of small entities, the entire audit may be conducted by a very small engagement team. Many audits of small entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, co-ordination of, and communication between, team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph 8.

### *The Audit Plan* (Ref: Para. 9)

A12. The audit plan is more detailed than the overall audit strategy in that it includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

A13. Determining the nature, timing and extent of planned risk assessment procedures, and the further audit procedures, as they relate to disclosures is important in light of both the wide range of information and the level of detail that may be encompassed in those disclosures. Further, certain disclosures may contain information that is obtained from outside of the general and subsidiary ledgers, which may also affect the assessed risks and the nature, timing and extent of audit procedures to address them.

A14. Consideration of disclosures early in the audit assists the auditor in giving appropriate attention to, and planning adequate time for, addressing disclosures in the same way as classes of transactions, events and account balances. Early consideration may also help the auditor to determine the effects on the audit of:

- Significant new or revised disclosures required as a result of changes in the entity’s environment, financial condition or activities (for example, a change in the required identification of segments and reporting of segment information arising from a significant business combination);
- Significant new or revised disclosures arising from changes in the applicable financial reporting framework;
- The need for the involvement of an auditor’s expert to assist with audit procedures related to particular disclosures (for example, disclosures related to pension or other retirement benefit obligations); and
- Matters relating to disclosures that the auditor may wish to discuss with those charged with governance.<sup>9</sup>

*Changes to Planning Decisions during the Course of the Audit* (Ref: Para. 10)

A15. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor’s attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

*Direction, Supervision and Review* (Ref: Para. 11)

A16. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

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

ISA 220 contains further guidance on the direction, supervision and review of audit work.<sup>10</sup>

<sup>9</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph A13

<sup>10</sup> ISA 220, paragraphs 15–17

### Considerations Specific to Smaller Entities

A17. If an audit is carried out entirely by the engagement partner, questions of direction and supervision of engagement team members and review of their work do not arise. In such cases, the engagement partner, having personally conducted all aspects of the work, will be aware of all material issues. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performs the entire audit. If particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably-experienced auditors or the auditor's professional body.

### **Documentation** (Ref: Para. 12)

A18. The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

A19. The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A20. A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

### *Considerations Specific to Smaller Entities*

A21. As discussed in paragraph A11, a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity. For the audit plan, standard audit programs or checklists (see paragraph A19) drawn up on the assumption of few relevant control activities, as is likely to be the case in a smaller entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

### **Additional Considerations in Initial Audit Engagements** (Ref: Para. 13)

A22. The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when

planning recurring engagements. For an initial audit engagement, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances.<sup>11</sup>
- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

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<sup>11</sup> ISA 510, *Initial Audit Engagements—Opening Balances*

## Appendix

(Ref: Para. 7–8, A8–A11)

### Considerations in Establishing the Overall Audit Strategy

This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters will also influence the auditor's detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required by other ISAs, not all matters are relevant to every audit engagement and the list is not necessarily complete.

#### Characteristics of the Engagement

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- Whether the entity has an internal audit function and, if so, whether, in which areas and to what extent, the work of the function can be used, or internal auditors can be used to provide direct assistance, for purposes of the audit.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.

- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

### **Reporting Objectives, Timing of the Audit, and Nature of Communications**

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

### **Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements**

- The determination of materiality in accordance with ISA 320<sup>1</sup> and, where applicable:
  - The determination of materiality for components and communication thereof to component auditors in accordance with ISA 600.<sup>2</sup>
  - The preliminary identification of significant components and material classes of transactions, account balances and disclosures.
- Preliminary identification of areas where there may be a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.

<sup>1</sup> ISA 320, *Materiality in Planning and Performing an Audit*

<sup>2</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraphs 21–23 and 40(c)

- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- Evidence of management’s commitment to the design, implementation and maintenance of sound internal control, including evidence of appropriate documentation of such internal control.
- Changes within the applicable financial reporting framework, such as changes in accounting standards, which may involve significant new or revised disclosures.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- The process(es) management uses to identify and prepare the disclosures required by the applicable financial reporting framework, including disclosures containing information that is obtained from outside of the general and subsidiary ledgers.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

### **Nature, Timing and Extent of Resources**

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

**INTERNATIONAL STANDARD ON AUDITING 315 (REVISED)**  
**IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL**  
**MISSTATEMENT THROUGH UNDERSTANDING THE**  
**ENTITY AND ITS ENVIRONMENT**

(Effective for audits of financial statements for periods  
ending on or after December 15, 2013)

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**ISA**

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

International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

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

### Effective Date

2. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2013.

### Objective

3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

### Definitions

4. For purposes of the ISA, the following terms have the meanings attributed below:
  - (a) **Assertions** – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.
  - (b) **Business risk** – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
  - (c) **Internal control** – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.
  - (d) **Risk assessment procedures** – The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
  - (e) **Significant risk** – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

## Requirements

### Risk Assessment Procedures and Related Activities

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1–A5)
6. The risk assessment procedures shall include the following:
  - (a) Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor’s judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6–A13)
  - (b) Analytical procedures. (Ref: Para. A14–A17)
  - (c) Observation and inspection. (Ref: Para. A18)
7. The auditor shall consider whether information obtained from the auditor’s client acceptance or continuance process is relevant to identifying risks of material misstatement.
8. If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.
9. Where the auditor intends to use information obtained from the auditor’s previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A19–A20)
10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity’s financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity’s facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A21–A24)

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

#### *The Entity and Its Environment*

11. The auditor shall obtain an understanding of the following:
  - (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A25–A30)

- (b) The nature of the entity, including:
  - (i) its operations;
  - (ii) its ownership and governance structures;
  - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
  - (iv) the way that the entity is structured and how it is financed, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A31–A35)
- (c) The entity’s selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity’s accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A36)
- (d) The entity’s objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A37–A43)
- (e) The measurement and review of the entity’s financial performance. (Ref: Para. A44–A49)

### *The Entity’s Internal Control*

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor’s professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A50–A73)

### Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity’s personnel. (Ref: Para. A74–A76)

### Components of Internal Control

#### Control environment

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and

- (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A77–A87)

The entity’s risk assessment process

- 15. The auditor shall obtain an understanding of whether the entity has a process for:
  - (a) Identifying business risks relevant to financial reporting objectives;
  - (b) Estimating the significance of the risks;
  - (c) Assessing the likelihood of their occurrence; and
  - (d) Deciding about actions to address those risks. (Ref: Para. A88)
- 16. If the entity has established such a process (referred to hereafter as the “entity’s risk assessment process”), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity’s risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity’s risk assessment process.
- 17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. A89)

The information system, including the related business processes, relevant to financial reporting, and communication

- 18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: (Ref: Para. A90–A92 and A95–A96)
  - (a) The classes of transactions in the entity’s operations that are significant to the financial statements;
  - (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

- (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
- (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and
- (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A93–A94)

This understanding of the information system relevant to financial reporting shall include relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers.

19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including: (Ref: Para. A97–A98)
- (a) Communications between management and those charged with governance; and
  - (b) External communications, such as those with regulatory authorities.

#### Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A99–A106)
21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A107–A109)

#### Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control relevant to financial reporting, including those

related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A110–A112)

23. If the entity has an internal audit function,<sup>1</sup> the auditor shall obtain an understanding of the nature of the internal audit function’s responsibilities, its organizational status, and the activities performed, or to be performed. (Ref: Para. A113–A120)
24. The auditor shall obtain an understanding of the sources of the information used in the entity’s monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A121)

### **Identifying and Assessing the Risks of Material Misstatement**

25. The auditor shall identify and assess the risks of material misstatement at:
- (a) the financial statement level; and (Ref: Para. A122–A125)
  - (b) the assertion level for classes of transactions, account balances, and disclosures, (Ref: Para. A126–A131)
- to provide a basis for designing and performing further audit procedures.
26. For this purpose, the auditor shall:
- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures (including the quantitative or qualitative aspects of such disclosures) in the financial statements; (Ref: Para. A132–A136)
  - (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
  - (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A137–A139)
  - (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement could result in a material misstatement. (Ref: Para. A140)

#### *Risks that Require Special Audit Consideration*

27. As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor’s judgment, a

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<sup>1</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 14(a), defines the term “internal audit function” for purposes of the ISA.

significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:
- (a) Whether the risk is a risk of fraud;
  - (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
  - (c) The complexity of transactions;
  - (d) Whether the risk involves significant transactions with related parties;
  - (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
  - (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A141–A145)
29. If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A146–A148)

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

30. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A149–A151)

*Revision of Risk Assessment*

31. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A152)

## Documentation

32. The auditor shall include in the audit documentation:<sup>2</sup>
- (a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;
  - (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14–24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
  - (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and
  - (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27–30. (Ref: Para. A153–A156)

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## Application and Other Explanatory Material

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

- A1. Obtaining an understanding of the entity and its environment, including the entity’s internal control (referred to hereafter as an “understanding of the entity”), is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:
- Assessing risks of material misstatement of the financial statements;
  - Determining materiality in accordance with ISA 320;<sup>3</sup>
  - Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
  - Identifying areas relating to amounts or disclosures in the financial statements where special audit consideration may be necessary, for example: related party transactions or management’s assessment of the entity’s ability to continue as a going concern; or when considering the business purpose of transactions;

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<sup>2</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

<sup>3</sup> ISA 320, *Materiality in Planning and Performing an Audit*

- Developing expectations for use when performing analytical procedures;
  - Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
  - Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.
- A2. Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures, and related assertions, and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.
- A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this ISA. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.
- A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this ISA. However, the significance of fraud is such that further requirements and guidance are included in ISA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.<sup>4</sup>
- A5. Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11–24), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include:
- Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.
  - Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.

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<sup>4</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 13–25

*Inquiries of Management, the Internal Audit Function and Others within the Entity*  
(Ref: Para. 6(a))

- A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity.
- A7. The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:
- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. ISA 260 (Revised)<sup>5</sup> identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
  - Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
  - Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
  - Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
  - Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
  - Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.
- A8. As obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's inquiries may occur throughout the audit engagement.

**Inquiries of the Internal Audit Function**

- A9. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in

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<sup>5</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 4(b)

obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.<sup>6</sup> Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.

- A10. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.
- A11. In addition, in accordance with ISA 240,<sup>7</sup> if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.
- A12. Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

Considerations specific to public sector entities (Ref: Para 6(a))

- A13. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of deficiencies in internal control over financial reporting.

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

- A14. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing

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<sup>6</sup> The relevant requirements are contained in ISA 610 (Revised 2013).

<sup>7</sup> ISA 240, paragraph 20

the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

- A15. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- A16. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

#### Considerations Specific to Smaller Entities

- A17. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

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

- A18. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:
- The entity's operations.
  - Documents (such as business plans and strategies), records, and internal control manuals.
  - Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
  - The entity's premises and plant facilities.

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

- A19. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:
- Past misstatements and whether they were corrected on a timely basis.
  - The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).
  - Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.
  - Those particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example, due to their complexity.
- A20. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

*Discussion among the Engagement Team* (Ref: Para. 10)

- A21. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:
- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
  - Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
  - Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures.

- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

ISA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.<sup>8</sup>

A22. As part of the discussion among the engagement team required by paragraph 10, consideration of the disclosure requirements of the applicable financial reporting framework assists in identifying early in the audit where there may be risks of material misstatement in relation to disclosures. Examples of matters the engagement team may discuss include:

- Changes in financial reporting requirements that may result in significant new or revised disclosures;
- Changes in the entity's environment, financial condition or activities that may result in significant new or revised disclosures, for example, a significant business combination in the period under audit;
- Disclosures for which obtaining sufficient appropriate audit evidence may have been difficult in the past; and
- Disclosures about complex matters, including those involving significant management judgment as to what information to disclose.

A23. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

#### Considerations Specific to Smaller Entities

A24. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

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<sup>8</sup> ISA 240, paragraph 16

## **The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control**

### **The Entity and Its Environment**

*Industry, Regulatory and Other External Factors* (Ref: Para. 11(a))

#### Industry Factors

A25. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include:

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

A26. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience.<sup>9</sup>

#### Regulatory Factors

A27. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include:

- Accounting principles and industry-specific practices.
- Regulatory framework for a regulated industry, including requirements for disclosures.
- Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

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<sup>9</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14

A28. ISA 250 (Revised) includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.<sup>10</sup>

#### Considerations specific to public sector entities

A29. For the audits of public sector entities, law, regulation or other authority may affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

#### Other External Factors

A30. Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

#### *Nature of the Entity* (Ref: Para. 11(b))

A31. An understanding of the nature of an entity enables the auditor to understand such matters as:

- Whether the entity has a complex structure, for example, with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately and whether adequate disclosure of such issues in the financial statements has been made.
- The ownership, and relationships between owners and other people or entities. This understanding assists in determining whether related party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial statements. ISA 550<sup>11</sup> establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

A32. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- Business operations such as:
  - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
  - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).

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<sup>10</sup> ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 13

<sup>11</sup> ISA 550, *Related Parties*

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

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

- Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A33. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

#### Nature of Special-Purpose Entities

A34. A special-purpose entity (sometimes referred to as a special-purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitization of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As ISA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.<sup>12</sup>

A35. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special-purpose entity.

#### *The Entity's Selection and Application of Accounting Policies* (Ref: Para. 11(c))

A36. An understanding of the entity's selection and application of accounting policies may encompass such matters as:

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

#### *Objectives and Strategies and Related Business Risks* (Ref: Para. 11(d))

A37. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the

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<sup>12</sup> ISA 550, paragraph A7

overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

- A38. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognize the need for change may also give rise to business risk. Business risk may arise, for example, from:
- The development of new products or services that may fail;
  - A market which, even if successfully developed, is inadequate to support a product or service; or
  - Flaws in a product or service that may result in liabilities and reputational risk.
- A39. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.
- A40. Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:
- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
  - New products and services (a potential related business risk might be, for example, that there is increased product liability).
  - Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
  - New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
  - Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
  - Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
  - Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).

- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A41. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in Appendix 2.

A42. Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A88–A89.

#### Considerations Specific to Public Sector Entities

A43. For the audits of public sector entities, “management objectives” may be influenced by concerns regarding public accountability and may include objectives which have their source in law, regulation or other authority.

#### *Measurement and Review of the Entity's Financial Performance* (Ref: Para. 11(e))

A44. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. See ISA 240 for requirements and guidance in relation to the risks of fraud.

A45. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A110–A121), though their purposes may overlap:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.

- A46. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:
- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
  - Period-on-period financial performance analyses.
  - Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.
  - Employee performance measures and incentive compensation policies.
  - Comparisons of an entity's performance with that of competitors.
- A47. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.
- A48. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

#### Considerations Specific to Smaller Entities

- A49. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

#### **The Entity's Internal Control** (Ref: Para. 12)

- A50. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.
- A51. The following application material on internal control is presented in four sections, as follows:

- General Nature and Characteristics of Internal Control.
- Controls Relevant to the Audit.
- Nature and Extent of the Understanding of Relevant Controls.
- Components of Internal Control.

### *General Nature and Characteristics of Internal Control*

#### Purpose of Internal Control

A52. Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- The reliability of the entity's financial reporting;
- The effectiveness and efficiency of its operations; and
- Its compliance with applicable laws and regulations.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

#### Considerations specific to smaller entities

A53. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

#### Limitations of Internal Control

A54. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

A55. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

- A56. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

#### Considerations specific to smaller entities

- A57. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.
- A58. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

#### Division of Internal Control into Components

- A59. The division of internal control into the following five components, for purposes of the ISA, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

- (a) The control environment;
- (b) The entity's risk assessment process;
- (c) The information system, including the related business processes, relevant to financial reporting, and communication;
- (d) Control activities; and
- (e) Monitoring of controls.

The division does not necessarily reflect how an entity designs, implements and maintains internal control, or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this ISA, provided all the components described in this ISA are addressed.

- A60. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A77–A121 below. Appendix 1 provides further explanation of these components of internal control.

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

- A61. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A62. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

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

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

A63. Generally, IT benefits an entity's internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information;
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

A64. IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.

- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
  - Unauthorized changes to data in master files.
  - Unauthorized changes to systems or programs.
  - Failure to make necessary changes to systems or programs.
  - Inappropriate manual intervention.
  - Potential loss of data or inability to access data as required.
- A65. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:
- Large, unusual or non-recurring transactions.
  - Circumstances where errors are difficult to define, anticipate or predict.
  - In changing circumstances that require a control response outside the scope of an existing automated control.
  - In monitoring the effectiveness of automated controls.
- A66. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:
- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
  - Control activities where the specific ways to perform the control can be adequately designed and automated.
- A67. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

*Controls Relevant to the Audit*

- A68. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

A69. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business, including its organization and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

A70. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

A71. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting.

A72. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

#### Considerations Specific to Public Sector Entities

A73. Public sector auditors often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice. Public sector auditors can also have responsibilities to report on

compliance with law, regulation or other authority. As a result, their review of internal control may be broader and more detailed.

*Nature and Extent of the Understanding of Relevant Controls* (Ref: Para. 13)

- A74. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.
- A75. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:
- Inquiring of entity personnel.
  - Observing the application of specific controls.
  - Inspecting documents and reports.
  - Tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

- A76. Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A63), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in ISA 330.<sup>13</sup>

*Components of Internal Control—Control Environment* (Ref: Para. 14)

- A77. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.
- A78. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

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<sup>13</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

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

- (a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- (b) *Commitment to competence* – Matters such as management’s consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- (c) *Participation by those charged with governance* – Attributes of those charged with governance such as:
  - Their independence from management.
  - Their experience and stature.
  - The extent of their involvement and the information they receive, and the scrutiny of activities.
  - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- (d) *Management’s philosophy and operating style* – Characteristics such as management’s:
  - Approach to taking and managing business risks.
  - Attitudes and actions toward financial reporting.
  - Attitudes toward information processing and accounting functions and personnel.
- (e) *Organizational structure* – The framework within which an entity’s activities for achieving its objectives are planned, executed, controlled, and reviewed.
- (f) *Assignment of authority and responsibility* – Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
- (g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Audit Evidence for Elements of the Control Environment

A79. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls

have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

- A80. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

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

- A81. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

- Their independence from management and their ability to evaluate the actions of management.
- Whether they understand the entity's business transactions.
- The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework, including whether the financial statements include adequate disclosures.

- A82. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.

- A83. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be

processed. As explained in ISA 330, the control environment also influences the nature, timing and extent of the auditor's further procedures.<sup>14</sup>

- A84. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

#### Considerations Specific to Smaller Entities

- A85. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small entity; it may, however, increase other risks, for example, the risk of override of controls.
- A86. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.
- A87. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

#### *Components of Internal Control—The Entity's Risk Assessment Process* (Ref: Para. 15)

- A88. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

#### Considerations Specific to Smaller Entities (Ref: Para. 17)

- A89. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

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<sup>14</sup> ISA 330, paragraphs A2–A3

*Components of Internal Control—The Information System, Including Related Business Processes, Relevant to Financial Reporting, and Communication*

The Information System, Including Related Business Processes, Relevant to Financial Reporting (Ref: Para. 18)

- A90. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:
- Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
  - Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
  - Process and account for system overrides or bypasses to controls;
  - Transfer information from transaction processing systems to the general ledger;
  - Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
  - Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements
- A91. Financial statements may contain information that is obtained from outside of the general and subsidiary ledgers. Examples of such information may include:
- Information obtained from lease agreements disclosed in the financial statements, such as renewal options or future lease payments.
  - Information disclosed in the financial statements that is produced by an entity's risk management system.
  - Fair value information produced by management's experts and disclosed in the financial statements.
  - Information disclosed in the financial statements that has been obtained from models, or from other calculations used to develop estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
    - Assumptions developed internally that may affect an asset's useful life; or

- Data such as interest rates that are affected by factors outside the control of the entity.
- Information disclosed in the financial statements about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.
- Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records.
- Information disclosed in the financial statements that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern.<sup>15</sup>

A92. The understanding of the information system relevant to financial reporting required by paragraph 18 of this ISA (including the understanding of relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers) is a matter of the auditor's professional judgment. For example, certain amounts or disclosures in the entity's financial statements (such as disclosures about credit risk, liquidity risk, and market risk) may be based on information obtained from the entity's risk management system. However, the auditor is not required to understand all aspects of the risk management system, and uses professional judgment in determining the necessary understanding.

#### Journal entries (Ref: Para. 18(f))

A93. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A94. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

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<sup>15</sup> See paragraphs 19–20 of ISA 570 (Revised), *Going Concern*.

Related business processes (Ref: Para. 18)

A95. An entity's business processes are the activities designed to:

- Develop, purchase, produce, sell and distribute an entity's products and services;
- Ensure compliance with laws and regulations; and
- Record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

Considerations specific to smaller entities (Ref: Para. 18)

A96. The information system, and related business processes relevant to financial reporting in small entities, including relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers, is likely to be less sophisticated than in larger entities, but its role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's information systems relevant to financial reporting may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

Communication (Ref: Para. 19)

A97. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A98. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

*Components of Internal Control—Control Activities Relevant to the Audit*  
(Ref: Para. 20)

A99. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:

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

A100. Control activities that are relevant to the audit are:

- Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30, respectively; or
- Those that are considered to be relevant in the judgment of the auditor.

A101. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

A102. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A103. Control activities relevant to the audit may include controls established by management that address risks of material misstatement related to disclosures not being prepared in accordance with the applicable financial reporting framework, in addition to controls that address risks related to account balances and transactions. Such control activities may relate to information included in the financial statements that is obtained from outside of the general and subsidiary ledgers.

A104. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

### Considerations Specific to Smaller Entities

A105. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A106. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

### Risks Arising from IT (Ref: Para. 21)

A107. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT controls and application controls.

A108. General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

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

They are generally implemented to deal with the risks referred to in paragraph A64 above.

A109. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

*Components of Internal Control—Monitoring of Controls* (Ref: Para. 22)

- A110. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- A111. Management’s monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

*Considerations Specific to Smaller Entities*

- A112. Management’s monitoring of control is often accomplished by management’s or the owner-manager’s close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

*The Entity’s Internal Audit Function* (Ref: Para. 23)

- A113. If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor’s understanding of the entity and its environment, including internal control, in particular the role that the function plays in the entity’s monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor’s inquiries in paragraph 6(a) of this ISA, may also provide information that is directly relevant to the auditor’s identification and assessment of the risks of material misstatement.
- A114. The objectives and scope of an internal audit function, the nature of its responsibilities and its status within the organization, including the function’s authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. These matters may be set out in an internal audit charter or terms of reference.
- A115. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control and governance processes. If so, the internal audit function may play an important role in the entity’s monitoring of internal control over financial reporting. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity’s financial reporting.

- A116. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6(a) of this ISA help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function.
- A117. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.
- A118. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, ISA 610 (Revised 2013) applies.
- A119. As is further discussed in ISA 610 (Revised 2013), the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.
- A120. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. ISA 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

Sources of Information (Ref: Para. 24)

- A121. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are

accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

- The sources of the information related to the entity's monitoring activities; and
- The basis upon which management considers the information to be sufficiently reliable for the purpose, is required as part of the auditor's understanding of the entity's monitoring activities as a component of internal control.

## **Identifying and Assessing the Risks of Material Misstatement**

*Assessment of Risks of Material Misstatement at the Financial Statement Level*  
(Ref: Para. 25(a))

- A122. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.
- A123. Risks at the financial statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as a lack of management competence or lack of oversight over the preparation of the financial statements may have a more pervasive effect on the financial statements and may require an overall response by the auditor.
- A124. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:
- Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
  - Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.
- A125. ISA 705 (Revised)<sup>16</sup> establishes requirements and provides guidance in determining whether there is a need for the auditor to express a qualified opinion

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<sup>16</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement where withdrawal is possible under applicable law or regulation.

*Assessment of Risks of Material Misstatement at the Assertion Level* (Ref: Para. 25(b))

A126. Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The Use of Assertions

A127. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding recognition, measurement, and presentation of classes of transactions and events, account balances and disclosures.

A128. The auditor may use the assertions as described in paragraph A 129(a)–(b) below or may express them differently provided all aspects described below have been covered. For example, the auditor may choose to combine the assertions about classes of transactions and events, and related disclosures, with the assertions about account balances, and related disclosures.

Assertions about classes of transactions, account balances, and related disclosures

A129. Assertions used by the auditor in considering the different types of potential misstatements that may occur may fall into the following categories:

- (a) Assertions about classes of transactions and events, and related disclosures, for the period under audit:
  - (i) Occurrence—transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
  - (ii) Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
  - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT  
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- (iv) Cutoff—transactions and events have been recorded in the correct accounting period.
  - (v) Classification—transactions and events have been recorded in the proper accounts.
  - (vi) Presentation—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
- (b) Assertions about account balances, and related disclosures, at the period end:
- (i) Existence—assets, liabilities, and equity interests exist.
  - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
  - (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
  - (iv) Accuracy, valuation and allocation—assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
  - (v) Classification—assets, liabilities and equity interests have been recorded in the proper accounts.
  - (vi) Presentation—assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Assertions about other disclosures

A130. The assertions described in paragraph 129(a)–(b) above, adapted as appropriate, may also be used by the auditor in considering the different types of potential misstatements that may occur in disclosures not directly related to recorded classes of transactions, events, or account balances. As an example of such a disclosure, the entity may be required to describe its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks.

Considerations specific to public sector entities

A131. When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A129(a)–(b), management may often assert that transactions and events have been carried out in accordance with law, regulation or other authority. Such assertions may fall within the scope of the financial statement audit.

*Process of Identifying Risks of Material Misstatement* (Ref: Para. 26(a))

A132. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing and extent of further audit procedures to be performed. In identifying the risks of material misstatement in the financial statements, the auditor exercises professional skepticism in accordance with ISA 200.<sup>17</sup>

A133. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement, including risks of material misstatement relating to disclosures.

A134. As explained in ISA 320,<sup>18</sup> materiality and audit risk are considered when identifying and assessing the risks of material misstatement in classes of transactions, account balances and disclosures. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial reporting needs of users of the financial statements.<sup>19</sup>

A135. The auditor's consideration of disclosures in the financial statements when identifying risks includes quantitative and qualitative disclosures, the misstatement of which could be material (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole). Depending on the circumstances of the entity and the engagement, examples of disclosures that will have qualitative aspects and that may be relevant when assessing the risks of material misstatement include disclosures about:

- Liquidity and debt covenants of an entity in financial distress.
- Events or circumstances that have led to the recognition of an impairment loss.
- Key sources of estimation uncertainty, including assumptions about the future.

<sup>17</sup> ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 15

<sup>18</sup> ISA 320, paragraph A1

<sup>19</sup> ISA 320, paragraph 4

- The nature of a change in accounting policy, and other relevant disclosures required by the applicable financial reporting framework, where, for example, new financial reporting requirements are expected to have a significant impact on the financial position and financial performance of the entity.
- Share-based payment arrangements, including information about how any amounts recognized were determined, and other relevant disclosures.
- Related parties, and related party transactions.
- Sensitivity analysis, including the effects of changes in assumptions used in the entity's valuation techniques intended to enable users to understand the underlying measurement uncertainty of a recorded or disclosed amount.

Considerations specific to smaller entities

A136. Disclosures in the financial statements of smaller entities may be less detailed or less complex (e.g., some financial reporting frameworks allow smaller entities to provide fewer disclosures in the financial statements). However, this does not relieve the auditor of the responsibility to obtain an understanding of the entity and its environment, including internal control, as it relates to disclosures.

*Relating Controls to Assertions* (Ref: Para. 26(c))

A137. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A138. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

A139. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

## Material Misstatements

A139. Potential misstatements in individual statements and disclosures may be judged to be material due to size, nature or circumstances. (Ref: Para. 26(d))

## *Significant Risks*

### Identifying Significant Risks (Ref: Para. 28)

A140. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A141. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

A142. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

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

A143. ISA 330 describes the consequences for further audit procedures of identifying a risk as significant.<sup>20</sup>

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

A144. ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.<sup>21</sup>

### Understanding Controls Related to Significant Risks (Ref: Para. 29)

A145. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have

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<sup>20</sup> ISA 330, paragraphs 15 and 21

<sup>21</sup> ISA 240, paragraphs 26–28

other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

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

A146. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A147. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant deficiency in internal control.<sup>22</sup>

*Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para. 30)*

A148. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A149. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

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<sup>22</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph A7

A150. The consequences for further audit procedures of identifying such risks are described in ISA 330.<sup>23</sup>

*Revision of Risk Assessment* (Ref: Para. 31)

A151. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. See ISA 330 for further guidance.

**Documentation** (Ref: Para. 32)

A152. The manner in which the requirements of paragraph 32 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.<sup>24</sup> Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures.<sup>25</sup> The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A153. For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

A154. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of ISA 230 are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

A155. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

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<sup>23</sup> ISA 330, paragraph 8

<sup>24</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9

<sup>25</sup> ISA 330, paragraph 28

## Appendix 1

(Ref: Para. 4(c), 14–24, A77–A121)

### Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14–24 and A77–A121, as they relate to a financial statement audit.

### Control Environment

2. The control environment encompasses the following elements:
  - (a) *Communication and enforcement of integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity’s ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
  - (b) *Commitment to competence.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual’s job.
  - (c) *Participation by those charged with governance.* An entity’s control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity’s internal control.
  - (d) *Management’s philosophy and operating style.* Management’s philosophy and operating style encompass a broad range of characteristics. For example, management’s attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
  - (e) *Organizational structure.* Establishing a relevant organizational structure includes considering key areas of authority and responsibility

and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.

- (f) *Assignment of authority and responsibility.* The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.
- (g) *Human resource policies and practices.* Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

### Entity's Risk Assessment Process

- 3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.
- 4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:
  - *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.

- *New personnel.* New personnel may have a different focus on or understanding of internal control.
- *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

### **Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication**

5. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).
6. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:
  - Identify and record all valid transactions.
  - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
  - Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
  - Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
  - Present properly the transactions and related disclosures in the financial statements.

7. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

### Control Activities

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:
  - *Performance reviews.* These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
  - *Information processing.* The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
  - *Physical controls.* Controls that encompass:
    - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
    - The authorization for access to computer programs and data files.
    - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

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

- *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.
10. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, non-routine transactions such as major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

### **Monitoring of Controls**

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.
12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.
13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

## Appendix 2

(Ref: Para. A41, A133)

### Conditions and Events That May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement in the financial statements. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.
- Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Deficiencies in internal control, especially those not addressed by management.
- Incentives for management and employees to engage in fraudulent financial reporting.

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- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including accounting estimates, and related disclosures.
- Omission, or obscuring, of significant information in disclosures.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

# INTERNATIONAL STANDARD ON AUDITING 320 MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 320, *Materiality in Planning and Performing an Audit*, should be read in the context of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. ISA 450<sup>1</sup> explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

### Materiality in the Context of an Audit

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
  - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
  - Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
  - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.<sup>2</sup> The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.
3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.
4. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

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<sup>1</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*

<sup>2</sup> For example, the *Framework for the Preparation and Presentation of Financial Statements*, adopted by the International Accounting Standards Board in April 2001, indicates that, for a profit-oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

- (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
  - (b) Understand that financial statements are prepared, presented and audited to levels of materiality;
  - (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
  - (d) Make reasonable economic decisions on the basis of the information in the financial statements.
5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)
6. In planning the audit, the auditor makes judgments about misstatements that will be considered material. These judgments provide a basis for:
- (a) Determining the nature, timing and extent of risk assessment procedures;
  - (b) Identifying and assessing the risks of material misstatement; and
  - (c) Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. It is not practicable to design audit procedures to detect all misstatements that could be material solely because of their nature. However, consideration of the nature of potential misstatements in disclosures is relevant to the design of audit procedures to address risks of material misstatement.<sup>3</sup> In addition, when evaluating the effect on the financial statements of all uncorrected misstatements, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence.<sup>4</sup> (Ref: Para. A2)

### Effective Date

7. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

<sup>3</sup> See ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, paragraphs A134–A135.

<sup>4</sup> ISA 450, paragraph A21

## Objective

8. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

## Definition

9. For purposes of the ISAs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

## Requirements

### Determining Materiality and Performance Materiality When Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A3–A12)
11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A13)

### Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A14)
13. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

## Documentation

14. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:<sup>5</sup>
- (a) Materiality for the financial statements as a whole (see paragraph 10);
  - (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);
  - (c) Performance materiality (see paragraph 11); and
  - (d) Any revision of (a)–(c) as the audit progressed (see paragraphs 12–13).

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## Application and Other Explanatory Material

### Materiality and Audit Risk (Ref: Para. 5)

- A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.<sup>6</sup> The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.<sup>7</sup> Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.<sup>8</sup> Materiality and audit risk are considered throughout the audit, in particular, when:
- (a) Identifying and assessing the risks of material misstatement;<sup>9</sup>
  - (b) Determining the nature, timing and extent of further audit procedures;<sup>10</sup> and
  - (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements<sup>11</sup> and in forming the opinion in the auditor's report.<sup>12</sup>

<sup>5</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

<sup>6</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 11

<sup>7</sup> ISA 200, paragraph 17

<sup>8</sup> ISA 200, paragraph 13(c)

<sup>9</sup> ISA 315 (Revised)

<sup>10</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>11</sup> ISA 450

<sup>12</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

**Materiality in the Context of an Audit** (Ref: Para. 6)

A2. Identifying and assessing the risks of material misstatement<sup>13</sup> involves the use of professional judgment to identify those classes of transactions, account balances and disclosures, including qualitative disclosures, the misstatement of which could be material (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole). When considering whether misstatements in qualitative disclosures could be material, the auditor may identify relevant factors such as:

- The circumstances of the entity for the period (for example, the entity may have undertaken a significant business combination during the period).
- The applicable financial reporting framework, including changes therein (for example, a new financial reporting standard may require new qualitative disclosures that are significant to the entity).
- Qualitative disclosures that are important to users of the financial statements because of the nature of an entity (for example, liquidity risk disclosures may be important to users of the financial statements for a financial institution).

**Determining Materiality and Performance Materiality When Planning the Audit***Considerations Specific to Public Sector Entities* (Ref: Para. 10)

A3. In the case of a public sector entity, legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of a public sector entity is therefore influenced by law, regulation or other authority, and by the financial information needs of legislators and the public in relation to public sector programs.

*Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole* (Ref: Para. 10)

A4. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

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<sup>13</sup> ISA 315 (Revised), paragraph 25, requires the auditor to identify and assess the risk of material misstatement at the financial statement and assertion level.

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
  - Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
  - The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;
  - The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
  - The relative volatility of the benchmark.
- A5. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.
- A6. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.
- A7. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.
- A8. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage

applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances.

#### Considerations Specific to Small Entities

- A9. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

#### Considerations Specific to Public Sector Entities

- A10. In an audit of a public sector entity, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program activities. Where a public sector entity has custody of public assets, assets may be an appropriate benchmark.

#### *Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures* (Ref: Para. 10)

- A11. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:
- Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, the remuneration of management and those charged with governance, and sensitivity analysis for fair value accounting estimates with high estimation uncertainty).
  - The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
  - Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, disclosures about segments or a significant business combination).
- A12. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

*Performance Materiality* (Ref: Para. 11)

- A13. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

**Revision as the Audit Progresses** (Ref: Para. 12)

- A14. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period-end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

# INTERNATIONAL STANDARD ON AUDITING 330

## THE AUDITOR'S RESPONSES TO ASSESSED RISKS

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 330, *The Auditor's Responses to Assessed Risks*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with ISA 315 (Revised)<sup>1</sup> in an audit of financial statements.

### Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

### Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Substantive procedure – An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:
    - (i) Tests of details (of classes of transactions, account balances, and disclosures); and
    - (ii) Substantive analytical procedures.
  - (b) Test of controls – An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

## Requirements

### Overall Responses

5. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1–A3)

### Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

6. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4–A8)

<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

7. In designing the further audit procedures to be performed, the auditor shall:
- (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
    - (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and
    - (ii) Whether the risk assessment takes account of relevant controls (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9–A18)
  - (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

#### *Tests of Controls*

8. The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:
- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
  - (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20–A24)
9. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25)

#### Nature and Extent of Tests of Controls

10. In designing and performing tests of controls, the auditor shall:
- (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
    - (i) How the controls were applied at relevant times during the period under audit;

- (ii) The consistency with which they were applied; and
  - (iii) By whom or by what means they were applied. (Ref: Para. A26–A29)
- (b) Determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30–A31)

#### Timing of Tests of Controls

11. The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs 12 and 15 below, in order to provide an appropriate basis for the auditor's intended reliance. (Ref: Para. A32)

#### Using audit evidence obtained during an interim period

12. If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:
- (a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and
  - (b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33–A34)

#### Using audit evidence obtained in previous audits

13. In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:
- (a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
  - (b) The risks arising from the characteristics of the control, including whether it is manual or automated;
  - (c) The effectiveness of general IT controls;
  - (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
  - (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
  - (f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)

14. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:
- (a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36)
  - (b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37–A39)

#### Controls over significant risks

15. If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

#### Evaluating the Operating Effectiveness of Controls

16. When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A40)
17. If deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether: (Ref: Para. A41)
- (a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
  - (b) Additional tests of controls are necessary; or
  - (c) The potential risks of misstatement need to be addressed using substantive procedures.

#### *Substantive Procedures*

18. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. (Ref: Para. A42–A47)

19. The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48–A51)

#### Substantive Procedures Related to the Financial Statement Closing Process

20. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:
- (a) Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers; and
  - (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)

#### Substantive Procedures Responsive to Significant Risks

21. If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)

#### Timing of Substantive Procedures

22. If substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:
- (a) substantive procedures, combined with tests of controls for the intervening period; or
  - (b) if the auditor determines that it is sufficient, further substantive procedures only,
- that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A54–A57)
23. If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified. (Ref: Para. A58)

#### Adequacy of Presentation of the Financial Statements

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework. In making this evaluation, the auditor shall consider whether the financial statements are presented in a manner that reflects the appropriate:

- Classification and description of financial information and the underlying transactions, events and conditions; and
- Presentation, structure and content of the financial statements. (Ref: Para. A59)

### **Evaluating the Sufficiency and Appropriateness of Audit Evidence**

25. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A60–A61)
26. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)
27. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

### **Documentation**

28. The auditor shall include in the audit documentation:<sup>2</sup>
  - (a) The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed;
  - (b) The linkage of those procedures with the assessed risks at the assertion level; and
  - (c) The results of the audit procedures, including the conclusions where these are not otherwise clear. (Ref: Para. A63)
29. If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit.
30. The auditor's documentation shall demonstrate that information in the financial statements agrees or reconciles with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers.

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<sup>2</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

## Application and Other Explanatory Material

### Overall Responses (Ref: Para. 5)

- A1. Overall responses to address the assessed risks of material misstatement at the financial statement level may include:
- Emphasizing to the engagement team the need to maintain professional skepticism.
  - Assigning more experienced staff or those with special skills or using experts.
  - Providing more supervision.
  - Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
  - Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.
- A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:
- Conducting more audit procedures as of the period end rather than at an interim date.
  - Obtaining more extensive audit evidence from substantive procedures.
  - Increasing the number of locations to be included in the audit scope.
- A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

### Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

#### *The Nature, Timing and Extent of Further Audit Procedures* (Ref: Para. 6)

- A4. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and

performing further audit procedures. For example, the auditor may determine that:

- (a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;
- (b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or
- (c) A combined approach using both tests of controls and substantive procedures is an effective approach.

However, as required by paragraph 18, irrespective of the approach selected, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure.

- A5. The nature of an audit procedure refers to its purpose (that is, test of controls or substantive procedure) and its type (that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks.
- A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.
- A7. Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.
- A8. Designing and performing further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage between the auditor's further audit procedures and the risk assessment.

Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))

#### Nature

- A9. The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the

assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

- A10. The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

### Timing

- A11. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from interim date to the period end would not be effective.
- A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.
- A13. In addition, certain audit procedures can be performed only at or after the period end, for example:
- Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers;
  - Examining adjustments made during the course of preparing the financial statements; and
  - Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized.

A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.
- The timing of the preparation of the financial statements, particularly for those disclosures that provide further explanation about amounts recorded in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.

#### Extent

A15. The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

A16. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

#### Considerations specific to public sector entities

A17. For the audits of public sector entities, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.

#### Considerations specific to smaller entities

A18. In the case of very small entities, there may not be many control activities that could be identified by the auditor, or the extent to which their existence or

operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of control activities or of other components of control may make it impossible to obtain sufficient appropriate audit evidence.

#### Higher Assessments of Risk (Ref: Para 7(b))

- A19. When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.

#### *Tests of Controls*

##### Designing and Performing Tests of Controls (Ref: Para. 8)

- A20. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.
- A21. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.
- A22. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:
- Inquiring about management's use of budgets.
  - Observing management's comparison of monthly budgeted and actual expenses.
  - Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts.

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

- A23. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.
- A24. In some cases, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level.<sup>3</sup> This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls.

#### Audit Evidence and Intended Reliance (Ref: Para. 9)

- A25. A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

#### Nature and Extent of Tests of Controls

##### Other audit procedures in combination with inquiry (Ref: Para. 10(a))

- A26. Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.
- A27. The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

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<sup>3</sup> ISA 315 (Revised), paragraph 30

## Extent of tests of controls

A28. When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control. As well as the degree of reliance on controls, matters the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

ISA 530<sup>4</sup> contains further guidance on the extent of testing.

A29. Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests might include determining that:

- Changes to the program are not made without being subject to the appropriate program change controls;
- The authorized version of the program is used for processing transactions; and
- Other relevant general controls are effective.

Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.

## Testing of indirect controls (Ref: Para. 10(b))

A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls. For example, when the auditor

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<sup>4</sup> ISA 530, *Audit Sampling*

decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, the general IT controls) are described as “indirect” controls.

- A31. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity’s general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.

### Timing of Tests of Controls

Intended period of reliance (Ref: Para. 11)

- A32. Audit evidence pertaining only to a point in time may be sufficient for the auditor’s purpose, for example, when testing controls over the entity’s physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity’s monitoring of controls.

Using audit evidence obtained during an interim period (Ref: Para. 12(b))

- A33. Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:
- The significance of the assessed risks of material misstatement at the assertion level.
  - The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel.
  - The degree to which audit evidence about the operating effectiveness of those controls was obtained.
  - The length of the remaining period.
  - The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.
  - The control environment.
- A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the entity’s monitoring of controls.

Using audit evidence obtained in previous audits (Ref: Para. 13)

A35. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

Controls that have changed from previous audits (Ref: Para. 14(a))

A36. Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A37. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

- (a) have not changed since they were last tested; and
- (b) are not controls that mitigate a significant risk,

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year.

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A deficient control environment.
- Deficient monitoring of controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT controls.

A39. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

#### Evaluating the Operating Effectiveness of Controls (Ref: Para. 16–17)

A40. A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

A41. The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor.

#### *Substantive Procedures* (Ref: Para. 18)

A42. Paragraph 18 requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. This requirement reflects the facts that: (a) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and (b) there are inherent limitations to internal control, including management override.

#### Nature and Extent of Substantive Procedures

A43. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

A44. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. ISA 520<sup>5</sup> establishes requirements and provides guidance on the application of analytical procedures during an audit.

A45. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion

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<sup>5</sup> ISA 520, *Analytical Procedures*

may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

- A46. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.
- A47. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. See ISA 500.<sup>6</sup>

#### Considering Whether External Confirmation Procedures Are to Be Performed (Ref: Para. 19)

A48. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cutoff assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms.

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<sup>6</sup> ISA 500, *Audit Evidence*, paragraph 10

- A49. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.
- A50. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor's decision about whether to perform external confirmation procedures.
- A51. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:
- The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
  - The ability or willingness of the intended confirming party to respond – for example, the confirming party:
    - May not accept responsibility for responding to a confirmation request;
    - May consider responding too costly or time consuming;
    - May have concerns about the potential legal liability resulting from responding;
    - May account for transactions in different currencies; or
    - May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

- The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

#### Substantive Procedures Related to the Financial Statement Closing Process (Ref: Para. 20)

- A52. The nature, and also the extent, of the auditor's substantive procedures related to the financial statement closing process depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

*Substantive Procedures Responsive to Significant Risks* (Ref: Para. 21)

A53. Paragraph 21 of this ISA requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

## Timing of Substantive Procedures (Ref: Para. 22–23)

A54. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. There are, however, exceptions, for example, a legal opinion obtained in a previous audit related to the structure of a securitization to which no changes have occurred, may be relevant in the current period. In such cases, it may be appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed, and audit procedures have been performed during the current period to establish its continuing relevance.

## Using audit evidence obtained during an interim period (Ref: Para. 22)

A55. In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to:

- (a) Identify amounts that appear unusual;
- (b) Investigate any such amounts; and
- (c) Perform substantive analytical procedures or tests of details to test the intervening period.

A56. Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the

remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The control environment and other relevant controls.
- The availability at a later date of information necessary for the auditor's procedures.
- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

A57. Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period end:

- Whether the period-end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.
- Whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.
- Whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:
  - (a) Significant unusual transactions or entries (including those at or near the period end);
  - (b) Other causes of significant fluctuations, or expected fluctuations that did not occur; and
  - (c) Changes in the composition of the classes of transactions or account balances.

Misstatements detected at an interim date (Ref: Para. 23)

A58. When the auditor concludes that the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating the procedures performed at the interim date at the period end.

**Adequacy of Presentation of the Financial Statements** (Ref: Para. 24)

A59. Evaluating the appropriate presentation, arrangement and content of the financial statements includes, for example, consideration of the terminology used as required by the applicable financial reporting framework, the level of detail provided, the aggregation and disaggregation of amounts and the bases of amounts set forth.

**Evaluating the Sufficiency and Appropriateness of Audit Evidence** (Ref: Para. 25–27)

A60. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example:

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a significant deficiency in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement.

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. ISA 315 (Revised) contains further guidance on revising the auditor's risk assessment.<sup>7</sup>

A61. The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

A62. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.

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<sup>7</sup> ISA 315 (Revised), paragraph 31

- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.
- Understanding of the entity and its environment, including the entity's internal control.

**Documentation** (Ref: Para. 28)

A63. The form and extent of audit documentation is a matter of professional judgment, and is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the audit.

**INTERNATIONAL STANDARD ON AUDITING 402**  
**AUDIT CONSIDERATIONS RELATING TO AN ENTITY**  
**USING A SERVICE ORGANIZATION**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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ISA

International Standard on Auditing (ISA) 402, *Audit Considerations Relating to an Entity Using a Service Organization*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organizations. Specifically, it expands on how the user auditor applies ISA 315 (Revised)<sup>1</sup> and ISA 330<sup>2</sup> in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.
2. Many entities outsource aspects of their business to organizations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions, such as the tax compliance function. Many of the services provided by such organizations are integral to the entity's business operations; however, not all those services are relevant to the audit.
3. Services provided by a service organization are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organization are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. A service organization's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:
  - (a) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
  - (b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
  - (c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;
  - (d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;

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<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>2</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

- (e) The financial reporting process used to prepare the user entity’s financial statements, including significant accounting estimates and disclosures; and
  - (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.
4. The nature and extent of work to be performed by the user auditor regarding the services provided by a service organization depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.
  5. This ISA does not apply to services provided by financial institutions that are limited to processing, for an entity’s account held at the financial institution, transactions that are specifically authorized by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker. In addition, this ISA does not apply to the audit of transactions arising from proprietary financial interests in other entities, such as partnerships, corporations and joint ventures, when proprietary interests are accounted for and reported to interest holders.

**Effective Date**

6. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

**Objectives**

7. The objectives of the user auditor, when the user entity uses the services of a service organization, are:
  - (a) To obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the user entity’s internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and
  - (b) To design and perform audit procedures responsive to those risks.

**Definitions**

8. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) 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, are identified in the description of its system.
  - (b) Report on the description and design of controls at a service organization (referred to in this ISA as a type 1 report) – A report that comprises:

- (i) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls that have been designed and implemented as at a specified date; and
  - (ii) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organization's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.
- (c) Report on the description, design, and operating effectiveness of controls at a service organization (referred to in this ISA as a type 2 report) – A report that comprises:
- (i) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and
  - (ii) A report by the service auditor with the objective of conveying reasonable assurance that includes:
    - a. The service auditor's opinion on the description of the service organization's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
    - b. A description of the service auditor's tests of the controls and the results thereof.
- (d) Service auditor – An auditor who, at the request of the service organization, provides an assurance report on the controls of a service organization.
- (e) Service organization – A third-party organization (or segment of a third-party organization) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.
- (f) Service organization's system – The policies and procedures designed, implemented and maintained by the service organization to provide user entities with the services covered by the service auditor's report.
- (g) Subservice organization – A service organization used by another service organization to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.

- (h) User auditor – An auditor who audits and reports on the financial statements of a user entity.
- (i) User entity – An entity that uses a service organization and whose financial statements are being audited.

## Requirements

### Obtaining an Understanding of the Services Provided by a Service Organization, Including Internal Control

9. When obtaining an understanding of the user entity in accordance with ISA 315 (Revised),<sup>3</sup> the user auditor shall obtain an understanding of how a user entity uses the services of a service organization in the user entity’s operations, including: (Ref: Para. A1–A2)
  - (a) The nature of the services provided by the service organization and the significance of those services to the user entity, including the effect thereof on the user entity’s internal control; (Ref: Para. A3–A5)
  - (b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organization; (Ref: Para. A6)
  - (c) The degree of interaction between the activities of the service organization and those of the user entity; and (Ref: Para. A7)
  - (d) The nature of the relationship between the user entity and the service organization, including the relevant contractual terms for the activities undertaken by the service organization. (Ref: Para. A8–A11)
10. When obtaining an understanding of internal control relevant to the audit in accordance with ISA 315 (Revised),<sup>4</sup> the user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization. (Ref: Para. A12–A14)
11. The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organization and their effect on the user entity’s internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.
12. If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures:

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<sup>3</sup> ISA 315 (Revised), paragraph 11

<sup>4</sup> ISA 315 (Revised), paragraph 12

- (a) Obtaining a type 1 or type 2 report, if available;
- (b) Contacting the service organization, through the user entity, to obtain specific information;
- (c) Visiting the service organization and performing procedures that will provide the necessary information about the relevant controls at the service organization; or
- (d) Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organization. (Ref: Para. A15–A20)

*Using a Type 1 or Type 2 Report to Support the User Auditor’s Understanding of the Service Organization*

13. In determining the sufficiency and appropriateness of the audit evidence provided by a type 1 or type 2 report, the user auditor shall be satisfied as to:
  - (a) The service auditor’s professional competence and independence from the service organization; and
  - (b) The adequacy of the standards under which the type 1 or type 2 report was issued. (Ref: Para. A 21)
14. If the user auditor plans to use a type 1 or type 2 report as audit evidence to support the user auditor’s understanding about the design and implementation of controls at the service organization, the user auditor shall:
  - (a) Evaluate whether the description and design of controls at the service organization is at a date or for a period that is appropriate for the user auditor’s purposes;
  - (b) Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity’s internal control relevant to the audit; and
  - (c) Determine whether complementary user entity controls identified by the service organization are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls. (Ref: Para. A22–A23)

**Responding to the Assessed Risks of Material Misstatement**

15. In responding to assessed risks in accordance with ISA 330, the user auditor shall:
  - (a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,

- (b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organization on the user auditor’s behalf. (Ref: Para. A24–A28)

*Tests of Controls*

16. When the user auditor’s risk assessment includes an expectation that controls at the service organization are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:
- (a) Obtaining a type 2 report, if available;
  - (b) Performing appropriate tests of controls at the service organization; or
  - (c) Using another auditor to perform tests of controls at the service organization on behalf of the user auditor. (Ref: Para. A29–A30)

**Using a Type 2 Report as Audit Evidence that Controls at the Service Organization Are Operating Effectively**

17. If, in accordance with paragraph 16(a), the user auditor plans to use a type 2 report as audit evidence that controls at the service organization are operating effectively, the user auditor shall determine whether the service auditor’s report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor’s risk assessment by:
- (a) Evaluating whether the description, design and operating effectiveness of controls at the service organization is at a date or for a period that is appropriate for the user auditor’s purposes;
  - (b) Determining whether complementary user entity controls identified by the service organization are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;
  - (c) Evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and
  - (d) Evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor’s report, are relevant to the assertions in the user entity’s financial statements and provide sufficient appropriate audit evidence to support the user auditor’s risk assessment. (Ref: Para. A31–A39)

**Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organization**

18. If the user auditor plans to use a type 1 or a type 2 report that excludes the services provided by a subservice organization and those services are relevant to the audit of the user entity’s financial statements, the user auditor shall

apply the requirements of this ISA with respect to the services provided by the subservice organization. (Ref: Para. A40)

### **Fraud, Non-Compliance with Laws and Regulations, and Uncorrected Misstatements in Relation to Activities at the Service Organization**

19. The user auditor shall inquire of management of the user entity whether the service organization has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report. (Ref: Para. A41)

#### **Reporting by the User Auditor**

20. The user auditor shall modify the opinion in the user auditor's report in accordance with ISA 705 (Revised)<sup>5</sup> if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organization relevant to the audit of the user entity's financial statements. (Ref: Para. A42)
21. The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion. (Ref: Para. A43)
22. If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion. (Ref: Para. A44)

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### **Application and Other Explanatory Material**

#### **Obtaining an Understanding of the Services Provided by a Service Organization, Including Internal Control**

*Sources of Information* (Ref: Para. 9)

- A1. Information on the nature of the services provided by a service organization may be available from a wide variety of sources, such as:
- User manuals.
  - System overviews.

<sup>5</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, paragraph 6

- Technical manuals.
- The contract or service level agreement between the user entity and the service organization.
- Reports by service organizations, the internal audit function or regulatory authorities on controls at the service organization.
- Reports by the service auditor, including management letters, if available.

A2. Knowledge obtained through the user auditor’s experience with the service organization, for example, through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organization. This may be particularly helpful if the services and controls at the service organization over those services are highly standardized.

*Nature of the Services Provided by the Service Organization* (Ref: Para. 9(a))

A3. A user entity may use a service organization such as one that processes transactions and maintains related accountability, or records transactions and processes related data. Service organizations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others; mortgage bankers that service mortgages for others; and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions.

A4. Examples of service organization services that are relevant to the audit include:

- Maintenance of the user entity’s accounting records.
- Management of assets.
- Initiating, recording or processing transactions as agent of the user entity.

Considerations Specific to Smaller Entities

A5. Smaller entities may use external bookkeeping services ranging from the processing of certain transactions (for example, payment of payroll taxes) and maintenance of their accounting records to the preparation of their financial statements. The use of such a service organization for the preparation of its financial statements does not relieve management of the smaller entity and, where appropriate, those charged with governance of their responsibilities for the financial statements.<sup>6</sup>

*Nature and Materiality of Transactions Processed by the Service Organization* (Ref: Para. 9(b))

A6. A service organization may establish policies and procedures that affect the user entity’s internal control. These policies and procedures are at least in part

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<sup>6</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraphs 4 and A4–A5

physically and operationally separate from the user entity. The significance of the controls of the service organization to those of the user entity depends on the nature of the services provided by the service organization, including the nature and materiality of the transactions it processes for the user entity. In certain situations, the transactions processed and the accounts affected by the service organization may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

*The Degree of Interaction between the Activities of the Service Organization and the User Entity* (Ref: Para. 9(c))

A7. The significance of the controls of the service organization to those of the user entity also depends on the degree of interaction between its activities and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organization. For example, a high degree of interaction exists between the activities of the user entity and those at the service organization when the user entity authorizes transactions and the service organization processes and does the accounting for those transactions. In these circumstances, it may be practicable for the user entity to implement effective controls over those transactions. On the other hand, when the service organization initiates or initially records, processes, and does the accounting for the user entity's transactions, there is a lower degree of interaction between the two organizations. In these circumstances, the user entity may be unable to, or may elect not to, implement effective controls over these transactions at the user entity and may rely on controls at the service organization.

*Nature of the Relationship between the User Entity and the Service Organization* (Ref: Para. 9(d))

- A8. The contract or service level agreement between the user entity and the service organization may provide for matters such as:
- The information to be provided to the user entity and responsibilities for initiating transactions relating to the activities undertaken by the service organization;
  - The application of requirements of regulatory bodies concerning the form of records to be maintained, or access to them;
  - The indemnification, if any, to be provided to the user entity in the event of a performance failure;
  - Whether the service organization will provide a report on its controls and, if so, whether such report would be a type 1 or type 2 report;

- Whether the user auditor has rights of access to the accounting records of the user entity maintained by the service organization and other information necessary for the conduct of the audit; and
- Whether the agreement allows for direct communication between the user auditor and the service auditor.

A9. There is a direct relationship between the service organization and the user entity and between the service organization and the service auditor. These relationships do not necessarily create a direct relationship between the user auditor and the service auditor. When there is no direct relationship between the user auditor and the service auditor, communications between the user auditor and the service auditor are usually conducted through the user entity and the service organization. A direct relationship may also be created between a user auditor and a service auditor, taking into account the relevant ethical and confidentiality considerations. A user auditor, for example, may use a service auditor to perform procedures on the user auditor's behalf, such as:

- (a) Tests of controls at the service organization; or
- (b) Substantive procedures on the user entity's financial statement transactions and balances maintained by a service organization.

#### Considerations Specific to Public Sector Entities

A10. Public sector auditors generally have broad rights of access established by legislation. However, there may be situations where such rights of access are not available, for example, when the service organization is located in a different jurisdiction. In such cases, a public sector auditor may need to obtain an understanding of the legislation applicable in the different jurisdiction to determine whether appropriate access rights can be obtained. A public sector auditor may also obtain or ask the user entity to incorporate rights of access in any contractual arrangements between the user entity and the service organization.

A11. Public sector auditors may also use another auditor to perform tests of controls or substantive procedures in relation to compliance with law, regulation or other authority.

#### *Understanding the Controls Relating to Services Provided by the Service Organization (Ref: Para. 10)*

A12. The user entity may establish controls over the service organization's services that may be tested by the user auditor and that may enable the user auditor to conclude that the user entity's controls are operating effectively for some or all of the related assertions, regardless of the controls in place at the service organization. If a user entity, for example, uses a service organization to process its payroll transactions, the user entity may establish controls over the submission and receipt of payroll information that could prevent or detect material misstatements. These controls may include:

- Comparing the data submitted to the service organization with reports of information received from the service organization after the data has been processed.
  - Recomputing a sample of the payroll amounts for clerical accuracy and reviewing the total amount of the payroll for reasonableness.
- A13. In this situation, the user auditor may perform tests of the user entity's controls over payroll processing that would provide a basis for the user auditor to conclude that the user entity's controls are operating effectively for the assertions related to payroll transactions.
- A14. As noted in ISA 315 (Revised),<sup>7</sup> in respect of some risks, the user auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions and account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. Such automated processing characteristics may be particularly present when the user entity uses service organizations. In such cases, the user entity's controls over such risks are relevant to the audit and the user auditor is required to obtain an understanding of, and to evaluate, such controls in accordance with paragraphs 9 and 10 of this ISA.

*Further Procedures When a Sufficient Understanding Cannot Be Obtained from the User Entity* (Ref: Para. 12)

- A15. The user auditor's decision as to which procedure, individually or in combination, in paragraph 12 to undertake, in order to obtain the information necessary to provide a basis for the identification and assessment of the risks of material misstatement in relation to the user entity's use of the service organization, may be influenced by such matters as:
- The size of both the user entity and the service organization;
  - The complexity of the transactions at the user entity and the complexity of the services provided by the service organization;
  - The location of the service organization (for example, the user auditor may decide to use another auditor to perform procedures at the service organization on the user auditor's behalf if the service organization is in a remote location);
  - Whether the procedure(s) is expected to effectively provide the user auditor with sufficient appropriate audit evidence; and
  - The nature of the relationship between the user entity and the service organization.

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<sup>7</sup> ISA 315 (Revised), paragraph 30

- A16. A service organization may engage a service auditor to report on the description and design of its controls (type 1 report) or on the description and design of its controls and their operating effectiveness (type 2 report). Type 1 or type 2 reports may be issued under International Standard on Assurance Engagements (ISAE) 3402<sup>8</sup> or under standards established by an authorized or recognized standards setting organization (which may identify them by different names, such as Type A or Type B reports).
- A17. The availability of a type 1 or type 2 report will generally depend on whether the contract between a service organization and a user entity includes the provision of such a report by the service organization. A service organization may also elect, for practical reasons, to make a type 1 or type 2 report available to the user entities. However, in some cases, a type 1 or type 2 report may not be available to user entities.
- A18. In some circumstances, a user entity may outsource one or more significant business units or functions, such as its entire tax planning and compliance functions, or finance and accounting or the controllership function to one or more service organizations. As a report on controls at the service organization may not be available in these circumstances, visiting the service organization may be the most effective procedure for the user auditor to gain an understanding of controls at the service organization, as there is likely to be direct interaction of management of the user entity with management at the service organization.
- A19. Another auditor may be used to perform procedures that will provide the necessary information about the relevant controls at the service organization. If a type 1 or type 2 report has been issued, the user auditor may use the service auditor to perform these procedures as the service auditor has an existing relationship with the service organization. The user auditor using the work of another auditor may find the guidance in ISA 600<sup>9</sup> useful as it relates to understanding another auditor (including that auditor's independence and professional competence), involvement in the work of another auditor in planning the nature, timing and extent of such work, and in evaluating the sufficiency and appropriateness of the audit evidence obtained.
- A20. A user entity may use a service organization that in turn uses a subservice organization to provide some of the services provided to a user entity that are part of the user entity's information system relevant to financial reporting. The subservice organization may be a separate entity from the service organization or may be related to the service organization. A user auditor may need to consider controls at the subservice organization. In situations where

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<sup>8</sup> ISAE 3402, *Assurance Reports on Controls at a Service Organization*

<sup>9</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph 2, states: "An auditor may find this ISA, adapted as necessary in the circumstances, useful when that auditor involves other auditors in the audit of financial statements that are not group financial statements ..." See also paragraph 19 of ISA 600.

one or more subservice organizations are used, the interaction between the activities of the user entity and those of the service organization is expanded to include the interaction between the user entity, the service organization and the subservice organizations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organization and the subservice organizations are the most important factors for the user auditor to consider in determining the significance of the service organization's and subservice organization's controls to the user entity's controls.

*Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organization (Ref: Para. 13–14)*

- A21. The user auditor may make inquiries about the service auditor to the service auditor's professional organization or other practitioners and inquire whether the service auditor is subject to regulatory oversight. The service auditor may be practicing in a jurisdiction where different standards are followed in respect of reports on controls at a service organization, and the user auditor may obtain information about the standards used by the service auditor from the standard setting organization.
- A22. A type 1 or type 2 report, along with information about the user entity, may assist the user auditor in obtaining an understanding of:
- (a) The aspects of controls at the service organization that may affect the processing of the user entity's transactions, including the use of subservice organizations;
  - (b) The flow of significant transactions through the service organization to determine the points in the transaction flow where material misstatements in the user entity's financial statements could occur;
  - (c) The control objectives at the service organization that are relevant to the user entity's financial statement assertions; and
  - (d) Whether controls at the service organization are suitably designed and implemented to prevent, or detect and correct processing errors that could result in material misstatements in the user entity's financial statements.

A type 1 or type 2 report may assist the user auditor in obtaining a sufficient understanding to identify and assess the risks of material misstatement. A type 1 report, however, does not provide any evidence of the operating effectiveness of the relevant controls.

- A23. A type 1 or type 2 report that is as of a date or for a period that is outside of the reporting period of a user entity may assist the user auditor in obtaining a preliminary understanding of the controls implemented at the service organization if the report is supplemented by additional current information

from other sources. If the service organization's description of controls is as of a date or for a period that precedes the beginning of the period under audit, the user auditor may perform procedures to update the information in a type 1 or type 2 report, such as:

- Discussing the changes at the service organization with user entity personnel who would be in a position to know of such changes;
- Reviewing current documentation and correspondence issued by the service organization; or
- Discussing the changes with service organization personnel.

### **Responding to the Assessed Risks of Material Misstatement (Ref: Para. 15)**

- A24. Whether the use of a service organization increases a user entity's risk of material misstatement depends on the nature of the services provided and the controls over these services; in some cases, the use of a service organization may decrease a user entity's risk of material misstatement, particularly if the user entity itself does not possess the expertise necessary to undertake particular activities, such as initiating, processing, and recording transactions, or does not have adequate resources (for example, an IT system).
- A25. When the service organization maintains material elements of the accounting records of the user entity, direct access to those records may be necessary in order for the user auditor to obtain sufficient appropriate audit evidence relating to the operations of controls over those records or to substantiate transactions and balances recorded in them, or both. Such access may involve either physical inspection of records at the service organization's premises or interrogation of records maintained electronically from the user entity or another location, or both. Where direct access is achieved electronically, the user auditor may thereby obtain evidence as to the adequacy of controls operated by the service organization over the completeness and integrity of the user entity's data for which the service organization is responsible.
- A26. In determining the nature and extent of audit evidence to be obtained in relation to balances representing assets held or transactions undertaken by a service organization on behalf of the user entity, the following procedures may be considered by the user auditor:
- (a) Inspecting records and documents held by the user entity: the reliability of this source of evidence is determined by the nature and extent of the accounting records and supporting documentation retained by the user entity. In some cases, the user entity may not maintain independent detailed records or documentation of specific transactions undertaken on its behalf.
  - (b) Inspecting records and documents held by the service organization: the user auditor's access to the records of the service organization may be

established as part of the contractual arrangements between the user entity and the service organization. The user auditor may also use another auditor, on its behalf, to gain access to the user entity's records maintained by the service organization.

- (c) Obtaining confirmations of balances and transactions from the service organization: where the user entity maintains independent records of balances and transactions, confirmation from the service organization corroborating the user entity's records may constitute reliable audit evidence concerning the existence of the transactions and assets concerned. For example, when multiple service organizations are used, such as an investment manager and a custodian, and these service organizations maintain independent records, the user auditor may confirm balances with these organizations in order to compare this information with the independent records of the user entity.

If the user entity does not maintain independent records, information obtained in confirmations from the service organization is merely a statement of what is reflected in the records maintained by the service organization. Therefore, such confirmations do not, taken alone, constitute reliable audit evidence. In these circumstances, the user auditor may consider whether an alternative source of independent evidence can be identified.

- (d) Performing analytical procedures on the records maintained by the user entity or on the reports received from the service organization: the effectiveness of analytical procedures is likely to vary by assertion and will be affected by the extent and detail of information available.

A27. Another auditor may perform procedures that are substantive in nature for the benefit of user auditors. Such an engagement may involve the performance, by another auditor, of procedures agreed upon by the user entity and its user auditor and by the service organization and its service auditor. The findings resulting from the procedures performed by another auditor are reviewed by the user auditor to determine whether they constitute sufficient appropriate audit evidence. In addition, there may be requirements imposed by governmental authorities or through contractual arrangements whereby a service auditor performs designated procedures that are substantive in nature. The results of the application of the required procedures to balances and transactions processed by the service organization may be used by user auditors as part of the evidence necessary to support their audit opinions. In these circumstances, it may be useful for the user auditor and the service auditor to agree, prior to the performance of the procedures, to the audit documentation or access to audit documentation that will be provided to the user auditor.

A28. In certain circumstances, in particular when a user entity outsources some or all of its finance function to a service organization, the user auditor may face a

situation where a significant portion of the audit evidence resides at the service organization. Substantive procedures may need to be performed at the service organization by the user auditor or another auditor on its behalf. A service auditor may provide a type 2 report and, in addition, may perform substantive procedures on behalf of the user auditor. The involvement of another auditor does not alter the user auditor's responsibility to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Accordingly, the user auditor's consideration of whether sufficient appropriate audit evidence has been obtained and whether the user auditor needs to perform further substantive procedures includes the user auditor's involvement with, or evidence of, the direction, supervision and performance of the substantive procedures performed by another auditor.

*Tests of Controls* (Ref: Para. 16)

A29. The user auditor is required by ISA 330<sup>10</sup> to design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls in certain circumstances. In the context of a service organization, this requirement applies when:

- (a) The user auditor's assessment of risks of material misstatement includes an expectation that the controls at the service organization are operating effectively (that is, the user auditor intends to rely on the operating effectiveness of controls at the service organization in determining the nature, timing and extent of substantive procedures); or
- (b) Substantive procedures alone, or in combination with tests of the operating effectiveness of controls at the user entity, cannot provide sufficient appropriate audit evidence at the assertion level.

A30. If a type 2 report is not available, a user auditor may contact the service organization, through the user entity, to request that a service auditor be engaged to provide a type 2 report that includes tests of the operating effectiveness of the relevant controls or the user auditor may use another auditor to perform procedures at the service organization that test the operating effectiveness of those controls. A user auditor may also visit the service organization and perform tests of relevant controls if the service organization agrees to it. The user auditor's risk assessments are based on the combined evidence provided by the work of another auditor and the user auditor's own procedures.

Using a Type 2 Report as Audit Evidence that Controls at the Service Organization Are Operating Effectively (Ref: Para. 17)

A31. A type 2 report may be intended to satisfy the needs of several different user auditors; therefore tests of controls and results described in the service

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<sup>10</sup> ISA 330, paragraph 8

auditor's report may not be relevant to assertions that are significant in the user entity's financial statements. The relevant tests of controls and results are evaluated to determine that the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment. In doing so, the user auditor may consider the following factors:

- (a) The time period covered by the tests of controls and the time elapsed since the performance of the tests of controls;
- (b) The scope of the service auditor's work and the services and processes covered, the controls tested and tests that were performed, and the way in which tested controls relate to the user entity's controls; and
- (c) The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

A32. For certain assertions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less audit evidence the test may provide. In comparing the period covered by the type 2 report to the user entity's financial reporting period, the user auditor may conclude that the type 2 report offers less audit evidence if there is little overlap between the period covered by the type 2 report and the period for which the user auditor intends to rely on the report. When this is the case, a type 2 report covering a preceding or subsequent period may provide additional audit evidence. In other cases, the user auditor may determine it is necessary to perform, or use another auditor to perform, tests of controls at the service organization in order to obtain sufficient appropriate audit evidence about the operating effectiveness of those controls.

A33. It may also be necessary for the user auditor to obtain additional evidence about significant changes to the relevant controls at the service organization outside of the period covered by the type 2 report or determine additional audit procedures to be performed. Relevant factors in determining what additional audit evidence to obtain about controls at the service organization that were operating outside of the period covered by the service auditor's report may include:

- The significance of the assessed risks of material misstatement at the assertion level;
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel;
- The degree to which audit evidence about the operating effectiveness of those controls was obtained;
- The length of the remaining period;

- The extent to which the user auditor intends to reduce further substantive procedures based on the reliance on controls; and
  - The effectiveness of the control environment and monitoring of controls at the user entity.
- A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the user entity's monitoring of controls.
- A35. If the service auditor's testing period is completely outside the user entity's financial reporting period, the user auditor will be unable to rely on such tests for the user auditor to conclude that the user entity's controls are operating effectively because they do not provide current audit period evidence of the effectiveness of the controls, unless other procedures are performed.
- A36. In certain circumstances, a service provided by the service organization may be designed with the assumption that certain controls will be implemented by the user entity. For example, the service may be designed with the assumption that the user entity will have controls in place for authorizing transactions before they are sent to the service organization for processing. In such a situation, the service organization's description of controls may include a description of those complementary user entity controls. The user auditor considers whether those complementary user entity controls are relevant to the service provided to the user entity.
- A37. If the user auditor believes that the service auditor's report may not provide sufficient appropriate audit evidence, for example, if a service auditor's report does not contain a description of the service auditor's tests of controls and results thereon, the user auditor may supplement the understanding of the service auditor's procedures and conclusions by contacting the service organization, through the user entity, to request a discussion with the service auditor about the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, the user auditor may contact the service organization, through the user entity, to request that the service auditor perform procedures at the service organization. Alternatively, the user auditor, or another auditor at the request of the user auditor, may perform such procedures.
- A38. The service auditor's type 2 report identifies results of tests, including exceptions and other information that could affect the user auditor's conclusions. Exceptions noted by the service auditor or a modified opinion in the service auditor's type 2 report do not automatically mean that the service auditor's type 2 report will not be useful for the audit of the user entity's financial statements in assessing the risks of material misstatement. Rather, the exceptions and the matter giving rise to a modified opinion in the service auditor's type 2 report are considered in the user auditor's assessment of the testing of controls performed by the service auditor. In considering the exceptions and matters giving rise to a modified opinion, the user auditor may discuss such matters with the service

auditor. Such communication is dependent upon the user entity contacting the service organization, and obtaining the service organization's approval for the communication to take place.

Communication of deficiencies in internal control identified during the audit

A39. The user auditor is required to communicate in writing significant deficiencies identified during the audit to both management and those charged with governance on a timely basis.<sup>11</sup> The user auditor is also required to communicate to management at an appropriate level of responsibility on a timely basis other deficiencies in internal control identified during the audit that, in the user auditor's professional judgment, are of sufficient importance to merit management's attention.<sup>12</sup> Matters that the user auditor may identify during the audit and may communicate to management and those charged with governance of the user entity include:

- Any monitoring of controls that could be implemented by the user entity, including those identified as a result of obtaining a type 1 or type 2 report;
- Instances where complementary user entity controls are noted in the type 1 or type 2 report and are not implemented at the user entity; and
- Controls that may be needed at the service organization that do not appear to have been implemented or that are not specifically covered by a type 2 report.

### **Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organization** (Ref: Para. 18)

A40. If a service organization uses a subservice organization, the service auditor's report may either include or exclude the subservice organization's relevant control objectives and related controls in the service organization's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the inclusive method and the carve-out method, respectively. If the type 1 or type 2 report excludes the controls at a subservice organization, and the services provided by the subservice organization are relevant to the audit of the user entity's financial statements, the user auditor is required to apply the requirements of this ISA in respect of the subservice organization. The nature and extent of work to be performed by the user auditor regarding the services provided by a subservice organization depend on the nature and significance of those services to the user entity and the relevance of those services to the audit. The application of the requirement in paragraph 9 assists the user auditor in determining the effect of the subservice organization and the nature and extent of work to be performed.

<sup>11</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraphs 9–10

<sup>12</sup> ISA 265, paragraph 10

**Fraud, Non-Compliance with Laws and Regulations, and Uncorrected Misstatements in Relation to Activities at the Service Organization** (Ref: Para. 19)

A41. A service organization may be required under the terms of the contract with user entities to disclose to affected user entities any fraud, non-compliance with laws and regulations or uncorrected misstatements attributable to the service organization's management or employees. As required by paragraph 19, the user auditor makes inquiries of the user entity management regarding whether the service organization has reported any such matters and evaluates whether any matters reported by the service organization affect the nature, timing and extent of the user auditor's further audit procedures. In certain circumstances, the user auditor may require additional information to perform this evaluation, and may request the user entity to contact the service organization to obtain the necessary information.

**Reporting by the User Auditor** (Ref: Para. 20)

A42. When a user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organization relevant to the audit of the user entity's financial statements, a limitation on the scope of the audit exists. This may be the case when:

- The user auditor is unable to obtain a sufficient understanding of the services provided by the service organization and does not have a basis for the identification and assessment of the risks of material misstatement;
- A user auditor's risk assessment includes an expectation that controls at the service organization are operating effectively and the user auditor is unable to obtain sufficient appropriate audit evidence about the operating effectiveness of these controls; or
- Sufficient appropriate audit evidence is only available from records held at the service organization, and the user auditor is unable to obtain direct access to these records.

Whether the user auditor expresses a qualified opinion or disclaims an opinion depends on the user auditor's conclusion as to whether the possible effects on the financial statements are material or pervasive.

*Reference to the Work of a Service Auditor* (Ref: Para. 21–22)

A43. In some cases, law or regulation may require a reference to the work of a service auditor in the user auditor's report, for example, for the purposes of transparency in the public sector. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

A44. The fact that a user entity uses a service organization does not alter the user auditor's responsibility under ISAs to obtain sufficient appropriate audit

evidence to afford a reasonable basis to support the user auditor's opinion. Therefore, the user auditor does not make reference to the service auditor's report as a basis, in part, for the user auditor's opinion on the user entity's financial statements. However, when the user auditor expresses a modified opinion because of a modified opinion in a service auditor's report, the user auditor is not precluded from referring to the service auditor's report if such reference assists in explaining the reason for the user auditor's modified opinion. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

**INTERNATIONAL STANDARD ON AUDITING 450**  
**EVALUATION OF MISSTATEMENTS IDENTIFIED**  
**DURING THE AUDIT**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 450, *Evaluation of Misstatements Identified during the Audit*, should be read in the context of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. ISA 700 deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by ISA 700 (Revised) takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this ISA.<sup>1</sup> ISA 320<sup>2</sup> deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

### Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objective

3. The objective of the auditor is to evaluate:
  - (a) The effect of identified misstatements on the audit; and
  - (b) The effect of uncorrected misstatements, if any, on the financial statements.

### Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) **Misstatement** – A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

- (b) **Uncorrected misstatements** – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

<sup>1</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 10–11

<sup>2</sup> ISA 320, *Materiality in Planning and Performing an Audit*

## Requirements

### Accumulation of Identified Misstatements

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2–A6)

### Consideration of Identified Misstatements as the Audit Progresses

6. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:
  - (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A7)
  - (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with ISA 320. (Ref: Para. A8)
7. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A9)

### Communication and Correction of Misstatements

8. The auditor shall communicate, unless prohibited by law or regulation, on a timely basis all misstatements accumulated during the audit with the appropriate level of management.<sup>3</sup> The auditor shall request management to correct those misstatements. (Ref: Para. A10–A12)
9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A13)

### Evaluating the Effect of Uncorrected Misstatements

10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with ISA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A14–A15)
11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

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<sup>3</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 7

- (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A16–A22, A24–A25)
- (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A23)

### *Communication with Those Charged with Governance*

- 12. The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor’s report, unless prohibited by law or regulation.<sup>4</sup> The auditor’s communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A26–A28)
- 13. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

### **Written Representations**

- 14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A29)

### **Documentation**

- 15. The auditor shall include in the audit documentation:<sup>5</sup> (Ref: Para. A30)
  - (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);
  - (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5, 8 and 12); and
  - (c) The auditor’s conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion (paragraph 11).

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<sup>4</sup> See footnote 3.

<sup>5</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

## Application and Other Explanatory Material

### Definition of Misstatement (Ref: Para. 4(a))

A1. Misstatements may result from:

- (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;
- (b) An omission of an amount or disclosure, including inadequate or incomplete disclosures, and those disclosures required to meet disclosure objectives of certain financial reporting frameworks as applicable;<sup>6</sup>
- (c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts;
- (d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.
- (e) An inappropriate classification, aggregation or disaggregation, of information; and
- (f) For financial statements prepared in accordance with a fair presentation framework, the omission of a disclosure necessary for the financial statements to achieve fair presentation beyond disclosures specifically required by the framework.<sup>7</sup>

Examples of misstatements arising from fraud are provided in ISA 240.<sup>8</sup>

### Accumulation of Identified Misstatements (Ref: Para. 5)

#### “Clearly Trivial”

A2. Paragraph 5 of this ISA requires the auditor to accumulate misstatements identified during the audit other than those that are clearly trivial. “Clearly trivial” is not another expression for “not material.” Misstatements that are clearly trivial will be of a wholly different (smaller) order of magnitude, or of a wholly different nature than those that would be determined to be material, and will be misstatements that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature

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<sup>6</sup> For example, International Financial Reporting Standard 7 (IFRS), *Financial Instruments: Disclosures*, paragraph 42H states that “an entity shall disclose any additional information that it considers necessary to meet the disclosure objectives in paragraph...”

<sup>7</sup> For example, IFRS requires an entity to provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial position and financial performance (International Accounting Standard 1, *Presentation of Financial Statements*, paragraph 17(c)).

<sup>8</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs A1–A7

or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the misstatement is considered not to be clearly trivial.

#### *Misstatements in Individual Statements*

- A3. The auditor may designate an amount below which misstatements of amounts in the individual statements would be clearly trivial, and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. However, misstatements of amounts that are above the designated amount are accumulated as required by paragraph 5 of this ISA. In addition, misstatements relating to amounts may not be clearly trivial when judged on criteria of nature or circumstances, and, if not, are accumulated as required by paragraph 5 of this ISA.

#### *Misstatements in Disclosures*

- A4. Misstatements in disclosures may also be clearly trivial whether taken individually or in aggregate, and whether judged by any criteria of size, nature or circumstances. Misstatements in disclosures that are not clearly trivial are also accumulated to assist the auditor in evaluating the effect of such misstatements on the relevant disclosures and the financial statements as a whole. Paragraph A17 of this ISA provides examples of where misstatements in qualitative disclosures may be material.

#### *Accumulation of Misstatements*

- A5. Misstatements by nature or circumstances, accumulated as described in paragraphs A3–A4, cannot be added together as is possible in the case of misstatements of amounts. Nevertheless, the auditor is required by paragraph 11 of this ISA to evaluate those misstatements individually and in aggregate (i.e., collectively with other misstatements) to determine whether they are material.
- A6. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.
- Factual misstatements are misstatements about which there is no doubt.
  - Judgmental misstatements are differences arising from the judgments of management including those concerning recognition, measurement, presentation and disclosure in the financial statements (including the selection or application of accounting policies) that the auditor considers unreasonable or inappropriate.
  - Projected misstatements are the auditor’s best estimate of misstatements in populations, involving the projection of misstatements identified in

audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in ISA 530.<sup>9</sup>

### **Consideration of Identified Misstatements as the Audit Progresses** (Ref: Para. 6–7)

- A7. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.
- A8. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with ISA 320, there may be a greater than acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.<sup>10</sup>
- A9. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

### **Communication and Correction of Misstatements** (Ref: Para. 8–9)

- A10. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the classes of transactions, account balances and disclosures are misstated, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.
- A11. In some jurisdictions, law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the auditor is required to report identified or suspected non-compliance with law or regulation to an appropriate authority pursuant to anti-money

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<sup>9</sup> ISA 530, *Audit Sampling*, paragraphs 14–15

<sup>10</sup> ISA 530, paragraph 5(c)–(d)

laundering legislation. In these circumstances, the issues considered by the auditor may be complex and the auditor may consider it appropriate to obtain legal advice.

- A12. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.
- A13. ISA 700 (Revised) requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments,<sup>11</sup> which may be affected by the auditor's understanding of management's reasons for not making the corrections.

#### **Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 10–11)**

- A14. The auditor's determination of materiality in accordance with ISA 320 is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with ISA 320 based on the actual financial results.
- A15. ISA 320 explains that, as the audit progresses, materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.<sup>12</sup> Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with ISA 320 (see paragraph 10 of this ISA) gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.
- A16. Each individual misstatement of an amount is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

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<sup>11</sup> ISA 700 (Revised), paragraph 12

<sup>12</sup> ISA 320, paragraph 12

A17. In addition, each individual misstatement of a qualitative disclosure is considered to evaluate its effect on the relevant disclosure(s), as well as its overall effect on the financial statements as a whole. The determination of whether a misstatement(s) in a qualitative disclosure is material, in the context of the applicable financial reporting framework and the specific circumstances of the entity, is a matter that involves the exercise of professional judgment. Examples where such misstatements may be material include:

- Inaccurate or incomplete descriptions of information about the objectives, policies and processes for managing capital for entities with insurance and banking activities.
- The omission of information about the events or circumstances that have led to an impairment loss (e.g., a significant long-term decline in the demand for a metal or commodity) in an entity with mining operations.
- The incorrect description of an accounting policy relating to a significant item in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.
- The inadequate description of the sensitivity of an exchange rate in an entity that undertakes international trading activities.

A18. In determining whether uncorrected misstatements by nature are material as required by paragraph 11 of this ISA, the auditor considers uncorrected misstatements in amounts and disclosures. Such misstatements may be considered material either individually, or when taken in combination with other misstatements. For example, depending on the misstatements identified in disclosures, the auditor may consider whether:

- (a) Identified errors are persistent or pervasive; or
- (b) A number of identified misstatements are relevant to the same matter, and considered collectively may affect the users' understanding of that matter.

This consideration of accumulated misstatements is also helpful when evaluating the financial statements in accordance with paragraph 13(d) of ISA 700 (Revised), which requires the auditor to consider whether the overall presentation of the financial statements has been undermined by including information that is not relevant or that obscures a proper understanding of the matters disclosed.

A19. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further

undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.<sup>13</sup>

- A20. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.
- A21. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:
- Affects compliance with regulatory requirements;
  - Affects compliance with debt covenants or other contractual requirements;
  - Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
  - Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
  - Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
  - Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
  - Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
  - Is significant having regard to the auditor's understanding of known previous communications to users, for example, in relation to forecast earnings;

<sup>13</sup> The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to reassess the risk of material misstatement for that account balance or class of transactions.

- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity’s management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users’ understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information to be included in the entity’s annual report (for example, information to be included in a “Management Discussion and Analysis” or an “Operating and Financial Review”) that may reasonably be expected to influence the economic decisions of the users of the financial statements. ISA 720 (Revised)<sup>14</sup> deals with the auditor’s responsibilities relating to other information.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

A22. ISA 240<sup>15</sup> explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements. Depending on the circumstances, misstatements in disclosures could also be indicative of fraud, and, for example, may arise from:

- Misleading disclosures that have resulted from bias in management’s judgments; or
- Extensive duplicative or uninformative disclosures that are intended to obscure a proper understanding of matters in the financial statements.

When considering the implications of misstatements in classes of transactions, account balances and disclosures, the auditor exercises professional skepticism in accordance with ISA 200.<sup>16</sup>

A23. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period’s financial statements. There are different acceptable approaches to the auditor’s evaluation of such uncorrected misstatements on the current period’s financial statements. Using the same evaluation approach provides consistency from period to period.

#### *Considerations Specific to Public Sector Entities*

A24. In the case of an audit of a public sector entity, the evaluation whether a misstatement is material may also be affected by the auditor’s responsibilities

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<sup>14</sup> ISA 720 (Revised), *The Auditor’s Responsibilities Relating to Other Information*

<sup>15</sup> ISA 240, paragraph 36

<sup>16</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 15

established by law, regulation or other authority to report specific matters, including, for example, fraud.

- A25. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with law, regulation or other authority.

*Communication with Those Charged with Governance* (Ref: Para. 12)

- A26. If uncorrected misstatements have been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.<sup>17</sup>
- A27. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.
- A28. ISA 260 (Revised) requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this ISA).<sup>18</sup> The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

**Written Representations** (Ref: Para. 14)

- A29. Because the preparation of the financial statements requires management and, where appropriate, those charged with governance to adjust the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: “We do not agree that items ... and ... constitute misstatements because [description of reasons].” Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

<sup>17</sup> ISA 260 (Revised), paragraph 13

<sup>18</sup> ISA 260 (Revised), paragraph 16(c)(ii)

**Documentation** (Ref: Para. 15)

A30. The auditor's documentation of uncorrected misstatements may take into account:

- (a) The consideration of the aggregate effect of uncorrected misstatements;
- (b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and
- (c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

# INTERNATIONAL STANDARD ON AUDITING 500

## AUDIT EVIDENCE

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 500, *Audit Evidence*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

ISA

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.
2. This ISA is applicable to all the audit evidence obtained during the course of the audit. Other ISAs deal with specific aspects of the audit (for example, ISA 315 (Revised)<sup>1</sup>), the audit evidence to be obtained in relation to a particular topic (for example, ISA 570 (Revised)<sup>2</sup>), specific procedures to obtain audit evidence (for example, ISA 520<sup>3</sup>), and the evaluation of whether sufficient appropriate audit evidence has been obtained (ISA 200<sup>4</sup> and ISA 330<sup>5</sup>).

### Effective Date

3. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objective

4. The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

### Definitions

5. For purposes of the ISA, the following terms have the meanings attributed below:
  - (a) Accounting records – The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
  - (b) Appropriateness (of audit evidence) – The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

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<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>2</sup> ISA 570 (Revised), *Going Concern*

<sup>3</sup> ISA 520, *Analytical Procedures*

<sup>4</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

<sup>5</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

- (c) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and information obtained from other sources.
- (d) External information source – An external individual or organization that provides information that has been used by the entity in preparing the financial statements, or that has been obtained by the auditor as audit evidence, when such information is suitable for use by a broad range of users. When information has been provided by an individual or organization acting in the capacity of a management’s expert, service organization,<sup>6</sup> or auditor’s expert<sup>7</sup> the individual or organization is not considered an external information source with respect to that particular information. (Ref: Para. A1–A4)
- (e) Management’s expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.
- (f) Sufficiency (of audit evidence) – The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence.

## Requirements

### Sufficient Appropriate Audit Evidence

- 6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A5–A29)

### Information to Be Used as Audit Evidence

- 7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence, including information obtained from an external information source. (Ref: Para. A30–A44)
- 8. If information to be used as audit evidence has been prepared using the work of a management’s expert, the auditor shall, to the extent necessary, having regard to the significance of that expert’s work for the auditor’s purposes: (Ref: Para. A45–A47)
  - (a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A48–A54)
  - (b) Obtain an understanding of the work of that expert; and (Ref: Para. A55–A58)

<sup>6</sup> ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*, paragraph 8

<sup>7</sup> ISA 620, *Using the Work of an Auditor’s Expert*, paragraph 6

- (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A59)
9. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including, as necessary in the circumstances:
- (a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A60–A61)
- (b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes. (Ref: Para. A62)

### **Selecting Items for Testing to Obtain Audit Evidence**

10. When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A63–A67)

### **Inconsistency in, or Doubts over Reliability of, Audit Evidence**

11. If:
- (a) audit evidence obtained from one source is inconsistent with that obtained from another; or
- (b) the auditor has doubts over the reliability of information to be used as audit evidence,

the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit. (Ref: Para. A68)

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## **Application and Other Explanatory Material**

### **External Information Source** (Ref: Para 5(d))

- A1. External information sources may include pricing services, governmental organizations, central banks or recognized stock exchanges. Examples of information that may be obtained from external information sources include:
- Prices and pricing related data;
  - Macro-economic data, such as historical and forecast unemployment rates and economic growth rates, or census data;
  - Credit history data;

- Industry specific data, such as an index of reclamation costs for certain extractive industries, or viewership information or ratings used to determine advertising revenue in the entertainment industry; and
  - Mortality tables used to determine liabilities in the life insurance and pension sectors.
- A2. A particular set of information is more likely to be suitable for use by a broad range of users and less likely to be subject to influence by any particular user if the external individual or organization provides it to the public for free, or makes it available to a wide range of users in return for payment of a fee. Judgment may be required in determining whether the information is suitable for use by a broad range of users, taking into account the ability of the entity to influence the external information source.
- A3. An external individual or organization cannot, in respect of any particular set of information, be both an external information source and a management's expert, or service organization or auditor's expert.
- A4. However, an external individual or organization may, for example, be acting as a management's expert when providing a particular set of information, but may be acting as an external information source when providing a different set of information. In some circumstances, professional judgment may be needed to determine whether an external individual or organization is acting as an external information source or as a management's expert with respect to a particular set of information. In other circumstances, the distinction may be clear. For example:
- An external individual or organization may be providing information about real estate prices that is suitable for use by a broad range of users, for example, information made generally available pertaining to a geographical region, and be determined to be an external information source with respect to that set of information. The same external organization may also be acting as a management's or auditor's expert in providing commissioned valuations, with respect to the entity's real estate portfolio specifically tailored for the entity's facts and circumstances.
  - Some actuarial organizations publish mortality tables for general use which, when used by an entity, would generally be considered to be information from an external information source. The same actuarial organization may also be a management's expert with respect to different information tailored to the specific circumstances of the entity to help management determine the pension liability for several of the entity's pension plans.
  - An external individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the external individual or organization

applies that expertise in making an estimate specifically for the entity and that work is used by management in preparing its financial statements, the external individual or organization is likely to be a management's expert with respect to that information. If, on the other hand, that external individual or organization merely provides, to the public, prices or pricing-related data regarding private transactions, and the entity uses that information in its own estimation methods, the external individual or organization is likely to be an external information source with respect to such information.

- An external individual or organization may publish information, suitable for a broad range of users, about risks or conditions in an industry. If used by an entity in preparing its risk disclosures (for example in compliance with IFRS 7<sup>8</sup>), such information would ordinarily be considered to be information from an external information source. However, if the same type of information has been specifically commissioned by the entity to use its expertise to develop information about those risks, tailored to the entity's circumstances, the external individual or organization is likely to be acting as a management's expert.
- An external individual or organization may apply its expertise in providing information about current and future market trends, which it makes available to, and is suitable for use by, a broad range of users. If used by the entity to help make decisions about assumptions to be used in making accounting estimates, such information is likely to be considered to be information from an external information source. If the same type of information has been commissioned by the entity to address current and future trends relevant to the entity's specific facts and circumstances, the external individual or organization is likely to be acting as a management's expert.

### **Sufficient Appropriate Audit Evidence** (Ref: Para. 6)

A5. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit<sup>9</sup>) or a firm's quality control procedures for client acceptance and continuance. In addition, the entity's accounting records and other sources internal to the entity are important sources of audit evidence. Information that may be used as audit evidence may have been prepared using the work of a management's expert or be obtained from an external information source. Audit evidence comprises both information that

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<sup>8</sup> International Financial Reporting Standards (IFRS) 7, *Financial Instruments: Disclosures*

<sup>9</sup> ISA 315 (Revised), paragraph 9

supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

- A6. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance, and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.
- A7. As explained in ISA 200,<sup>10</sup> reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.
- A8. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.
- A9. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. 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.
- A10. ISA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained.<sup>11</sup> Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. ISA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

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<sup>10</sup> ISA 200, paragraph 5

<sup>11</sup> ISA 330, paragraph 26

*Sources of Audit Evidence*

- A11. Some audit evidence is obtained by performing audit procedures to test the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.
- A12. More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.
- A13. Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties and information from an external information source, including analysts' reports, and comparable data about competitors (benchmarking data).

*Audit Procedures for Obtaining Audit Evidence*

- A14. As required by, and explained further in, ISA 315 (Revised) and ISA 330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:
- (a) Risk assessment procedures; and
  - (b) Further audit procedures, which comprise:
    - (i) Tests of controls, when required by the ISA or when the auditor has chosen to do so; and
    - (ii) Substantive procedures, including tests of details and substantive analytical procedures.
- A15. The audit procedures described in paragraphs A18–A29 below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor. As explained in ISA 330, audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance.<sup>12</sup>
- A16. The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in

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<sup>12</sup> ISA 330, paragraph A35

electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

- A17. Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

### Inspection

- A18. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.
- A19. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.
- A20. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

### Observation

- A21. Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed. See ISA 501 for further guidance on observation of the counting of inventory.<sup>13</sup>

### External Confirmation

- A22. An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming

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<sup>13</sup> ISA 501, *Audit Evidence—Specific Considerations for Selected Items*

party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a “side agreement” that may influence revenue recognition. See ISA 505 for further guidance.<sup>14</sup>

#### Recalculation

A23. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

#### Reperformance

A24. Repformance involves the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control.

#### Analytical Procedures

A25. Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. See ISA 520 for further guidance.

#### Inquiry

A26. Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

A27. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

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<sup>14</sup> ISA 505, *External Confirmations*

- A28. Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.
- A29. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries. See ISA 580 for further guidance.<sup>15</sup>

### Information to Be Used as Audit Evidence

#### *Relevance and Reliability* (Ref: Para. 7)

- A30. As noted in paragraph A5, while audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources such as, for example, previous audits, in certain circumstances, a firm's quality control procedures for client acceptance and continuance and complying with certain additional responsibilities under law, regulation or relevant ethical requirements (e.g., regarding an entity's non-compliance with laws and regulations). The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

#### Relevance

- A31. Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing. For example, if the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.
- A32. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cutoff. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding

<sup>15</sup> ISA 580, *Written Representations*

another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

- A33. Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.
- A34. Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

### Reliability

- A35. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalizations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from a source independent of the entity may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful:
- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
  - The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
  - Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
  - Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

- A36. ISA 520 provides further guidance regarding the reliability of data used for purposes of designing analytical procedures as substantive procedures.<sup>16</sup>
- A37. ISA 240 deals with circumstances where the auditor has reason to believe that a document may not be authentic, or may have been modified without that modification having been disclosed to the auditor.<sup>17</sup>
- A38. ISA 250 (Revised)<sup>18</sup> provides further guidance with respect to the auditor complying with any additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's identified or suspected non-compliance with laws and regulations that may provide further information that is relevant to the auditor's work in accordance with ISAs and evaluating the implications of such non-compliance in relation to other aspects of the audit.

#### External Information Sources

- A39. The auditor is required by paragraph 7 to consider the relevance and reliability of information obtained from an external information source that is to be used as audit evidence, regardless of whether that information has been used by the entity in preparing the financial statements or obtained by the auditor. For information obtained from an external information source, that consideration may, in certain cases, include audit evidence about the external information source or the preparation of the information by the external information source, obtained through designing and performing further audit procedures in accordance with ISA 330 or, where applicable, ISA 540 (Revised).<sup>19</sup>
- A40. Obtaining an understanding of why management or, when applicable, a management's expert uses an external information source, and how the relevance and reliability of the information was considered (including its accuracy and completeness), may help to inform the auditor's consideration of the relevance and reliability of that information.
- A41. The following factors may be important when considering the relevance and reliability of information obtained from an external information source, including its accuracy and completeness, taking into account that some of these factors may only be relevant when the information has been used by

<sup>16</sup> ISA 520, paragraph 5(a)

<sup>17</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 14

<sup>18</sup> ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 9

<sup>19</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Disclosures*

management in preparing the financial statements or has been obtained by the auditor:

- The nature and authority of the external information source. For example, a central bank or government statistics office with a legislative mandate to provide industry information to the public is likely to be an authority for certain types of information;
- The ability to influence the information obtained, through relationships between the entity and the information source;
- The competence and reputation of the external information source with respect to the information, including whether, in the auditor's professional judgment, the information is routinely provided by a source with a track record of providing reliable information;
- Past experience of the auditor with the reliability of the information provided by the external information source;
- Evidence of general market acceptance by users of the relevance or reliability of information from an external information source for a similar purpose to that for which the information has been used by management or the auditor;
- Whether the entity has in place controls to address the relevance and reliability of the information obtained and used;
- Whether the external information source accumulates overall market information or engages directly in "setting" market transactions;
- Whether the information is suitable for use in the manner in which it is being used and, if applicable, was developed taking into account the applicable financial reporting framework;
- Alternative information that may contradict the information used;
- The nature and extent of disclaimers or other restrictive language relating to the information obtained;
- Information about the methods used in preparing the information, how the methods are being applied including, where applicable, how models have been used in such application, and the controls over the methods; and
- When available, information relevant to considering the appropriateness of assumptions and other data applied by the external information sources in developing the information obtained.

A42. The nature and extent of the auditor's consideration takes into account the assessed risks of material misstatement at the assertion level to which the use of the external information is relevant, the degree to which the use of

that information is relevant to the reasons for the assessed risks of material misstatement and the possibility that the information from the external information source may not be reliable (for example, whether it is from a credible source). Based on the auditor's consideration of the matters described in paragraph A39, the auditor may determine that further understanding of the entity and its environment, including its internal control, is needed, in accordance with ISA 315, or that further audit procedures, in accordance with ISA 330,<sup>20</sup> and ISA 540 (Revised)<sup>21</sup> when applicable, are appropriate in the circumstances, to respond to the assessed risks of material misstatement related to the use of information from an external information source. Such procedures may include:

- Performing a comparison of information obtained from the external information source with information obtained from an alternative independent information source.
- When relevant to considering management's use of an external information source, obtaining an understanding of controls management has in place to consider the reliability of the information from external information sources, and potentially testing the operating effectiveness of such controls.
- Performing procedures to obtain information from the external information source to understand its processes, techniques, and assumptions, for the purposes of identifying, understanding and, when relevant, testing the operating effectiveness of its controls.

A43. In some situations, there may be only one provider of certain information, for example, information from a central bank or government, such as an inflation rate, or a single recognized industry body. In such cases, the auditor's determination of the nature and extent of audit procedures that may be appropriate in the circumstances is influenced by the nature and credibility of the source of the information, the assessed risks of material misstatement to which that external information is relevant, and the degree to which the use of that information is relevant to the reasons for the assessed risk of material misstatement. For example, when the information is from a credible authoritative source, the extent of the auditor's further audit procedures may be less extensive, such as corroborating the information to the source's website or published information. In other cases, if a source is not assessed as credible, the auditor may determine that more extensive procedures are appropriate and, in the absence of any alternative independent information source against which to compare, may consider whether performing procedures to obtain information from the external information source, when practical, is appropriate in order to obtain sufficient appropriate audit evidence.

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<sup>20</sup> ISA 330, paragraph 6

<sup>21</sup> ISA 540 (Revised), paragraph 30

A44. When the auditor does not have a sufficient basis with which to consider the relevance and reliability of information from an external information source, the auditor may have a limitation on scope if sufficient appropriate audit evidence cannot be obtained through alternative procedures. Any imposed limitation on scope is evaluated in accordance with the requirements of ISA 705 (Revised).<sup>22</sup>

*Reliability of Information Produced by a Management's Expert* (Ref: Para. 8)

A45. The preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. Failure to do so when such expertise is necessary increases the risks of material misstatement.

A46. When information to be used as audit evidence has been prepared using the work of a management's expert, the requirement in paragraph 8 of this ISA applies. For example, an individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organization applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organization is a management's expert and paragraph 8 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph 7 of this ISA, being information from an external information source and not the use of a management's expert by the entity.

A47. The nature, timing and extent of audit procedures in relation to the requirement in paragraph 8 of this ISA, may be affected by such matters as:

- The nature and complexity of the matter to which the management's expert relates.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.

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<sup>22</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, paragraph 13

- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

The Competence, Capabilities and Objectivity of a Management's Expert (Ref: Para. 8(a))

- A48. Competence relates to the nature and level of expertise of the management's expert. Capability relates to the ability of the management's expert to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert. The competence, capabilities and objectivity of a management's expert, and any controls within the entity over that expert's work, are important factors in relation to the reliability of any information produced by a management's expert.
- A49. Information regarding the competence, capabilities and objectivity of a management's expert may come from a variety of sources, such as:
- Personal experience with previous work of that expert.
  - Discussions with that expert.
  - Discussions with others who are familiar with that expert's work.
  - Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
  - Published papers or books written by that expert.
  - An auditor's expert, if any, who assists the auditor in obtaining sufficient appropriate audit evidence with respect to information produced by the management's expert.
- A50. Matters relevant to evaluating the competence, capabilities and objectivity of a management's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.
- A51. Other matters that may be relevant include:
- The relevance of the management's expert's competence to the matter for which that expert's work will be used, including any areas of

specialty within that expert's field. For example, a particular actuary may specialize in property and casualty insurance, but have limited expertise regarding pension calculations.

- The management's expert's competence with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.
- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the management's expert as the audit progresses.

A52. A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats, and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures).

A53. Although safeguards cannot eliminate all threats to a management's expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

A54. When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

Obtaining an Understanding of the Work of the Management's Expert (Ref: Para. 8(b))

A55. An understanding of the work of the management's expert includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor's determination of whether the auditor has the expertise to evaluate the work of

the management's expert, or whether the auditor needs an auditor's expert for this purpose.<sup>23</sup>

A56. Aspects of the management's expert's field relevant to the auditor's understanding may include:

- Whether that expert's field has areas of specialty within it that are relevant to the audit.
- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
- The nature of internal and external data or information the management's expert uses.

A57. In the case of a management's expert engaged by the entity, there will ordinarily be an engagement letter or other written form of agreement between the entity and that expert. Evaluating that agreement when obtaining an understanding of the work of the management's expert may assist the auditor in determining the appropriateness of the following for the auditor's purposes:

- The nature, scope and objectives of that expert's work;
- The respective roles and responsibilities of management and that expert; and
- The nature, timing and extent of communication between management and that expert, including the form of any report to be provided by that expert.

A58. In the case of a management's expert employed by the entity, it is less likely there will be a written agreement of this kind. Inquiry of the expert and other members of management may be the most appropriate way for the auditor to obtain the necessary understanding.

Evaluating the Appropriateness of the Management's Expert's Work (Ref: Para. 8(c))

A59. Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods;

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<sup>23</sup> ISA 620, paragraph 7

- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data; and
- If that expert's work involves the use of information from an external information source, the relevance and reliability of that information.

*Information Produced by the Entity and Used for the Auditor's Purposes* (Ref: Para. 9(a)–(b))

- A60. In order for the auditor to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of auditing revenue by applying standard prices to records of sales volume is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (for example, payments) for a certain characteristic (for example, authorization), the results of the test will be less reliable if the population from which items are selected for testing is not complete.
- A61. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.
- A62. In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to make use of the entity's performance measures for the purpose of analytical procedures, or to make use of the entity's information produced for monitoring activities, such as reports of the internal audit function. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.

**Selecting Items for Testing to Obtain Audit Evidence** (Ref: Para. 10)

- A63. An effective test provides appropriate audit evidence to an extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purposes. In selecting items for testing, the auditor is required by paragraph 7 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The means available to the auditor for selecting items for testing are:

- (a) Selecting all items (100% examination);
- (b) Selecting specific items; and
- (c) Audit sampling.

The application of any one or combination of these means may be appropriate depending on the particular circumstances, for example, the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

### *Selecting All Items*

A64. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details. 100% examination may be appropriate when, for example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

### *Selecting Specific Items*

A65. The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- *High value or key items.* The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- *Items to obtain information.* The auditor may examine items to obtain information about matters such as the nature of the entity, or the nature of transactions.

A66. While selective examination of specific items from a class of transactions or account balance will often be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide audit evidence concerning the remainder of the population.

#### *Audit Sampling*

A67. Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. Audit sampling is discussed in ISA 530.<sup>24</sup>

#### **Inconsistency in, or Doubts over Reliability of, Audit Evidence (Ref: Para. 11)**

A68. Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal auditors, and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. ISA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.<sup>25</sup>

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<sup>24</sup> ISA 530, *Audit Sampling*

<sup>25</sup> ISA 230, *Audit Documentation*, paragraph 11

**INTERNATIONAL STANDARD ON AUDITING 501**  
**AUDIT EVIDENCE—SPECIFIC CONSIDERATIONS**  
**FOR SELECTED ITEMS**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 501, *Audit Evidence—Specific Considerations for Selected Items*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with ISA 330,<sup>1</sup> ISA 500<sup>2</sup> and other relevant ISAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.

### Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:
  - (a) Existence and condition of inventory;
  - (b) Completeness of litigation and claims involving the entity; and
  - (c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

## Requirements

### Inventory

4. If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:
  - (a) Attendance at physical inventory counting, unless impracticable, to: (Ref: Para. A1–A3)
    - (i) Evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting; (Ref: Para. A4)
    - (ii) Observe the performance of management’s count procedures; (Ref: Para. A5)
    - (iii) Inspect the inventory; and (Ref: Para. A6)
    - (iv) Perform test counts; and (Ref: Para. A7–A8)

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<sup>1</sup> ISA 330, *The Auditor’s Responses to Assessed Risks*

<sup>2</sup> ISA 500, *Audit Evidence*

- (b) Performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.
5. If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9–A11)
  6. If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.
  7. If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor’s report in accordance with ISA 705 (Revised).<sup>3</sup> (Ref: Para. A12–A14)
  8. If inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:
    - (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. (Ref: Para. A15)
    - (b) Perform inspection or other audit procedures appropriate in the circumstances. (Ref: Para. A16)

### Litigation and Claims

9. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including: (Ref: Para. A17–A19)
  - (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
  - (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
  - (c) Reviewing legal expense accounts. (Ref: Para. A20)
10. If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other ISAs, seek direct communication with the entity’s external legal counsel. The auditor shall do so through a letter of inquiry, prepared

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<sup>3</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor’s Report*

by management and sent by the auditor, requesting the entity’s external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity’s external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures. (Ref: Para. A21–A25)

11. If:
- (a) management refuses to give the auditor permission to communicate or meet with the entity’s external legal counsel, or the entity’s external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and
  - (b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures,
- the auditor shall modify the opinion in the auditor’s report in accordance with ISA 705 (Revised).

#### *Written Representations*

12. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

#### **Segment Information**

13. The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by: (Ref: Para. A26)
- (a) Obtaining an understanding of the methods used by management in determining segment information, and: (Ref: Para. A27)
    - (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
    - (ii) Where appropriate, testing the application of such methods; and
  - (b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

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## Application and Other Explanatory Material

### Inventory

#### *Attendance at Physical Inventory Counting* (Ref: Para. 4(a))

- A1. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.
- A2. Attendance at physical inventory counting involves:
- Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
  - Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
  - Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

- A3. Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs 4–8 of this ISA) include, for example:
- The risks of material misstatement related to inventory.
  - The nature of the internal control related to inventory.
  - Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
  - The timing of physical inventory counting.
  - Whether the entity maintains a perpetual inventory system.
  - The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate. ISA 600<sup>4</sup> deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regard to attendance of physical inventory counting at a remote location.

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<sup>4</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

- Whether the assistance of an auditor’s expert is needed. ISA 620<sup>5</sup> deals with the use of an auditor’s expert to assist the auditor to obtain sufficient appropriate audit evidence.

Evaluate Management’s Instructions and Procedures (Ref: Para. 4(a)(i))

A4. Matters relevant in evaluating management’s instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example:

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.
- The accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment.
- The procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile.
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.

Observe the Performance of Management’s Count Procedures (Ref: Para. 4(a)(ii))

A5. Observing the performance of management’s count procedures, for example, those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management’s instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cutoff information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspect the Inventory (Ref: Para. 4(a)(iii))

A6. Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or aging inventory.

Perform Test Counts (Ref: Para. 4(a)(iv))

A7. Performing test counts, for example, by tracing items selected from management’s count records to the physical inventory and tracing items selected from the physical inventory to management’s count records, provides audit evidence about the completeness and the accuracy of those records.

A8. In addition to recording the auditor’s test counts, obtaining copies of management’s completed physical inventory count records assists the auditor

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<sup>5</sup> ISA 620, *Using the Work of an Auditor’s Expert*

in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

*Physical Inventory Counting Conducted Other than at the Date of the Financial Statements* (Ref: Para. 5)

- A9. For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes. ISA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date.<sup>6</sup>
- A10. Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.
- A11. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:
- Whether the perpetual inventory records are properly adjusted.
  - Reliability of the entity's perpetual inventory records.
  - Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

*Attendance at Physical Inventory Counting Is Impracticable* (Ref: Para. 7)

- A12. In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in ISA 200,<sup>7</sup> the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

<sup>6</sup> ISA 330, paragraphs 22–23

<sup>7</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A50

- A13. In some cases where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.
- A14. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, ISA 705 (Revised) requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.<sup>8</sup>

### *Inventory under the Custody and Control of a Third Party*

#### Confirmation (Ref: Para. 8(a))

- A15. ISA 505<sup>9</sup> establishes requirements and provides guidance for performing external confirmation procedures.

#### Other Audit Procedures (Ref: Para. 8(b))

- A16. Depending on the circumstances, for example, where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include:
- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
  - Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
  - Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
  - Requesting confirmation from other parties when inventory has been pledged as collateral.

## **Litigation and Claims**

### *Completeness of Litigations and Claims* (Ref: Para. 9)

- A17. Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

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<sup>8</sup> ISA 705 (Revised), paragraph 13

<sup>9</sup> ISA 505, *External Confirmations*

- A18. In addition to the procedures identified in paragraph 9, other relevant procedures include, for example, using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation and claims involving the entity.
- A19. Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation and claims. ISA 540 (Revised)<sup>10</sup> establishes requirements and provides guidance relevant to the auditor’s consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

#### Reviewing Legal Expense Accounts (Ref: Para. 9(c))

- A20. Depending on the circumstances, the auditor may judge it appropriate to examine related source documents, such as invoices for legal expenses, as part of the auditor’s review of legal expense accounts.

#### *Communication with the Entity’s External Legal Counsel* (Ref: Para. 10–11)

- A21. Direct communication with the entity’s external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management’s estimates of the financial implications, including costs, are reasonable.
- A22. In some cases, the auditor may seek direct communication with the entity’s external legal counsel through a letter of general inquiry. For this purpose, a letter of general inquiry requests the entity’s external legal counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.
- A23. If it is considered unlikely that the entity’s external legal counsel will respond appropriately to a letter of general inquiry, for example, if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:
- (a) A list of litigation and claims;
  - (b) Where available, management’s assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

<sup>10</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

- (c) A request that the entity’s external legal counsel confirm the reasonableness of management’s assessments and provide the auditor with further information if the list is considered by the entity’s external legal counsel to be incomplete or incorrect.

A24. In certain circumstances, the auditor also may judge it necessary to meet with the entity’s external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:

- The auditor determines that the matter is a significant risk.
- The matter is complex.
- There is disagreement between management and the entity’s external legal counsel.

Ordinarily, such meetings require management’s permission and are held with a representative of management in attendance.

A25. In accordance with ISA 700 (Revised),<sup>11</sup> the auditor is required to date the auditor’s report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor’s report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity’s external legal counsel.

### **Segment Information** (Ref: Para. 13)

A26. Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor’s responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a standalone basis.

### *Understanding of the Methods Used by Management* (Ref: Para. 13(a))

A27. Depending on the circumstances, example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.

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<sup>11</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 49

- Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
- The allocation of assets and costs among segments.
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

# INTERNATIONAL STANDARD ON AUDITING 505

## EXTERNAL CONFIRMATIONS

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 505, *External Confirmations*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of ISA 330<sup>1</sup> and ISA 500.<sup>2</sup> It does not address inquiries regarding litigation and claims, which are dealt with in ISA 501.<sup>3</sup>

### External Confirmation Procedures to Obtain Audit Evidence

2. ISA 500 indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.<sup>4</sup> That ISA also includes the following generalizations applicable to audit evidence:<sup>5</sup>
  - Audit evidence is more reliable when it is obtained from independent sources outside the entity.
  - Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
  - Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity. This ISA is intended to assist the auditor in designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

3. Other ISAs recognize the importance of external confirmations as audit evidence, for example:
  - ISA 330 discusses the auditor's responsibility to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level, and to design and perform further audit procedures whose nature, timing and extent are based on, and are responsive to, the assessed risks of material misstatement at the assertion level.<sup>6</sup> In addition, ISA 330 requires that, irrespective of the assessed risks of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. The auditor is also required to consider whether

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<sup>1</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>2</sup> ISA 500, *Audit Evidence*

<sup>3</sup> ISA 501, *Audit Evidence—Specific Considerations for Selected Items*

<sup>4</sup> ISA 500, paragraph A9

<sup>5</sup> ISA 500, paragraph A35

<sup>6</sup> ISA 330, paragraphs 5–6

external confirmation procedures are to be performed as substantive audit procedures.<sup>7</sup>

- ISA 330 requires that the auditor obtain more persuasive audit evidence the higher the auditor's assessment of risk.<sup>8</sup> To do this, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable, or both. For example, the auditor may place more emphasis on obtaining evidence directly from third parties or obtaining corroborating evidence from a number of independent sources. ISA 330 also indicates that external confirmation procedures may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error.<sup>9</sup>
- ISA 240 indicates that the auditor may design confirmation requests to obtain additional corroborative information as a response to address the assessed risks of material misstatement due to fraud at the assertion level.<sup>10</sup>
- ISA 500 indicates that corroborating information obtained from a source independent of the entity, such as external confirmations, may increase the assurance the auditor obtains from evidence existing within the accounting records or from representations made by management.<sup>11</sup>

### Effective Date

4. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objective

5. The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

### Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) External confirmation – Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

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<sup>7</sup> ISA 330, paragraphs 18–19

<sup>8</sup> ISA 330, paragraph 7(b)

<sup>9</sup> ISA 330, paragraph A53

<sup>10</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph A38

<sup>11</sup> ISA 500, paragraphs A12–A13

- (b) Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
- (c) Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
- (d) Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
- (e) Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity’s records, and information provided by the confirming party.

## Requirements

### External Confirmation Procedures

- 7. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:
  - (a) Determining the information to be confirmed or requested; (Ref: Para. A1)
  - (b) Selecting the appropriate confirming party; (Ref: Para. A2)
  - (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and (Ref: Para. A3–A6)
  - (d) Sending the requests, including follow-up requests when applicable, to the confirming party. (Ref: Para. A7)

### Management’s Refusal to Allow the Auditor to Send a Confirmation Request

- 8. If management refuses to allow the auditor to send a confirmation request, the auditor shall:
  - (a) Inquire as to management’s reasons for the refusal, and seek audit evidence as to their validity and reasonableness; (Ref: Para. A8)
  - (b) Evaluate the implications of management’s refusal on the auditor’s assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and (Ref: Para. A9)
  - (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence. (Ref: Para. A10)

9. If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with ISA 260 (Revised).<sup>12</sup> The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with ISA 705 (Revised).<sup>13</sup>

## **Results of the External Confirmation Procedures**

### *Reliability of Responses to Confirmation Requests*

10. If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts. (Ref: Para. A11–A16)
11. If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures. (Ref: Para. A17)

### *Non-Responses*

12. In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. (Ref: Para A18–A19)

### *When a Response to a Positive Confirmation Request Is Necessary to Obtain Sufficient Appropriate Audit Evidence*

13. If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion in accordance with ISA 705 (Revised). (Ref: Para A20)

### *Exceptions*

14. The auditor shall investigate exceptions to determine whether or not they are indicative of misstatements. (Ref: Para. A21–A22)

## **Negative Confirmations**

15. Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present: (Ref: Para. A23)

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<sup>12</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 16

<sup>13</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

- (a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
- (b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous account balances, transactions or conditions;
- (c) A very low exception rate is expected; and
- (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

### **Evaluating the Evidence Obtained**

16. The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary. (Ref: Para A24–A25)

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## **Application and Other Explanatory Material**

### **External Confirmation Procedures**

*Determining the Information to Be Confirmed or Requested* (Ref: Para. 7(a))

- A1. External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a “side agreement.”

*Selecting the Appropriate Confirming Party* (Ref: Para. 7(b))

- A2. Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

*Designing Confirmation Requests* (Ref: Para. 7(c))

- A3. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

- A4. Factors to consider when designing confirmation requests include:
- The assertions being addressed.
  - Specific identified risks of material misstatement, including fraud risks.
  - The layout and presentation of the confirmation request.
  - Prior experience on the audit or similar engagements.
  - The method of communication (for example, in paper form, or by electronic or other medium).
  - Management's authorization or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorization.
  - The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).
- A5. A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties.
- A6. Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.

*Follow-Up on Confirmation Requests (Ref: Para. 7(d))*

- A7. The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

**Management's Refusal to Allow the Auditor to Send a Confirmation Request**

*Reasonableness of Management's Refusal (Ref: Para. 8(a))*

- A8. A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation. A common

reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

*Implications for the Assessment of Risks of Material Misstatement* (Ref: Para. 8(b))

A9. The auditor may conclude from the evaluation in paragraph 8(b) that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures in accordance with ISA 315 (Revised).<sup>14</sup> For example, if management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with ISA 240.<sup>15</sup>

*Alternative Audit Procedures* (Ref: Para. 8(c))

A10. The alternative audit procedures performed may be similar to those appropriate for a non-response as set out in paragraphs A18–A19 of this ISA. Such procedures also would take account of the results of the auditor's evaluation in paragraph 8(b) of this ISA.

## Results of the External Confirmation Procedures

*Reliability of Responses to Confirmation Requests* (Ref: Para. 10)

A11. ISA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability.<sup>16</sup> All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include that it:

- Was received by the auditor indirectly; or
- Appeared not to come from the originally intended confirming party.

A12. Responses received electronically, for example, by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. A process used by the auditor and the respondent that creates a secure environment for responses received electronically may mitigate these risks. If the auditor is satisfied that such a process is secure and properly controlled, the reliability of the related responses is enhanced. An electronic confirmation

<sup>14</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 31

<sup>15</sup> ISA 240, paragraph 25

<sup>16</sup> ISA 500, paragraph A35

process might incorporate various techniques for validating the identity of a sender of information in electronic form, for example, through the use of encryption, electronic digital signatures, and procedures to verify web site authenticity.

- A13. If a confirming party uses a third party to coordinate and provide responses to confirmation requests, the auditor may perform procedures to address the risks that:
- (a) The response may not be from the proper source;
  - (b) A respondent may not be authorized to respond; and
  - (c) The integrity of the transmission may have been compromised.
- A14. The auditor is required by ISA 500 to determine whether to modify or add procedures to resolve doubts over the reliability of information to be used as audit evidence.<sup>17</sup> The auditor may choose to verify the source and contents of a response to a confirmation request by contacting the confirming party. For example, when a confirming party responds by electronic mail, the auditor may telephone the confirming party to determine whether the confirming party did, in fact, send the response. When a response has been returned to the auditor indirectly (for example, because the confirming party incorrectly addressed it to the entity rather than to the auditor), the auditor may request the confirming party to respond in writing directly to the auditor.
- A15. On its own, an oral response to a confirmation request does not meet the definition of an external confirmation because it is not a direct written response to the auditor. However, upon obtaining an oral response to a confirmation request, the auditor may, depending on the circumstances, request the confirming party to respond in writing directly to the auditor. If no such response is received, in accordance with paragraph 12, the auditor seeks other audit evidence to support the information in the oral response.
- A16. A response to a confirmation request may contain restrictive language regarding its use. Such restrictions do not necessarily invalidate the reliability of the response as audit evidence.

*Unreliable Responses* (Ref: Para. 11)

- A17. When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with ISA 315 (Revised).<sup>18</sup> For example, an unreliable response may indicate a fraud risk factor that requires evaluation in accordance with ISA 240.<sup>19</sup>

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<sup>17</sup> ISA 500, paragraph 11

<sup>18</sup> ISA 315 (Revised), paragraph 31

<sup>19</sup> ISA 240, paragraph 25

*Non-Responses* (Ref: Para. 12)

A18. Examples of alternative audit procedures the auditor may perform include:

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period end.
- For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

A19. The nature and extent of alternative audit procedures are affected by the account and assertion in question. A non-response to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level, and modify planned audit procedures, in accordance with ISA 315 (Revised).<sup>20</sup> For example, fewer responses to confirmation requests than anticipated, or a greater number of responses than anticipated, may indicate a previously unidentified fraud risk factor that requires evaluation in accordance with ISA 240.<sup>21</sup>

*When a Response to a Positive Confirmation Request Is Necessary to Obtain Sufficient Appropriate Audit Evidence* (Ref: Para. 13)

A20. In certain circumstances, the auditor may identify an assessed risk of material misstatement at the assertion level for which a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. Such circumstances may include where:

- The information available to corroborate management’s assertion(s) is only available outside the entity.
- Specific fraud risk factors, such as the risk of management override of controls, or the risk of collusion which can involve employee(s) and/or management, prevent the auditor from relying on evidence from the entity.

*Exceptions* (Ref: Para. 14)

A21. Exceptions noted in responses to confirmation requests may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor is required by ISA 240 to evaluate whether such misstatement is indicative of fraud.<sup>22</sup> Exceptions may provide a guide to the quality of responses from similar confirming parties or for similar accounts. Exceptions also may indicate a deficiency, or deficiencies, in the entity’s internal control over financial reporting.

<sup>20</sup> ISA 315 (Revised), paragraph 31

<sup>21</sup> ISA 240, paragraph 25

<sup>22</sup> ISA 240, paragraph 36

A22. Some exceptions do not represent misstatements. For example, the auditor may conclude that differences in responses to confirmation requests are due to timing, measurement, or clerical errors in the external confirmation procedures.

### **Negative Confirmations** (Ref: Para. 15)

A23. The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favor, and less likely to respond otherwise. For example, holders of bank deposit accounts may be more likely to respond if they believe that the balance in their account is understated in the confirmation request, but may be less likely to respond when they believe the balance is overstated. Therefore, sending negative confirmation requests to holders of bank deposit accounts may be a useful procedure in considering whether such balances may be understated, but is unlikely to be effective if the auditor is seeking evidence regarding overstatement.

### **Evaluating the Evidence Obtained** (Ref: Para. 16)

A24. When evaluating the results of individual external confirmation requests, the auditor may categorize such results as follows:

- (a) A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;
- (b) A response deemed unreliable;
- (c) A non-response; or
- (d) A response indicating an exception.

A25. The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether further audit evidence is necessary, as required by ISA 330.<sup>23</sup>

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<sup>23</sup> ISA 330, paragraphs 26–27

**INTERNATIONAL STANDARD ON AUDITING 510**  
**INITIAL AUDIT ENGAGEMENTS—OPENING BALANCES**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 510, *Initial Audit Engagements—Opening Balances*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to opening balances in an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments. When the financial statements include comparative financial information, the requirements and guidance in ISA 710<sup>1</sup> also apply. ISA 300<sup>2</sup> includes additional requirements and guidance regarding activities prior to starting an initial audit.

### Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objective

3. In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:
  - Opening balances contain misstatements that materially affect the current period's financial statements; and
  - Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

### Definitions

4. For the purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Initial audit engagement – An engagement in which either:
    - (i) The financial statements for the prior period were not audited; or
    - (ii) The financial statements for the prior period were audited by a predecessor auditor.
  - (b) Opening balances – Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior

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<sup>1</sup> ISA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*

<sup>2</sup> ISA 300, *Planning an Audit of Financial Statements*

periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

- (c) Predecessor auditor – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

## Requirements

### Audit Procedures

#### *Opening Balances*

5. The auditor shall read the most recent financial statements, if any, and the predecessor auditor’s report thereon, if any, for information relevant to opening balances, including disclosures.
6. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period’s financial statements by: (Ref: Para. A1–A2)
  - (a) Determining whether the prior period’s closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;
  - (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
  - (c) Performing one or more of the following: (Ref: Para. A3–A7)
    - (i) Where the prior year financial statements were audited, reviewing the predecessor auditor’s working papers to obtain evidence regarding the opening balances;
    - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
    - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.
7. If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period’s financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period’s financial statements. If the auditor concludes that such misstatements exist in the current period’s financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance in accordance with ISA 450.<sup>3</sup>

<sup>3</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraphs 8 and 12

*Consistency of Accounting Policies*

8. The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

*Relevant Information in the Predecessor Auditor's Report*

9. If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements in accordance with ISA 315 (Revised).<sup>4</sup>

**Audit Conclusions and Reporting***Opening Balances*

10. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements, as appropriate, in accordance with ISA 705 (Revised).<sup>5</sup> (Ref: Para. A8)
11. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with ISA 705 (Revised).

*Consistency of Accounting Policies*

12. If the auditor concludes that:
- (a) the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or
  - (b) a change in accounting policies is not appropriately accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,
- the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with ISA 705 (Revised).

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<sup>4</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>5</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

*Modification to the Opinion in the Predecessor Auditor's Report*

13. If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements in accordance with ISA 705 (Revised) and ISA 710. (Ref: Para. A9)

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**Application and Other Explanatory Material****Audit Procedures***Considerations Specific to Public Sector Entities* (Ref: Para. 6)

- A1. In the public sector, there may be legal or regulatory limitations on the information that the current auditor can obtain from a predecessor auditor. For example, if a public sector entity that has previously been audited by a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General) is privatized, the amount of access to working papers or other information that the statutorily appointed auditor can provide a newly-appointed auditor that is in the private sector may be constrained by privacy or secrecy laws or regulations. In situations where such communications are constrained, audit evidence may need to be obtained through other means and, if sufficient appropriate audit evidence cannot be obtained, consideration given to the effect on the auditor's opinion.
- A2. If the statutorily appointed auditor outsources an audit of a public sector entity to a private sector audit firm, and the statutorily appointed auditor appoints an audit firm other than the firm that audited the financial statements of the public sector entity in the prior period, this is not usually regarded as a change in auditors for the statutorily appointed auditor. Depending on the nature of the outsourcing arrangement, however, the audit engagement may be considered an initial audit engagement from the perspective of the private sector auditor in fulfilling the auditor's responsibilities, and therefore this ISA applies.

*Opening Balances* (Ref: Para. 6(c))

- A3. The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:
- The accounting policies followed by the entity.
  - The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.

- The significance of the opening balances relative to the current period's financial statements.
  - Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.
- A4. If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by reviewing the predecessor auditor's working papers. Whether such a review provides sufficient appropriate audit evidence is influenced by the professional competence and independence of the predecessor auditor.
- A5. Relevant ethical and professional requirements guide the current auditor's communications with the predecessor auditor.
- A6. For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period. In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:
- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
  - Performing audit procedures on the valuation of the opening inventory items.
  - Performing audit procedures on gross profit and cutoff.
- A7. For non-current assets and liabilities, such as property, plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

### **Audit Conclusions and Reporting**

#### *Opening Balances* (Ref: Para. 10)

- A8. ISA 705 (Revised) establishes requirements and provides guidance on circumstances that may result in a modification to the auditor's opinion on the financial statements, the type of opinion appropriate in the circumstances, and

the content of the auditor's report when the auditor's opinion is modified. The inability of the auditor to obtain sufficient appropriate audit evidence regarding opening balances may result in one of the following modifications to the opinion in the auditor's report:

- A qualified opinion or a disclaimer of opinion, as is appropriate in the circumstances; or
- Unless prohibited by law or regulation, an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations, and cash flows, where relevant, and unmodified regarding financial position.

The Appendix includes illustrative auditors' reports.

*Modification to the Opinion in the Predecessor Auditor's Report* (Ref: Para. 13)

- A9. In some situations, a modification to the predecessor auditor's opinion may not be relevant and material to the opinion on the current period's financial statements. This may be the case where, for example, there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been resolved in the current period.

**Appendix**

(Ref: Para. A8)

**Illustrations of Auditors' Reports with Modified Opinions**

Note: Throughout these illustrative auditor's reports, the Opinion section has been positioned first in accordance with ISA 700 (Revised), and the Basis for Opinion section is positioned immediately after the Opinion section. Also, the first and last sentence that was included in the extant auditor's responsibilities section is now subsumed as part of the new Basis for Opinion section.

**Illustration 1:**

**For purposes of this illustrative auditor's report, the following circumstances are assumed:**

- **Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600<sup>1</sup> does not apply).**
- **The financial statements are prepared by management of the entity in accordance with International Financial Reporting Standards (IFRSs) (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.<sup>2</sup>**
- **The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.**
- **The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's financial performance and cash flows.<sup>3</sup>**
- **The financial position at year end is fairly presented.**
- **In this particular jurisdiction, law and regulation prohibit the auditor from giving an opinion which is qualified regarding the financial performance and cash flows and unmodified regarding financial position.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**

<sup>1</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

<sup>2</sup> ISA 210, *Agreeing the Terms of Audit Engagements*

<sup>3</sup> If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's financial performance and cash flows, the auditor would disclaim an opinion on the financial performance and cash flows.

- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).<sup>4</sup>**
- **The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.<sup>5</sup>**
- **The auditor has obtained all of the other information prior to the date of the auditor’s report and has not identified a material misstatement of the other information.**
- **Corresponding figures are presented, and the prior period’s financial statements were audited by a predecessor auditor. The auditor is not prohibited by law or regulation from referring to the predecessor auditor’s report on the corresponding figures and has decided to do so.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>6</sup>

#### Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

<sup>4</sup> ISA 570 (Revised), *Going Concern*

<sup>5</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*

<sup>6</sup> The sub-title “Report on the Audit of the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.

### **Basis for Qualified Opinion**

We were appointed as auditors of the company on June 30, 20X1 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at December 31, 20X0. Since opening inventories enter into the determination of the financial performance and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the statement of comprehensive income and the net cash flows from operating activities reported in the statement of cash flows.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

### **Other Matter**

The financial statements of the Company for the year ended December 31, 20X0 were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

### **Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 1 in Appendix 2 of ISA 720 (Revised).]

### **Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>7</sup>**

[Reporting in accordance with ISA 700 (Revised)<sup>8</sup> – see Illustration 1 in ISA 700 (Revised).]

### **Auditor’s Responsibilities for the Audit of the Financial Statements**

[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]

### **Report on Other Legal and Regulatory Requirements**

[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

<sup>7</sup> Throughout these illustrative auditor’s reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

<sup>8</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

**Illustration 2:**

**For purposes of this illustrative auditor’s report, the following circumstances are assumed:**

- **Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).**
- **The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.**
- **The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.**
- **The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity’s financial performance and cash flows.<sup>9</sup>**
- **The financial position at year end is fairly presented.**
- **An opinion that is qualified regarding the financial performance and cash flows and unmodified regarding financial position is considered appropriate in the circumstances.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.**
- **The auditor has obtained all of the other information prior to the date of the auditor’s report and has not identified a material misstatement of the other information.**
- **Corresponding figures are presented, and the prior period’s financial statements were audited by a predecessor auditor. The auditor is not**

<sup>9</sup> If the possible effects, in the auditor’s judgment, are considered to be material and pervasive to the entity’s financial performance and cash flows, the auditor would disclaim the opinion on the financial performance and cash flows.

**prohibited by law or regulation from referring to the predecessor auditor’s report on the corresponding figures and has decided to do so.**

- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>10</sup>

#### Opinions

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

#### *Qualified Opinion on the Financial Performance and Cash Flows*

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying statement of comprehensive income and statement of cash flows present fairly, in all material respects (or give a true and fair view of), the financial performance and cash flows of the Company for the year ended December 31, 20X1 in accordance with International Financial Reporting Standards (IFRSs).

#### *Opinion on the Financial Position*

In our opinion, the accompanying statement of financial position presents fairly, in all material respects (or gives a true and fair view of), the financial position of the Company as at December 31, 20X1 in accordance with IFRSs.

#### **Basis for Opinions, Including Basis for Qualified Opinion on the Financial Performance and Cash Flows**

We were appointed as auditors of the Company on June 30, 20X1 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at December 31, 20X0. Since opening inventories enter into the determination of the financial performance and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported

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<sup>10</sup> The sub-title “Report on the Audit of the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.

in the statement of comprehensive income and the net cash flows from operating activities reported in the statement of cash flows.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our unmodified opinion on the financial position and our qualified audit opinion on the financial performance and cash flows.

#### Other Matter

The financial statements of the Company for the year ended December 31, 20X0 were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

#### **Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

*[Reporting in accordance with the reporting requirements in ISA 720 (Revised)—see Illustration 1 in Appendix 2 of ISA 720 (Revised)]*

#### **Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>11</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

#### **Auditor’s Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

#### **Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>11</sup> Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

**INTERNATIONAL STANDARD ON AUDITING 520**  
**ANALYTICAL PROCEDURES**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 520, *Analytical Procedures*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"). It also deals with the auditor's responsibility to perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. ISA 315 (Revised)<sup>1</sup> deals with the use of analytical procedures as risk assessment procedures. ISA 330 includes requirements and guidance regarding the nature, timing and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures.<sup>2</sup>

### Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objectives

3. The objectives of the auditor are:
  - (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
  - (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

### Definition

4. For the purposes of the ISAs, the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. (Ref: Para. A1–A3)

## Requirements

### Substantive Analytical Procedures

5. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with ISA 330,<sup>3</sup> the auditor shall: (Ref: Para. A4–A5)

<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 6(b)

<sup>2</sup> ISA 330, *The Auditor's Responses to Assessed Risks*, paragraphs 6 and 18

<sup>3</sup> ISA 330, paragraph 18

- (a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions; (Ref: Para. A6–A11)
- (b) Evaluate the reliability of data from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation; (Ref: Para. A12–A14)
- (c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and (Ref: Para. A15)
- (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7. (Ref: Para. A16)

### **Analytical Procedures that Assist When Forming an Overall Conclusion**

6. The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor’s understanding of the entity. (Ref: Para. A17–A19)

### **Investigating Results of Analytical Procedures**

7. If analytical procedures performed in accordance with this ISA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:
  - (a) Inquiring of management and obtaining appropriate audit evidence relevant to management’s responses; and
  - (b) Performing other audit procedures as necessary in the circumstances. (Ref: Para. A20–A21)

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## **Application and Other Explanatory Material**

### **Definition of Analytical Procedures (Ref: Para. 4)**

- A1. Analytical procedures include the consideration of comparisons of the entity’s financial information with, for example:
  - Comparable information for prior periods.
  - Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.

- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.
- A2. Analytical procedures also include consideration of relationships, for example:
- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
  - Between financial information and relevant non-financial information, such as payroll costs to number of employees.
- A3. Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

#### **Substantive Analytical Procedures** (Ref: Para. 5)

- A4. The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.
- A5. The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

#### *Suitability of Particular Analytical Procedures for Given Assertions* (Ref: Para. 5(a))

- A6. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- A7. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a

high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

- A8. Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.
- A9. The determination of the suitability of particular substantive analytical procedures is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are deficient, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.
- A10. Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

#### Considerations Specific to Public Sector Entities

- A11. The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.

*The Reliability of the Data* (Ref: Para. 5(b))

- A12. The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:
- (a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;<sup>4</sup>
  - (b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products;
  - (c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
  - (d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.
- A13. The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. ISA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.<sup>5</sup>
- A14. The matters discussed in paragraphs A12(a)–A12(d) are relevant irrespective of whether the auditor performs substantive analytical procedures on the entity's period-end financial statements, or at an interim date and plans to perform substantive analytical procedures for the remaining period. ISA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date.<sup>6</sup>

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<sup>4</sup> ISA 500, *Audit Evidence*, paragraph A35

<sup>5</sup> ISA 500, paragraph 10

<sup>6</sup> ISA 330, paragraphs 22–23

*Evaluation Whether the Expectation Is Sufficiently Precise (Ref: Para. 5(c))*

A15. Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information as discussed in paragraphs A12–A13 above.

*Amount of Difference of Recorded Amounts from Expected Values that Is Acceptable (Ref: Para. 5(d))*

A16. The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality<sup>7</sup> and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. ISA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk.<sup>8</sup> Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence.<sup>9</sup>

**Analytical Procedures that Assist When Forming an Overall Conclusion**

(Ref: Para. 6)

A17. The conclusions drawn from the results of analytical procedures designed and performed in accordance with paragraph 6 are intended to corroborate conclusions

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<sup>7</sup> ISA 320, *Materiality in Planning and Performing an Audit*, paragraph A14

<sup>8</sup> ISA 330, paragraph 7(b)

<sup>9</sup> ISA 330, paragraph A19

formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.

- A18. The results of such analytical procedures may identify a previously unrecognized risk of material misstatement. In such circumstances, ISA 315 (Revised) requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.<sup>10</sup>
- A19. The analytical procedures performed in accordance with paragraph 6 may be similar to those that would be used as risk assessment procedures.

**Investigating Results of Analytical Procedures** (Ref: Para. 7)

- A20. Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.
- A21. The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

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<sup>10</sup> ISA 315 (Revised), paragraph 31

**INTERNATIONAL STANDARD ON AUDITING 530**  
**AUDIT SAMPLING**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 530, *Audit Sampling*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor's *use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.*
2. This ISA complements ISA 500,<sup>1</sup> which deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. ISA 500 provides guidance on the means available to the auditor for selecting items for testing, of which audit sampling is one means.

### Effective Date

3. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objective

4. The objective of the auditor, when using audit sampling, is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

### Definitions

5. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Audit sampling (sampling) – The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.
  - (b) Population – The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
  - (c) Sampling risk – The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:
    - (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous

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<sup>1</sup> ISA 500, *Audit Evidence*

conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

- (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
- (d) Non-sampling risk – The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. (Ref: Para. A1)
- (e) Anomaly – A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.
- (f) Sampling unit – The individual items constituting a population. (Ref: Para. A2)
- (g) Statistical sampling – An approach to sampling that has the following characteristics:
  - (i) Random selection of the sample items; and
  - (ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.
- (h) Stratification – The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).
- (i) Tolerable misstatement – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. (Ref: Para. A3)
- (j) Tolerable rate of deviation – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

## Requirements

### Sample Design, Size, and Selection of Items for Testing

6. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. (Ref: Para. A4–A9)

7. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. (Ref: Para. A10–A11)
8. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12–A13)

### **Performing Audit Procedures**

9. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
10. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. (Ref: Para. A14)
11. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. (Ref: Para. A15–A16)

### **Nature and Cause of Deviations and Misstatements**

12. The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. (Ref: Para. A17)
13. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

### **Projecting Misstatements**

14. For tests of details, the auditor shall project misstatements found in the sample to the population. (Ref: Para. A18–A20)

### **Evaluating Results of Audit Sampling**

15. The auditor shall evaluate:
  - (a) The results of the sample; and (Ref: Para. A21–A22)
  - (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

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## Application and Other Explanatory Material

### Definitions

#### *Non-Sampling Risk* (Ref: Para. 5(d))

- A1. Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

#### *Sampling Unit* (Ref: Para. 5(f))

- A2. The sampling units might be physical items (for example, checks listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances) or monetary units.

#### *Tolerable Misstatement* (Ref: Para. 5(i))

- A3. When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, as defined in ISA 320,<sup>2</sup> to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

### Sample Design, Size, and Selection of Items for Testing

#### *Sample Design* (Ref: Para. 6)

- A4. Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.
- A5. When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of paragraph 9 of ISA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

<sup>2</sup> ISA 320, *Materiality in Planning and Performing an Audit*, paragraph 9

- A6. The auditor's consideration of the purpose of the audit procedure, as required by paragraph 6, includes a clear understanding of what constitutes a deviation or misstatement so that all, and only those, conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.
- A7. In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.
- A8. In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. Appendix 1 provides further discussion on stratification and value-weighted selection.
- A9. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

*Sample Size* (Ref: Para. 7)

- A10. The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.
- A11. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. Appendices 2 and 3 indicate the influences that various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 2 and 3 will be similar regardless of whether a statistical or non-statistical approach is chosen.

*Selection of Items for Testing* (Ref: Para. 8)

- A12. With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling *is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected*, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.
- A13. The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 4.

**Performing Audit Procedures** (Ref: Para. 10–11)

- A14. An example of when it is necessary to perform the procedure on a replacement item is when a voided check is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly voided such that it does not constitute a deviation, an appropriately chosen replacement is examined.
- A15. An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.
- A16. An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

**Nature and Cause of Deviations and Misstatements** (Ref: Para. 12)

- A17. In analyzing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

**Projecting Misstatements** (Ref: Para. 14)

- A18. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.
- A19. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

A20. For tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole. ISA 330<sup>3</sup> provides guidance when deviations from controls upon which the auditor intends to rely are detected.

### **Evaluating Results of Audit Sampling (Ref: Para. 15)**

A21. For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

A22. In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

A23. If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

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<sup>3</sup> ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 17

**Appendix 1**

(Ref: Para. A8)

**Stratification and Value-Weighted Selection**

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. This Appendix provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

**Stratification**

1. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.
2. When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.
3. The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).
4. If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

**Value-Weighted Selection**

5. When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the

accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units. One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes. This approach may be used in conjunction with the systematic method of sample selection (described in Appendix 4) and is most efficient when selecting items using random selection.

**Appendix 2**

(Ref: Para. A11)

**Examples of Factors Influencing Sample Size for Tests of Controls**

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

<b>FACTOR</b>	<b>EFFECT ON SAMPLE SIZE</b>	
1. An increase in the extent to which the auditor's risk assessment takes into account relevant controls	Increase	The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased).
2. An increase in the tolerable rate of deviation	Decrease	The lower the tolerable rate of deviation, the larger the sample size needs to be.

AUDIT SAMPLING

<b>FACTOR</b>	<b>EFFECT ON SAMPLE SIZE</b>	
3. An increase in the expected rate of deviation of the population to be tested	Increase	The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
4. An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population	Increase	The greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
5. An increase in the number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence.

**Appendix 3**

(Ref: Para. A11)

**Examples of Factors Influencing Sample Size for Tests of Details**

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

<b>FACTOR</b>	<b>EFFECT ON SAMPLE SIZE</b>	
1. An increase in the auditor's assessment of the risk of material misstatement	Increase	The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.
2. An increase in the use of other substantive procedures directed at the same assertion	Decrease	The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.

AUDIT SAMPLING

<b>FACTOR</b>	<b>EFFECT ON SAMPLE SIZE</b>	
3. An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase	The greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
4. An increase in tolerable misstatement	Decrease	The lower the tolerable misstatement, the larger the sample size needs to be.
5. An increase in the amount of misstatement the auditor expects to find in the population	Increase	The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor's consideration of the expected misstatement amount include the extent to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.
6. Stratification of the population when appropriate	Decrease	When there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

<b>FACTOR</b>	<b>EFFECT ON SAMPLE SIZE</b>	
7. The number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole [and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures].)

**Appendix 4**

(Ref: Para. A13)

**Sample Selection Methods**

There are many methods of selecting samples. The principal methods are as follows:

- (a) Random selection (applied through random number generators, for example, random number tables).
- (b) Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- (c) Monetary Unit Sampling is a type of value-weighted selection (as described in Appendix 1) in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- (d) Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
- (e) Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

**INTERNATIONAL STANDARD ON AUDITING 540 (REVISED)**  
**AUDITING ACCOUNTING ESTIMATES AND  
RELATED DISCLOSURES**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2019)

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<p>International Standard on Auditing (ISA) 540 (Revised), <i>Auditing Accounting Estimates and Related Disclosures</i>, should be read in conjunction with ISA 200, <i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing</i>.</p>
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## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of financial *statements*. Specifically, it includes requirements and guidance that refer to, or expand on, how ISA 315 (Revised),<sup>1</sup> ISA 330,<sup>2</sup> ISA 450,<sup>3</sup> ISA 500<sup>4</sup> and other relevant ISAs are to be applied in relation to accounting estimates and related disclosures. It also includes requirements and guidance on the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible management bias.

### Nature of Accounting Estimates

2. Accounting estimates vary widely in nature and are required to be made by management when the monetary amounts cannot be directly observed. The measurement of these monetary amounts is subject to estimation uncertainty, which reflects inherent limitations in knowledge or data. These limitations give rise to inherent subjectivity and variation in the measurement outcomes. The process of making accounting estimates involves selecting and applying a method using assumptions and data, which requires judgment by management and can give rise to complexity in measurement. The effects of complexity, subjectivity or other inherent risk factors on the measurement of these monetary amounts affects their susceptibility to misstatement. (Ref: Para. A1–A6, Appendix 1)
3. Although this ISA applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing and extent of the risk assessment and further audit procedures required by this ISA will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be very low, based on their nature, and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures required by this ISA would not be expected to be extensive. When estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive. This ISA contains guidance on how the requirements of this ISA can be scaled. (Ref: Para. A7)

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<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>2</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>3</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*

<sup>4</sup> ISA 500, *Audit Evidence*

## Key Concepts of This ISA

4. This ISA requires a separate assessment of inherent risk for purposes of assessing the risks of material misstatement at the assertion level for accounting estimates. Depending on the nature of a particular accounting estimate, the susceptibility of an assertion to a misstatement that could be material may be subject to or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, and the interrelationship among them. As explained in ISA 200,<sup>5</sup> inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale that is referred to in this ISA as the spectrum of inherent risk. (Ref: Para. A8–A9, A65–A66, Appendix 1)
5. This ISA refers to relevant requirements in ISA 315 (Revised) and ISA 330, and provides related guidance, to emphasize the importance of the auditor's decisions about controls relating to accounting estimates, including decisions about whether:
  - There are controls relevant to the audit, for which the auditor is required to evaluate their design and determine whether they have been implemented.
  - To test the operating effectiveness of relevant controls.
6. This ISA also requires a separate assessment of control risk when assessing the risks of material misstatement at the assertion level for accounting estimates. In assessing control risk, the auditor takes into account whether the auditor's further audit procedures contemplate planned reliance on the operating effectiveness of controls. If the auditor does not perform tests of controls, the auditor's assessment of the risk of material misstatement at the assertion level cannot be reduced for the effective operation of controls with respect to the particular assertion.<sup>6</sup> (Ref: Para. A10)
7. This ISA emphasizes that the auditor's further audit procedures (including, where appropriate, tests of controls) need to be responsive to the reasons for the assessed risks of material misstatement at the assertion level, taking into account the effect of one or more inherent risk factors and the auditor's assessment of control risk.
8. The exercise of professional skepticism in relation to accounting estimates is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity,

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<sup>5</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A40

<sup>6</sup> ISA 530, *Audit Sampling*, Appendix 3

subjectivity or other inherent risk factors. Similarly, the exercise of professional skepticism is important when there is greater susceptibility to misstatement due to management bias or fraud. (Ref: Para. A11)

9. This ISA requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable<sup>7</sup> in the context of the applicable financial reporting framework, or are misstated. For purposes of this ISA, reasonable in the context of the applicable financial reporting framework means that the relevant requirements of the applicable financial reporting framework have been applied appropriately, including those that address: (Ref: Para. A12–A13, A139–A144)
- The making of the accounting estimate, including the selection of the method, assumptions and data in view of the nature of the accounting estimate and the facts and circumstances of the entity;
  - The selection of management’s point estimate; and
  - The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty.

### Effective Date

10. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2019.

### Objective

11. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework.

### Definitions

12. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Accounting estimate – A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty. (Ref: Para. A14)
  - (b) Auditor’s point estimate or auditor’s range – An amount, or range of amounts, respectively, developed by the auditor in evaluating management’s point estimate. (Ref: Para. A15)

<sup>7</sup> See also ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 13(c).

- (c) Estimation uncertainty – Susceptibility to an inherent lack of precision in measurement. (Ref: Para. A16, Appendix 1)
- (d) Management bias – A lack of neutrality by management in the preparation of information. (Ref: Para. A17)
- (e) Management’s point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
- (f) Outcome of an accounting estimate – The actual monetary amount that results from the resolution of the transaction(s), event(s) or condition(s) addressed by an accounting estimate. (Ref: Para. A18)

## Requirements

### Risk Assessment Procedures and Related Activities

13. When obtaining an understanding of the entity and its environment, including the entity’s internal control, as required by ISA 315 (Revised),<sup>8</sup> the auditor shall obtain an understanding of the following matters related to the entity’s accounting estimates. The auditor’s procedures to obtain the understanding shall be performed to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. (Ref: Para. A19–A22)

#### *The Entity and Its Environment*

- (a) The entity’s transactions and other events and conditions that may give rise to the need for, or changes in, accounting estimates to be recognized or disclosed in the financial statements. (Ref: Para. A23)
- (b) The requirements of the applicable financial reporting framework related to accounting estimates (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements); and how they apply in the context of the nature and circumstances of the entity and its environment, including how transactions and other events or conditions are subject to, or affected by, inherent risk factors. (Ref: Para. A24–A25)
- (c) Regulatory factors relevant to the entity’s accounting estimates, including, when applicable, regulatory frameworks related to prudential supervision. (Ref: Para. A26)
- (d) The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity’s financial statements, based on the auditor’s understanding of the matters in 13(a)–(c) above. (Ref: Para. A27)

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<sup>8</sup> ISA 315 (Revised), paragraphs 3, 5–6, 9, 11–12, 15–17, and 20–21

*The Entity's Internal Control*

- (e) The nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates. (Ref: Para. A28–A30)
- (f) How management identifies the need for, and applies, specialized skills or knowledge related to accounting estimates, including with respect to the use of a management's expert. (Ref: Para. A31)
- (g) How the entity's risk assessment process identifies and addresses risks relating to accounting estimates. (Ref: Para. A32–A33)
- (h) The entity's information system as it relates to accounting estimates, including:
  - (i) The classes of transactions, events and conditions that are significant to the financial statements and that give rise to the need for, or changes in, accounting estimates and related disclosures; and (Ref: Para. A34–A35)
  - (ii) For such accounting estimates and related disclosures, how management:
    - a. Identifies the relevant methods, assumptions or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework, including how management: (Ref: Para. A36–A37)
      - i. Selects or designs, and applies, the methods used, including the use of models; (Ref: Para. A38–A39)
      - ii. Selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions; and (Ref: Para. A40–A43)
      - iii. Selects the data to be used; (Ref: Para. A44)
    - b. Understands the degree of estimation uncertainty, including through considering the range of possible measurement outcomes; and (Ref: Para. A45)
    - c. Addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements. (Ref: Para. A46–A49)
- (i) Control activities relevant to the audit over management's process for making accounting estimates as described in paragraph 13(h)(ii). (Ref: Para. A50–A54)
- (j) How management reviews the outcome(s) of previous accounting estimates and responds to the results of that review.

14. The auditor shall review the outcome of previous accounting estimates, or, where applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor shall take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question judgments about previous period accounting estimates that were appropriate based on the information available at the time they were made. (Ref: Para. A55–A60)
15. With respect to accounting estimates, the auditor shall determine whether the engagement team requires specialized skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained. (Ref: Para. A61–A63)

### **Identifying and Assessing the Risks of Material Misstatement**

16. In identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the assertion level, as required by ISA 315 (Revised),<sup>9</sup> the auditor shall separately assess inherent risk and control risk. The auditor shall take the following into account in identifying the risks of material misstatement and in assessing inherent risk: (Ref: Para. A64–A71)
  - (a) The degree to which the accounting estimate is subject to estimation uncertainty; and (Ref: Para. A72–A75)
  - (b) The degree to which the following are affected by complexity, subjectivity, or other inherent risk factors: (Ref: Para. A76–A79)
    - (i) The selection and application of the method, assumptions and data in making the accounting estimate; or
    - (ii) The selection of management’s point estimate and related disclosures for inclusion in the financial statements.
17. The auditor shall determine whether any of the risks of material misstatement identified and assessed in accordance with paragraph 16 are, in the auditor’s judgment, a significant risk.<sup>10</sup> If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity’s controls, including control activities, relevant to that risk.<sup>11</sup> (Ref: Para. A80)

### **Responses to the Assessed Risks of Material Misstatement**

18. As required by ISA 330,<sup>12</sup> the auditor’s further audit procedures shall be responsive to the assessed risks of material misstatement at the assertion level,<sup>13</sup>

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<sup>9</sup> ISA 315 (Revised), paragraphs 25 and 26

<sup>10</sup> ISA 315 (Revised), paragraph 27

<sup>11</sup> ISA 315 (Revised), paragraph 29

<sup>12</sup> ISA 330, paragraphs 6–15 and 18

<sup>13</sup> ISA 330, paragraphs 6–7 and 21

considering the reasons for the assessment given to those risks. The auditor's further audit procedures shall include one or more of the following approaches:

- (a) Obtaining audit evidence from events occurring up to the date of the auditor's report (see paragraph 21);
- (b) Testing how management made the accounting estimate (see paragraphs 22–27); or
- (c) Developing an auditor's point estimate or range (see paragraphs 28–29).

The auditor's further audit procedures shall take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be.<sup>14</sup> The auditor shall design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. (Ref: Para. A81–A84)

19. As required by ISA 330,<sup>15</sup> the auditor shall design and perform tests to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls, if:
- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively; or
  - (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In relation to accounting estimates, the auditor's tests of such controls shall be responsive to the reasons for the assessment given to the risks of material misstatement. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.<sup>16</sup> (Ref: Para. A85–A89)

20. For a significant risk relating to an accounting estimate, the auditor's further audit procedures shall include tests of controls in the current period if the auditor plans to rely on those controls. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.<sup>17</sup> (Ref: Para. A90)

### *Obtaining Audit Evidence from Events Occurring up to the Date of the Auditor's Report*

21. When the auditor's further audit procedures include obtaining audit evidence from events occurring up to the date of the auditor's report, the auditor shall

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<sup>14</sup> ISA 330, paragraph 7(b)

<sup>15</sup> ISA 330, paragraph 8

<sup>16</sup> ISA 330, paragraph 9

<sup>17</sup> ISA 330, paragraphs 15 and 21

evaluate whether such audit evidence is sufficient and appropriate to address the risks of material misstatement relating to the accounting estimate, taking into account that changes in circumstances and other relevant conditions between the event and the measurement date may affect the relevance of such audit evidence in the context of the applicable financial reporting framework. (Ref: Para. A91–A93)

#### *Testing How Management Made the Accounting Estimate*

22. When testing how management made the accounting estimate, the auditor's further audit procedures shall include procedures, designed and performed in accordance with paragraphs 23–26, to obtain sufficient appropriate audit evidence regarding the risks of material misstatement relating to: (Ref: Para. A94)
- (a) The selection and application of the methods, significant assumptions and the data used by management in making the accounting estimate; and
  - (b) How management selected the point estimate and developed related disclosures about estimation uncertainty.

#### Methods

23. In applying the requirements of paragraph 22, with respect to methods, the auditor's further audit procedures shall address:
- (a) Whether the method selected is appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from the method used in prior periods are appropriate; (Ref: Para. A95, A97)
  - (b) Whether judgments made in selecting the method give rise to indicators of possible management bias; (Ref: Para. A96)
  - (c) Whether the calculations are applied in accordance with the method and are mathematically accurate;
  - (d) When management's application of the method involves complex modelling, whether judgments have been applied consistently and whether, when applicable: (Ref: Para. A98–A100)
    - (i) The design of the model meets the measurement objective of the applicable financial reporting framework, is appropriate in the circumstances, and, if applicable, changes from the prior period's model are appropriate in the circumstances; and
    - (ii) Adjustments to the output of the model are consistent with the measurement objective of the applicable financial reporting framework and are appropriate in the circumstances; and
  - (e) Whether the integrity of the significant assumptions and the data has been maintained in applying the method. (Ref: Para. A101)

### Significant Assumptions

24. In applying the requirements of paragraph 22, with respect to significant assumptions, the auditor's further audit procedures shall address:
- (a) Whether the significant assumptions are appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate; (Ref: Para. A95, A102–A103)
  - (b) Whether judgments made in selecting the significant assumptions give rise to indicators of possible management bias; (Ref: Para. A96)
  - (c) Whether the significant assumptions are consistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit; and (Ref: Para. A104)
  - (d) When applicable, whether management has the intent to carry out specific courses of action and has the ability to do so. (Ref: Para. A105)

### Data

25. In applying the requirements of paragraph 22, with respect to data, the auditor's further audit procedures shall address:
- (a) Whether the data is appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate (Ref: Para. A95, A106);
  - (b) Whether judgments made in selecting the data give rise to indicators of possible management bias; (Ref: Para. A96)
  - (c) Whether the data is relevant and reliable in the circumstances; and (Ref: Para. A107)
  - (d) Whether the data has been appropriately understood or interpreted by management, including with respect to contractual terms. (Ref: Para. A108)

### Management's Selection of a Point Estimate and Related Disclosures about Estimation Uncertainty

26. In applying the requirements of paragraph 22, the auditor's further audit procedures shall address whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to:
- (a) Understand estimation uncertainty; and (Ref: Para. A109)
  - (b) Address estimation uncertainty by selecting an appropriate point estimate and by developing related disclosures about estimation uncertainty. (Ref: Para. A110–A114)

27. When, in the auditor's judgment based on the audit evidence obtained, management has not taken appropriate steps to understand or address estimation uncertainty, the auditor shall: (Ref: Para. A115–A117)
- (a) Request management to perform additional procedures to understand estimation uncertainty or to address it by reconsidering the selection of management's point estimate or considering providing additional disclosures relating to the estimation uncertainty, and evaluate management's response(s) in accordance with paragraph 26;
  - (b) If the auditor determines that management's response to the auditor's request does not sufficiently address estimation uncertainty, to the extent practicable, develop an auditor's point estimate or range in accordance with paragraphs 28–29; and
  - (c) Evaluate whether a deficiency in internal control exists and, if so, communicate in accordance with ISA 265.<sup>18</sup>

*Developing an Auditor's Point Estimate or Range*

28. When the auditor develops a point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty, including when required by paragraph 27(b), the auditor's further audit procedures shall include procedures to evaluate whether the methods, assumptions or data used are appropriate in the context of the applicable financial reporting framework. Regardless of whether the auditor uses management's or the auditor's own methods, assumptions or data, these further audit procedures shall be designed and performed to address the matters in paragraphs 23–25. (Ref: Para. A118–A123)
29. If the auditor develops an auditor's range, the auditor shall:
- (a) Determine that the range includes only amounts that are supported by sufficient appropriate audit evidence and have been evaluated by the auditor to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework; and (Ref: Para. A124–A125)
  - (b) Design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement relating to the disclosures in the financial statements that describe the estimation uncertainty.

*Other Considerations Relating to Audit Evidence*

30. In obtaining audit evidence regarding the risks of material misstatement relating to accounting estimates, irrespective of the sources of information to be used

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<sup>18</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

as audit evidence, the auditor shall comply with the relevant requirements in ISA 500.

When using the work of a management's expert, the requirements in paragraphs 21–29 of this ISA may assist the auditor in evaluating the appropriateness of the expert's work as audit evidence for a relevant assertion in accordance with paragraph 8(c) of ISA 500. In evaluating the work of the management's expert, the nature, timing and extent of the further audit procedures are affected by the auditor's evaluation of the expert's competence, capabilities and objectivity, the auditor's understanding of the nature of the work performed by the expert, and the auditor's familiarity with the expert's field of expertise. (Ref: Para. A126–A132)

### **Disclosures Related to Accounting Estimates**

31. The auditor shall design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level for disclosures related to an accounting estimate, other than those related to estimation uncertainty addressed in paragraphs 26(b) and 29(b).

### **Indicators of Possible Management Bias**

32. The auditor shall evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, are indicators of possible management bias. When indicators of possible management bias are identified, the auditor shall evaluate the implications for the audit. Where there is intention to mislead, management bias is fraudulent in nature. (Ref: Para. A133–A136)

### **Overall Evaluation Based on Audit Procedures Performed**

33. In applying ISA 330 to accounting estimates,<sup>19</sup> the auditor shall evaluate, based on the audit procedures performed and audit evidence obtained, whether: (Ref: Para A137–A138)
  - (a) The assessments of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified;
  - (b) Management's decisions relating to the recognition, measurement, presentation and disclosure of these accounting estimates in the financial statements are in accordance with the applicable financial reporting framework; and
  - (c) Sufficient appropriate audit evidence has been obtained.

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<sup>19</sup> ISA 330, paragraphs 25–26

34. In making the evaluation required by paragraph 33(c), the auditor shall take into account all relevant audit evidence obtained, whether corroborative or contradictory.<sup>20</sup> If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall evaluate the implications for the audit or the auditor's opinion on the financial statements in accordance with ISA 705 (Revised).<sup>21</sup>

#### Determining Whether the Accounting Estimates are Reasonable or Misstated

35. The auditor shall determine whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. ISA 450<sup>22</sup> provides guidance on how the auditor may distinguish misstatements (whether factual, judgmental, or projected) for the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. (Ref: Para. A12–A13, A139–A144)
36. In relation to accounting estimates, the auditor shall evaluate:
- (a) In the case of a fair presentation framework, whether management has included disclosures, beyond those specifically required by the framework, that are necessary to achieve the fair presentation of the financial statements as a whole;<sup>23</sup> or
  - (b) In the case of a compliance framework, whether the disclosures are those that are necessary for the financial statements not to be misleading.<sup>24</sup>

#### Written Representations

37. The auditor shall request written representations from management<sup>25</sup> and, when appropriate, those charged with governance about whether the methods, significant assumptions and the data used in making the accounting estimates and the related disclosures are appropriate to achieve recognition, measurement or disclosure that is in accordance with the applicable financial reporting framework. The auditor shall also consider the need to obtain representations about specific accounting estimates, including in relation to the methods, assumptions, or data used. (Ref: Para. A145)

#### Communication with Those Charged With Governance, Management, or Other Relevant Parties

38. In applying ISA 260 (Revised)<sup>26</sup> and ISA 265,<sup>27</sup> the auditor is required to communicate with those charged with governance or management about certain

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<sup>20</sup> ISA 500, paragraph 11

<sup>21</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

<sup>22</sup> ISA 450, paragraph A6

<sup>23</sup> See also ISA 700 (Revised), paragraph 14.

<sup>24</sup> See also ISA 700 (Revised), paragraph 19.

<sup>25</sup> ISA 580, *Written Representations*

<sup>26</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 16(a)

<sup>27</sup> ISA 265, paragraph 9

matters, including significant qualitative aspects of the entity's accounting practices and significant deficiencies in internal control, respectively. In doing so, the auditor shall consider the matters, if any, to communicate regarding accounting estimates and take into account whether the reasons given to the risks of material misstatement relate to estimation uncertainty, or the effects of complexity, subjectivity or other inherent risk factors in making accounting estimates and related disclosures. In addition, in certain circumstances, the auditor is required by law or regulation to communicate about certain matters with other relevant parties, such as regulators or prudential supervisors. (Ref: Para. A146–A148)

### Documentation

39. The auditor shall include in the audit documentation:<sup>28</sup> (Ref: Para. A149–A152)
- (a) Key elements of the auditor's understanding of the entity and its environment, including the entity's internal control related to the entity's accounting estimates;
  - (b) The linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level,<sup>29</sup> taking into account the reasons (whether related to inherent risk or control risk) given to the assessment of those risks;
  - (c) The auditor's response(s) when management has not taken appropriate steps to understand and address estimation uncertainty;
  - (d) Indicators of possible management bias related to accounting estimates, if any, and the auditor's evaluation of the implications for the audit, as required by paragraph 32; and
  - (e) Significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

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## Application and Other Explanatory Material

### Nature of Accounting Estimates (Ref: Para. 2)

#### *Examples of Accounting Estimates*

- A1. Examples of accounting estimates related to classes of transactions, account balances and disclosures include:
- Inventory obsolescence.

<sup>28</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, A6, A7 and A10

<sup>29</sup> ISA 330, paragraph 28(b)

- Depreciation of property and equipment.
- Valuation of infrastructure assets.
- Valuation of financial instruments.
- Outcome of pending litigation.
- Provision for expected credit losses.
- Valuation of insurance contract liabilities.
- Warranty obligations.
- Employee retirement benefits liabilities.
- Share-based payments.
- Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets.
- Impairment of long-lived assets or property or equipment held for disposal.
- Non-monetary exchanges of assets or liabilities between independent parties.
- Revenue recognized for long-term contracts.

### *Methods*

A2. A method is a measurement technique used by management to make an accounting estimate in accordance with the required measurement basis. For example, one recognized method used to make accounting estimates relating to share-based payment transactions is to determine a theoretical option call price using the Black-Scholes option pricing formula. A method is applied using a computational tool or process, sometimes referred to as a model, and involves applying assumptions and data and taking into account a set of relationships between them.

### *Assumptions and Data*

- A3. Assumptions involve judgments based on available information about matters such as the choice of an interest rate, a discount rate, or judgments about future conditions or events. An assumption may be selected by management from a range of appropriate alternatives. Assumptions that may be made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate.
- A4. For purposes of this ISA, data is information that can be obtained through direct observation or from a party external to the entity. Information obtained by applying analytical or interpretive techniques to data is referred to as derived data when such techniques have a well-established theoretical basis

and therefore less need for management judgment. Otherwise, such information is an assumption.

A5. Examples of data include:

- Prices agreed in market transactions;
- Operating times or quantities of output from a production machine;
- Historical prices or other terms included in contracts, such as a contracted interest rate, a payment schedule, and term included in a loan agreement;
- Forward-looking information such as economic or earnings forecasts obtained from an external information source, or
- A future interest rate determined using interpolation techniques from forward interest rates (derived data).

A6. Data can come from a wide range of sources. For example, data can be:

- Generated within the organization or externally;
- Obtained from a system that is either within or outside the general or subsidiary ledgers;
- Observable in contracts; or
- Observable in legislative or regulatory pronouncements.

*Scalability* (Ref: Para. 3)

A7. Examples of paragraphs that include guidance on how the requirements of this ISA can be scaled include paragraphs A20–A22, A63, A67, and A84.

## **Key Concepts of This ISA**

*Inherent Risk Factors* (Ref: Para. 4)

- A8. Inherent risk factors are characteristics of conditions and events that may affect the susceptibility of an assertion to misstatement, before consideration of controls. Appendix 1 further explains the nature of these inherent risk factors, and their inter-relationships, in the context of making accounting estimates and their presentation in the financial statements.
- A9. In addition to the inherent risk factors of estimation uncertainty, complexity or subjectivity, other inherent risk factors that the auditor may consider in identifying and assessing the risks of material misstatement may include the extent to which the accounting estimate is subject to, or affected by:
- Change in the nature or circumstances of the relevant financial statement items, or requirements of the applicable financial reporting framework which may give rise to the need for changes in the method, assumptions or data used to make the accounting estimate.

- Susceptibility to misstatement due to management bias or fraud in making the accounting estimate.

*Control Risk* (Ref: Para. 6)

A10. An important consideration for the auditor in assessing control risk at the assertion level is the effectiveness of the design of the controls that the auditor intends to rely on and the extent to which the controls address the assessed inherent risks at the assertion level. The auditor's evaluation that controls are effectively designed and have been implemented supports an expectation about the operating effectiveness of the controls in determining whether to test them.

*Professional Skepticism* (Ref: Para. 8)

A11. Paragraphs A60, A95, A96, A137 and A139 are examples of paragraphs that describe ways in which the auditor can exercise professional skepticism. Paragraph A152 provides guidance on ways in which the auditor's exercise of professional skepticism may be documented, and includes examples of specific paragraphs in this ISA for which documentation may provide evidence of the exercise of professional skepticism.

*Concept of "Reasonable"* (Ref: Para. 9, 35)

A12. Other considerations that may be relevant to the auditor's consideration of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework include whether:

- The data and assumptions used in making the accounting estimate are consistent with each other and with those used in other accounting estimates or areas of the entity's business activities; and
- The accounting estimate takes into account appropriate information as required by the applicable financial reporting framework.

A13. The term "applied appropriately" as used in paragraph 9 means in a manner that not only complies with the requirements of the applicable financial reporting framework but, in doing so, reflects judgments that are consistent with the objective of the measurement basis in that framework.

## **Definitions**

*Accounting Estimate* (Ref: Para. 12(a))

A14. Accounting estimates are monetary amounts that may be related to classes of transactions or account balances recognized or disclosed in the financial statements. Accounting estimates also include monetary amounts included in disclosures or used to make judgments about recognition or disclosure relating to a class of transactions or account balance.

*Auditor's Point Estimate or Auditor's Range* (Ref: Para. 12(b))

- A15. An auditor's point estimate or range may be used to evaluate an accounting estimate directly (for example, an impairment provision or the fair value of different types of financial instruments), or indirectly (for example, an amount to be used as a significant assumption for an accounting estimate). A similar approach may be taken by the auditor in developing an amount or range of amounts in evaluating a non-monetary item of data or an assumption (for example, an estimated useful life of an asset).

*Estimation Uncertainty* (Ref: Para. 12(c))

- A16. Not all accounting estimates are subject to a high degree of estimation uncertainty. For example, some financial statement items may have an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

*Management Bias* (Ref: Para. 12(d))

- A17. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Estimation uncertainty gives rise to subjectivity in making an accounting estimate. The presence of subjectivity gives rise to the need for judgment by management and the susceptibility to unintentional or intentional management bias (for example, as a result of motivation to achieve a desired profit target or capital ratio). The susceptibility of an accounting estimate to management bias increases with the extent to which there is subjectivity in making the accounting estimate.

*Outcome of an Accounting Estimate* (Ref: Para. 12(f))

- A18. Some accounting estimates, by their nature, do not have an outcome that is relevant for the auditor's work performed in accordance with this ISA. For example, an accounting estimate may be based on perceptions of market participants at a point in time. Accordingly, the price realized when an asset is sold or a liability is transferred may differ from the related accounting estimate made at the reporting date because, with the passage of time, the market participants' perceptions of value have changed.

**Risk Assessment Procedures and Related Activities***Obtaining an Understanding of the Entity and Its Environment* (Ref: Para. 13)

- A19. Paragraphs 11–24 of ISA 315 (Revised) require the auditor to obtain an understanding of certain matters about the entity and its environment, including

the entity's internal control. The requirements in paragraph 13 of this ISA relate more specifically to accounting estimates and build on the broader requirements in ISA 315 (Revised).

### Scalability

- A20. The nature, timing and extent of the auditor's procedures to obtain the understanding of the entity and its environment, including the entity's internal control, related to the entity's accounting estimates, may depend, to a greater or lesser degree, on the extent to which the individual matter(s) apply in the circumstances. For example, the entity may have few transactions or other events and conditions that give rise to the need for accounting estimates, the applicable financial reporting requirements may be simple to apply, and there may be no relevant regulatory factors. Further, the accounting estimates may not require significant judgments, and the process for making the accounting estimates may be less complex. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree and there may be fewer controls relevant to the audit. If so, the auditor's risk assessment procedures are likely to be less extensive and may be obtained primarily through inquiries of management with appropriate responsibilities for the financial statements and simple walk-throughs of management's process for making the accounting estimate.
- A21. By contrast, the accounting estimates may require significant judgments by management, and the process for making the accounting estimates may be complex and involve the use of complex models. In addition, the entity may have a more sophisticated information system, and more extensive controls over accounting estimates. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, subjectivity, complexity or other inherent risk factors to a greater degree. If so, the nature or timing of the auditor's risk assessment procedures are likely to be different, or be more extensive, than in the circumstances in paragraph A20.
- A22. The following considerations may be relevant for entities with only simple businesses, which may include many smaller entities:
- Processes relevant to accounting estimates may be uncomplicated because the business activities are simple or the required estimates may have a lesser degree of estimation uncertainty.
  - Accounting estimates may be generated outside of the general and subsidiary ledgers, controls over their development may be limited, and an owner-manager may have significant influence over their determination. The owner-manager's role in making the accounting estimates may need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering the risk of management bias.

## The Entity and Its Environment

The entity's transactions and other events and conditions (Ref: Para. 13(a))

A23. Changes in circumstances that may give rise to the need for, or changes in, accounting estimates may include, for example, whether:

- The entity has engaged in new types of transactions;
- Terms of transactions have changed; or
- New events or conditions have occurred.

The requirements of the applicable financial reporting framework (Ref: Para. 13(b))

A24. Obtaining an understanding of the requirements of the applicable financial reporting framework provides the auditor with a basis for discussion with management and, where applicable, those charged with governance about how management has applied those requirements relevant to the accounting estimates, and about the auditor's determination of whether they have been applied appropriately. This understanding also may assist the auditor in communicating with those charged with governance when the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be the most appropriate in the circumstances of the entity.<sup>30</sup>

A25. In obtaining this understanding, the auditor may seek to understand whether:

- The applicable financial reporting framework:
  - Prescribes certain criteria for the recognition, or methods for the measurement of accounting estimates;
  - Specifies certain criteria that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability; or
  - Specifies required or suggested disclosures, including disclosures concerning judgments, assumptions, or other sources of estimation uncertainty relating to accounting estimates; and
- Changes in the applicable financial reporting framework require changes to the entity's accounting policies relating to accounting estimates.

Regulatory factors (Ref: Para. 13(c))

A26. Obtaining an understanding of regulatory factors, if any, that are relevant to accounting estimates may assist the auditor in identifying applicable regulatory frameworks (for example, regulatory frameworks established by prudential

<sup>30</sup> ISA 260 (Revised), paragraph 16(a)

supervisors in the banking or insurance industries) and in determining whether such regulatory framework(s):

- Addresses conditions for the recognition, or methods for the measurement, of accounting estimates, or provides related guidance thereon;
- Specifies, or provides guidance about, disclosures in addition to the requirements of the applicable financial reporting framework;
- Provides an indication of areas for which there may be a potential for management bias to meet regulatory requirements; or
- Contains requirements for regulatory purposes that are not consistent with requirements of the applicable financial reporting framework, which may indicate potential risks of material misstatement. For example, some regulators may seek to influence minimum levels for expected credit loss provisions that exceed those required by the applicable financial reporting framework.

The nature of the accounting estimates and related disclosures that the auditor expects to be included in the financial statements (Ref: Para. 13(d))

A27. Obtaining an understanding of the nature of accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements assists the auditor in understanding the measurement basis of such accounting estimates and the nature and extent of disclosures that may be relevant. Such an understanding provides the auditor with a basis for discussion with management about how management makes the accounting estimates.

#### *The Entity's Internal Control Relevant to the Audit*

The nature and extent of oversight and governance (Ref: Para. 13(e))

A28. In applying ISA 315 (Revised),<sup>31</sup> the auditor's understanding of the nature and extent of oversight and governance that the entity has in place over management's process for making accounting estimates may be important to the auditor's required evaluation as it relates to whether:

- Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
- The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are undermined by deficiencies in the control environment.

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<sup>31</sup> ISA 315 (Revised), paragraph 14

A29. The auditor may obtain an understanding of whether those charged with governance:

- Have the skills or knowledge to understand the characteristics of a particular method or model to make accounting estimates, or the risks related to the accounting estimate, for example, risks related to the method or information technology used in making the accounting estimates;
- Have the skills and knowledge to understand whether management made the accounting estimates in accordance with the applicable financial reporting framework;
- Are independent from management, have the information required to evaluate on a timely basis how management made the accounting estimates, and the authority to call into question management's actions when those actions appear to be inadequate or inappropriate;
- Oversee management's process for making the accounting estimates, including the use of models; or
- Oversee the monitoring activities undertaken by management. This may include supervision and review procedures designed to detect and correct any deficiencies in the design or operating effectiveness of controls over the accounting estimates.

A30. Obtaining an understanding of the oversight by those charged with governance may be important when there are accounting estimates that:

- Require significant judgment by management to address subjectivity;
- Have high estimation uncertainty;
- Are complex to make, for example, because of the extensive use of information technology, large volumes of data or the use of multiple data sources or assumptions with complex interrelationships;
- Had, or ought to have had, a change in the method, assumptions or data compared to previous periods; or
- Involve significant assumptions.

Management's application of specialized skills or knowledge, including the use of management's experts (Ref: Para. 13(f))

A31. The auditor may consider whether the following circumstances increase the likelihood that management needs to engage an expert:<sup>32</sup>

- The specialized nature of the matter requiring estimation, for example, the accounting estimate may involve measurement of mineral or hydrocarbon reserves in extractive industries or the evaluation of the likely outcome of applying complex contractual terms.

<sup>32</sup> ISA 500, paragraph 8

- The complex nature of the models required to apply the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements, such as level 3 fair values.<sup>33</sup>
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

The entity's risk assessment process (Ref: Para. 13(g))

A32. Understanding how the entity's risk assessment process identifies and addresses risks relating to accounting estimates may assist the auditor in considering changes in:

- The requirements of the applicable financial reporting framework related to the accounting estimates;
- The availability or nature of data sources that are relevant to making the accounting estimates or that may affect the reliability of the data used;
- The entity's information system or IT environment; and
- Key personnel.

A33. Matters that the auditor may consider in obtaining an understanding of how management identified and addresses the susceptibility to misstatement due to management bias or fraud in making accounting estimates, include whether and, if so, how management:

- Pays particular attention to selecting or applying the methods, assumptions and data used in making accounting estimates.
- Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors.
- Identifies financial or other incentives that may be a motivation for bias.
- Monitors the need for changes in the methods, significant assumptions or the data used in making accounting estimates.
- Establishes appropriate oversight and review of models used in making accounting estimates.
- Requires documentation of the rationale for, or an independent review of, significant judgments made in making accounting estimates.

The entity's information system relating to accounting estimates (Ref: Para. 13(h)(i))

A34. The classes of transactions, events and conditions within the scope of paragraph 13(h) are the same as the classes of transactions, events and conditions relating

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<sup>33</sup> See, for example, International Financial Reporting Standard (IFRS) 13, *Fair Value Measurement*.

to accounting estimates and related disclosures that are subject to paragraphs 18(a) and (d) of ISA 315 (Revised). In obtaining the understanding of the entity's information system as it relates to accounting estimates, the auditor may consider:

- Whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions.
- How the information system addresses the completeness of accounting estimates and related disclosures, in particular for accounting estimates related to liabilities.

A35. During the audit, the auditor may identify classes of transactions, events and conditions that give rise to the need for accounting estimates and related disclosures that management failed to identify. ISA 315 (Revised) deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment process.<sup>34</sup>

Management's identification of the relevant methods, assumptions and sources of data (Ref: Para. 13(h)(ii)(a))

A36. If management has changed the method for making an accounting estimate, considerations may include whether the new method is, for example, more appropriate, is itself a response to changes in the environment or circumstances affecting the entity, or to changes in the requirements of the applicable financial reporting framework or regulatory environment, or whether management has another valid reason.

A37. If management has not changed the method for making an accounting estimate, considerations may include whether the continued use of the previous methods, assumptions and data is appropriate in view of the current environment or circumstances.

Methods (Ref: Para. 13(h)(ii)(a)(i))

A38. The applicable financial reporting framework may prescribe the method to be used in making an accounting estimate. In many cases, however, the applicable financial reporting framework does not prescribe a single method, or the required measurement basis prescribes, or allows, the use of alternative methods.

## Models

A39. Management may design and implement specific controls around models used for making accounting estimates, whether management's own model or an

<sup>34</sup> ISA 315 (Revised), paragraph 17

external model. When the model itself has an increased level of complexity or subjectivity, such as an expected credit loss model or a fair value model using level 3 inputs, controls that address such complexity or subjectivity may be more likely to be identified as relevant to the audit. When complexity in relation to models is present, controls over data integrity are also more likely to be relevant to the audit. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and of control activities relevant to the audit include the following:

- How management determines the relevance and accuracy of the model;
- The validation or back testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model may include evaluation of:
  - The model's theoretical soundness;
  - The model's mathematical integrity; and
  - The accuracy and completeness of the data and the appropriateness of data and assumptions used in the model;
- How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model;
- Whether adjustments, also referred to as overlays in certain industries, are made to the output of the model and whether such adjustments are appropriate in the circumstances in accordance with the requirements of the applicable financial reporting framework. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias; and
- Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, the results of any validation performed on it and the nature of, and basis for, any adjustments made to its output.

Assumptions (Ref: Para. 13(h)(ii)(a)(ii))

A40. Matters that the auditor may consider in obtaining an understanding of how management selected the assumptions used in making the accounting estimates include, for example:

- The basis for management's selection and the documentation supporting the selection of the assumption. The applicable financial reporting framework may provide criteria or guidance to be used in the selection of an assumption.

- How management assesses whether the assumptions are relevant and complete.
- When applicable, how management determines that the assumptions are consistent with each other, with those used in other accounting estimates or areas of the entity's business activities, or with other matters that are:
  - Within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and whether they are consistent with the entity's business plans and the external environment; and
  - Outside the control of management (for example, assumptions about interest rates, mortality rates or potential judicial or regulatory actions).
- The requirements of the applicable financial reporting framework related to the disclosure of assumptions.

A41. With respect to fair value accounting estimates, assumptions vary in terms of the sources of the data and the basis for the judgments to support them, as follows:

- (a) Those that reflect what marketplace participants would use in pricing an asset or liability, developed based on market data obtained from sources independent of the reporting entity.
- (b) Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability, developed based on the best data available in the circumstances.

In practice, however, the distinction between (a) and (b) may not always be apparent and distinguishing between them depends on understanding the sources of data and the basis for the judgments that support the assumption. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A42. Assumptions used in making an accounting estimate are referred to as significant assumptions in this ISA if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate. A sensitivity analysis may be useful in demonstrating the degree to which the measurement varies based on one or more assumptions used in making the accounting estimate.

#### Inactive or illiquid markets

A43. When markets are inactive or illiquid, the auditor's understanding of how management selects assumptions may include understanding whether management has:

- Implemented appropriate policies for adapting the application of the method in such circumstances. Such adaptation may include making model adjustments or developing new models that are appropriate in the circumstances;
- Resources with the necessary skills or knowledge to adapt or develop a model, if necessary on an urgent basis, including selecting the valuation technique that is appropriate in such circumstances;
- The resources to determine the range of outcomes, given the uncertainties involved, for example by performing a sensitivity analysis;
- The means to assess how, when applicable, the deterioration in market conditions has affected the entity's operations, environment and relevant business risks and the implications for the entity's accounting estimates, in such circumstances; and
- An appropriate understanding of how the price data, and the relevance thereof, from particular external information sources may vary in such circumstances.

#### Data (Ref: Para. 13(h)(ii)(a)(iii))

A44. Matters that the auditor may consider in obtaining an understanding of how management selects the data on which the accounting estimates are based include:

- The nature and source of the data, including information obtained from an external information source.
- How management evaluates whether the data is appropriate.
- The accuracy and completeness of the data.
- The consistency of the data used with data used in previous periods.
- The complexity of the information technology systems used to obtain and process the data, including when this involves handling large volumes of data.
- How the data is obtained, transmitted and processed and how its integrity is maintained.

#### How management understands and addresses estimation uncertainty (Ref: Para. 13(h)(ii)(b)–13(h)(ii)(c))

A45. Matters that may be appropriate for the auditor to consider relating to whether and how management understands the degree of estimation uncertainty include, for example:

- Whether and, if so, how management identified alternative methods, significant assumptions or sources of data that are appropriate in the context of the applicable financial reporting framework.

- Whether and, if so, how management considered alternative outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the significant assumptions or the data used in making the accounting estimate.
- A46. The requirements of the applicable financial reporting framework may specify the approach to selecting management's point estimate from the reasonably possible measurement outcomes. Financial reporting frameworks may recognize that the appropriate amount is one that is appropriately selected from the reasonably possible measurement outcomes and, in some cases, may indicate that the most relevant amount may be in the central part of that range.
- A47. For example, with respect to fair value estimates, IFRS 13<sup>35</sup> indicates that, if multiple valuation techniques are used to measure fair value, the results (i.e., respective indications of fair value) shall be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances. In other cases, the applicable financial reporting framework may specify the use of a probability-weighted average of the reasonably possible measurement outcomes, or of the measurement amount that is most likely or that is more likely than not.
- A48. The applicable financial reporting framework may prescribe disclosures or disclosure objectives related to accounting estimates, and some entities may choose to disclose additional information. These disclosures or disclosure objectives may address, for example:
- The method of estimation used, including any applicable model and the basis for its selection.
  - Information that has been obtained from models, or from other calculations used to determine estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
    - Assumptions developed internally; or
    - Data, such as interest rates, that are affected by factors outside the control of the entity.
  - The effect of any changes to the method of estimation from the prior period.
  - The sources of estimation uncertainty.
  - Fair value information.
  - Information about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.

<sup>35</sup> IFRS 13, *Fair Value Measurement*, paragraph 63

A49. In some cases, the applicable financial reporting framework may require specific disclosures regarding estimation uncertainty, for example:

- The disclosure of information about the assumptions made about the future and other major sources of estimation uncertainty that give rise to a higher likelihood or magnitude of material adjustment to the carrying amounts of assets and liabilities after the period end. Such requirements may be described using terms such as “Key Sources of Estimation Uncertainty” or “Critical Accounting Estimates.” They may relate to accounting estimates that require management’s most difficult, subjective or complex judgments. Such judgments may be more subjective and complex, and accordingly the potential for a consequential material adjustment to the carrying amounts of assets and liabilities may increase, with the number of items of data and assumptions affecting the possible future resolution of the estimation uncertainty. Information that may be disclosed includes:
  - The nature of the assumption or other source of estimation uncertainty;
  - The sensitivity of carrying amounts to the methods and assumptions used, including the reasons for the sensitivity;
  - The expected resolution of an uncertainty and the range of reasonably possible outcomes in respect of the carrying amounts of the assets and liabilities affected; and
  - An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of specific information, such as:
  - Information regarding the significance of fair value accounting estimates to the entity’s financial position and performance; and
  - Disclosures regarding market inactivity or illiquidity.
- Qualitative disclosures such as the exposures to risk and how they arise, the entity’s objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.
- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity’s key management personnel, including credit risk, liquidity risk and market risk.

Control activities relevant to the audit over management's process for making accounting estimates (Ref: Para 13(i))

- A50. The auditor's judgment in identifying controls relevant to the audit, and therefore the need to evaluate the design of those controls and determine whether they have been implemented, relates to management's process described in paragraph 13(h)(ii). The auditor may not identify relevant control activities in relation to all the elements of paragraph 13(h)(ii), depending on the complexity associated with the accounting estimate.
- A51. As part of obtaining an understanding of the control activities relevant to the audit, the auditor may consider:
- How management determines the appropriateness of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers.
  - The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
  - The segregation of duties between those responsible for making the accounting estimates and those committing the entity to the related transactions, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity's financial products staffed by individuals whose remuneration is not tied to such products.
  - The effectiveness of the design of the control activities. Generally, it may be more difficult for management to design controls that address subjectivity and estimation uncertainty in a manner that effectively prevents, or detects and corrects, material misstatements, than it is to design controls that address complexity. Controls that address subjectivity and estimation uncertainty may need to include more manual elements, which may be less reliable than automated controls as they can be more easily bypassed, ignored or overridden by management. The design effectiveness of controls addressing complexity may vary depending on the reason for, and the nature of, the complexity. For example, it may be easier to design more effective controls related to a method that is routinely used or over the integrity of data.
- A52. When management makes extensive use of information technology in making an accounting estimate, controls relevant to the audit are likely to include

general IT controls and application controls. Such controls may address risks related to:

- Whether the information technology system has the capability and is appropriately configured to process large volumes of data;
- Complex calculations in applying a method. When diverse systems are required to process complex transactions, regular reconciliations between the systems are made, in particular when the systems do not have automated interfaces or may be subject to manual intervention;
- Whether the design and calibration of models is periodically evaluated;
- The complete and accurate extraction of data regarding accounting estimates from the entity's records or from external information sources;
- Data, including the complete and accurate flow of data through the entity's information system, the appropriateness of any modification to the data used in making accounting estimates, the maintenance of the integrity and security of the data;
- When using external information sources, risks related to processing or recording the data;
- Whether management has controls around access, change and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models; and
- Whether there are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over journal entries.

A53. In some industries, such as banking or insurance, the term governance may be used to describe activities within the control environment, monitoring of controls, and other components of internal control, as described in ISA 315 (Revised).<sup>36</sup>

A54. For entities with an internal audit function, its work may be particularly helpful to the auditor in obtaining an understanding of:

- The nature and extent of management's use of accounting estimates;
- The design and implementation of control activities that address the risks related to the data, assumptions and models used to make the accounting estimates;
- The aspects of the entity's information system that generate the data on which the accounting estimates are based; and
- How new risks relating to accounting estimates are identified, assessed and managed.

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<sup>36</sup> ISA 315 (Revised) paragraph A77

*Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates* (Ref: Para. 14)

- A55. A review of the outcome or re-estimation of previous accounting estimates (retrospective review) assists in identifying and assessing the risks of material misstatement when previous accounting estimates have an outcome through transfer or realization of the asset or liability in the current period, or are re-estimated for the purpose of the current period. Through performing a retrospective review, the auditor may obtain:
- Information regarding the effectiveness of management’s previous estimation process, from which the auditor can obtain audit evidence about the likely effectiveness of management’s current process.
  - Audit evidence of matters, such as the reasons for changes that may be required to be disclosed in the financial statements.
  - Information regarding the complexity or estimation uncertainty pertaining to the accounting estimates.
  - Information regarding the susceptibility of accounting estimates to, or that may be an indicator of, possible management bias. The auditor’s professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.
- A56. A retrospective review may provide audit evidence that supports the identification and assessment of the risks of material misstatement in the current period. Such a retrospective review may be performed for accounting estimates made for the prior period’s financial statements, or may be performed over several periods or a shorter period (such as half-yearly or quarterly). In some cases, a retrospective review over several periods may be appropriate when the outcome of an accounting estimate is resolved over a longer period.
- A57. A retrospective review of management judgments and assumptions related to significant accounting estimates is required by ISA 240.<sup>37</sup> As a practical matter, the auditor’s review of previous accounting estimates as a risk assessment procedure in accordance with this ISA may be carried out in conjunction with the review required by ISA 240.
- A58. Based on the auditor’s previous assessment of the risks of material misstatement, for example, if inherent risk is assessed as higher for one or more risks of material misstatement, the auditor may judge that a more detailed retrospective review is required. As part of the detailed retrospective review, the auditor may pay particular attention, when practicable, to the effect of data and significant assumptions used in making the previous accounting estimates. On the other

<sup>37</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 33(b)(ii)

hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

- A59. The measurement objective for fair value accounting estimates and other accounting estimates, based on current conditions at the measurement date, deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that may be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions that affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant audit evidence. In this case, audit evidence may be obtained by understanding the outcomes of assumptions (such as a cash flow projections) and understanding the effectiveness of management's prior estimation process that supports the identification and assessment of the risk of material misstatement in the current period.
- A60. A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. However, such a difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.<sup>38</sup> Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may reassess control risk and may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

*Specialized Skills or Knowledge* (Ref: Para. 15)

- A61. Matters that may affect the auditor's determination of whether the engagement team requires specialized skills or knowledge, include, for example:<sup>39</sup>
- The nature of the accounting estimates for a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments, insurance contract liabilities).

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<sup>38</sup> ISA 560, Subsequent Events, paragraph 14

<sup>39</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14 and ISA 300, *Planning an Audit of Financial Statements*, paragraph 8(e)

- The degree of estimation uncertainty.
- The complexity of the method or model used.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice or areas where there are inconsistencies in how accounting estimates are made.
- The procedures the auditor intends to undertake in responding to assessed risks of material misstatement.
- The need for judgment about matters not specified by the applicable financial reporting framework.
- The degree of judgment needed to select data and assumptions.
- The complexity and extent of the entity's use of information technology in making accounting estimates.

The nature, timing and extent of the involvement of individuals with specialized skills and knowledge may vary throughout the audit.

- A62. The auditor may not possess the specialized skills or knowledge necessary when the matter involved is in a field other than accounting or auditing (for example, valuation skills) and may need to use an auditor's expert.<sup>40</sup>
- A63. Many accounting estimates do not require the application of specialized skills or knowledge. For example, specialized skills or knowledge may not be needed for a simple inventory obsolescence calculation. However, for example, for expected credit losses of a banking institution or an insurance contract liability for an insurance entity, the auditor is likely to conclude that it is necessary to apply specialized skills or knowledge.

### **Identifying and Assessing the Risks of Material Misstatement** (Ref: Para. 4, 16)

- A64. Identifying and assessing risks of material misstatement at the assertion level relating to accounting estimates is important for all accounting estimates, including not only those that are recognized in the financial statements, but also those that are included in the notes to the financial statements.
- A65. Paragraph A42 of ISA 200 states that the ISAs do not ordinarily refer to inherent risk and control risk separately. However, this ISA requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the risks of material misstatement, including significant risks, at the assertion level for accounting estimates in accordance with ISA 330.<sup>41</sup>

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<sup>40</sup> ISA 620, *Using the Work of an Auditor's Expert*

<sup>41</sup> ISA 330, paragraph 7(b)

A66. In identifying the risks of material misstatement and in assessing inherent risk, the auditor is required to take into account the degree to which the accounting estimate is subject to, or affected by, estimation uncertainty, complexity, subjectivity, or other inherent risk factors. The auditor's consideration of the inherent risk factors may also provide information to be used in determining:

- Where inherent risk is assessed on the spectrum of inherent risk; and
- The reasons for the assessment given to the risks of material misstatement at the assertion level, and that the auditor's further audit procedures in accordance with paragraph 18 are responsive to those reasons.

The interrelationships between the inherent risk factors are further explained in Appendix 1.

A67. The reasons for the auditor's assessment of inherent risk at the assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity or other inherent risk factors. For example:

- (a) Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgments about future events or conditions. Similar considerations apply to insurance contract liabilities.
- (b) An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes, but may involve little subjectivity and the degree of estimation uncertainty may be low, depending on the nature of the inventory.
- (c) Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an accounting estimate that requires a single critical judgment about a liability, the amount of which is contingent on the outcome of the litigation.

A68. The relevance and significance of inherent risk factors may vary from one estimate to another. Accordingly, the inherent risk factors may, either individually or in combination, affect simple accounting estimates to a lesser degree and the auditor may identify fewer risks or assess inherent risk at the lower end of the spectrum of inherent risk.

A69. Conversely, the inherent risk factors may, either individually or in combination, affect complex accounting estimates to a greater degree, and may lead the

auditor to assess inherent risk at the higher end of the spectrum of inherent risk. For these accounting estimates, the auditor's consideration of the effects of the inherent risk factors is likely to directly affect the number and nature of identified risks of material misstatement, the assessment of such risks, and ultimately the persuasiveness of the audit evidence needed in responding to the assessed risks. Also, for these accounting estimates the auditor's application of professional skepticism may be particularly important.

- A70. Events occurring after the date of the financial statements may provide additional information relevant to the auditor's assessment of the risks of material misstatement at the assertion level. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise the assessment of the risks of material misstatement at the assertion level,<sup>42</sup> regardless of the degree to which the accounting estimate was subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors. Events occurring after the date of the financial statements also may influence the auditor's selection of the approach to testing the accounting estimate in accordance with paragraph 18. For example, for a simple bonus accrual that is based on a straightforward percentage of compensation for selected employees, the auditor may conclude that there is relatively little complexity or subjectivity in making the accounting estimate, and therefore may assess inherent risk at the assertion level at the lower end of the spectrum of inherent risk. The payment of the bonuses subsequent to period end may provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level.
- A71. The auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, minimum) or in terms of the auditor's expectation of how effective the control(s) is in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.

*Estimation Uncertainty* (Ref: Para. 16(a))

- A72. In taking into account the degree to which the accounting estimate is subject to estimation uncertainty, the auditor may consider:
- Whether the applicable financial reporting framework requires:
    - The use of a method to make the accounting estimate that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of unobservable inputs.

<sup>42</sup> ISA 315 (Revised), paragraph 31

- The use of assumptions that inherently have a high level of estimation uncertainty, such as assumptions with a long forecast period, assumptions that are based on data that is unobservable and are therefore difficult for management to develop, or the use of various assumptions that are interrelated.
- Disclosures about estimation uncertainty.
- The business environment. An entity may be active in a market that experiences turmoil or possible disruption (for example, from major currency movements or inactive markets) and the accounting estimate may therefore be dependent on data that is not readily observable.
- Whether it is possible (or practicable, insofar as permitted by the applicable financial reporting framework) for management:
  - To make a precise and reliable prediction about the future realization of a past transaction (for example, the amount that will be paid under a contingent contractual term), or about the incidence and impact of future events or conditions (for example, the amount of a future credit loss or the amount at which an insurance claim will be settled and the timing of its settlement); or
  - To obtain precise and complete information about a present condition (for example, information about valuation attributes that would reflect the perspective of market participants at the date of the financial statements, to develop a fair value estimate).

A73. The size of the amount recognized or disclosed in the financial statements for an accounting estimate is not, in itself, an indicator of its susceptibility to misstatement because, for example, the accounting estimate may be understated.

A74. In some circumstances, the estimation uncertainty may be so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may preclude recognition of an item in the financial statements, or its measurement at fair value. In such cases, there may be risks of material misstatement that relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the reasonableness of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the estimation uncertainty associated with them (see paragraphs A112–A113, A143–A144).

A75. In some cases, the estimation uncertainty relating to an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. ISA 570 (Revised)<sup>43</sup> establishes requirements and provides guidance in such circumstances.

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<sup>43</sup> ISA 570, (Revised), *Going Concern*

*Complexity or Subjectivity* (Ref: Para. 16(b))

## The Degree to Which Complexity Affects the Selection and Application of the Method

A76. In taking into account the degree to which the selection and application of the method used in making the accounting estimate are affected by complexity, the auditor may consider:

- The need for specialized skills or knowledge by management which may indicate that the method used to make an accounting estimate is inherently complex and therefore the accounting estimate may have a greater susceptibility to material misstatement. There may be a greater susceptibility to material misstatement when management has developed a model internally and has relatively little experience in doing so, or uses a model that applies a method that is not established or commonly used in a particular industry or environment.
- The nature of the measurement basis required by the applicable financial reporting framework, which may result in the need for a complex method that requires multiple sources of historical and forward-looking data or assumptions, with multiple interrelationships between them. For example, an expected credit loss provision may require judgments about future credit repayments and other cash flows, based on consideration of historical experience data and the application of forward looking assumptions. Similarly, the valuation of an insurance contract liability may require judgments about future insurance contract payments to be projected based on historical experience and current and assumed future trends.

## The Degree to Which Complexity Affects the Selection and Application of the Data

A77. In taking into account the degree to which the selection and application of the data used in making the accounting estimate are affected by complexity, the auditor may consider:

- The complexity of the process to derive the data, taking into account the relevance and reliability of the data source. Data from certain sources may be more reliable than from others. Also, for confidentiality or proprietary reasons, some external information sources will not (or not fully) disclose information that may be relevant in considering the reliability of the data they provide, such as the sources of the underlying data they used or how it was accumulated and processed.
- The inherent complexity in maintaining the integrity of the data. When there is a high volume of data and multiple sources of data, there may be inherent complexity in maintaining the integrity of data that is used to make an accounting estimate.

- The need to interpret complex contractual terms. For example, the determination of cash inflows or outflows arising from a commercial supplier or customer rebates may depend on very complex contractual terms that require specific experience or competence to understand or interpret.

#### The Degree to Which Subjectivity Affects the Selection and Application of the Method, Assumptions or Data

A78. In taking into account the degree to which the selection and application of method, assumptions or data are affected by subjectivity, the auditor may consider:

- The degree to which the applicable financial reporting framework does not specify the valuation approaches, concepts, techniques and factors to use in the estimation method.
- The uncertainty regarding the amount or timing, including the length of the forecast period. The amount and timing are a source of inherent estimation uncertainty, and give rise to the need for management judgment in selecting a point estimate, which in turn creates an opportunity for management bias. For example, an accounting estimate that incorporates forward looking assumptions may have a high degree of subjectivity which may be susceptible to management bias.

#### *Other Inherent Risk Factors* (Ref: Para. 16(b))

A79. The degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or fraud. For example, when an accounting estimate is subject to a high degree of subjectivity, the accounting estimate is likely to be more susceptible to misstatement due to management bias or fraud and this may result in a wide range of possible measurement outcomes. Management may select a point estimate from that range that is inappropriate in the circumstances, or that is inappropriately influenced by unintentional or intentional management bias, and that is therefore misstated. For continuing audits, indicators of possible management bias identified during the audit of preceding periods may influence the planning and risk assessment procedures in the current period.

#### *Significant Risks* (Ref: Para. 17)

A80. The auditor's assessment of inherent risk, which takes into account the degree to which an accounting estimate is subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, assists the auditor in determining whether any of the risks of material misstatement identified and assessed are a significant risk.

## Responses to the Assessed Risks of Material Misstatement

### *The Auditor's Further Audit Procedures (Ref: Para. 18)*

A81. In designing and performing further audit procedures the auditor may use any of the three testing approaches (individually or in combination) listed in paragraph 18. For example, when several assumptions are used to make an accounting estimate, the auditor may decide to use a different testing approach for each assumption tested.

### Obtaining Relevant Audit Evidence Whether Corroborative or Contradictory

A82. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.<sup>44</sup> Obtaining audit evidence in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence.

A83. ISA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of the risk.<sup>45</sup> Therefore, the consideration of the nature or quantity of the audit evidence may be more important when inherent risks relating to an accounting estimate is assessed at the higher end of the spectrum of inherent risk.

### Scalability

A84. The nature, timing and extent of the auditor's further audit procedures are affected by, for example:

- The assessed risks of material misstatement, which affect the persuasiveness of the audit evidence needed and influence the approach the auditor selects to audit an accounting estimate. For example, the assessed risks of material misstatement relating to the existence or valuation assertions may be lower for a straightforward accrual for bonuses that are paid to employees shortly after period end. In this situation, it may be more practical for the auditor to obtain sufficient appropriate audit evidence by evaluating events occurring up to the date of the auditor's report, rather than through other testing approaches.
- The reasons for the assessed risks of material misstatement.

### *When the Auditor Intends to Rely on the Operating Effectiveness of Relevant Controls (Ref: Para: 19)*

A85. Testing the operating effectiveness of relevant controls may be appropriate when inherent risk is assessed as higher on the spectrum of inherent risk, including for

<sup>44</sup> ISA 500, paragraph A5

<sup>45</sup> ISA 330, paragraphs 7(b) and A19

significant risks. This may be the case when the accounting estimate is subject to or affected by a high degree of complexity. When the accounting estimate is affected by a high degree of subjectivity, and therefore requires significant judgment by management, inherent limitations in the effectiveness of the design of controls may lead the auditor to focus more on substantive procedures than on testing the operating effectiveness of controls.

A86. In determining the nature, timing and extent of testing of the operating effectiveness of controls relating to accounting estimates, the auditor may consider factors such as:

- The nature, frequency and volume of transactions;
- The effectiveness of the design of the controls, including whether controls are appropriately designed to respond to the assessed inherent risk, and the strength of governance;
- The importance of particular controls to the overall control objectives and processes in place at the entity, including the sophistication of the information system to support transactions;
- The monitoring of controls and identified deficiencies in internal control;
- The nature of the risks the controls are intended to address, for example, controls related to the exercise of judgment compared with controls over supporting data;
- The competency of those involved in the control activities;
- The frequency of performance of the control activities; and
- The evidence of performance of control activities.

#### Substantive Procedures Alone Cannot Provide Sufficient Appropriate Audit Evidence

A87. In some industries, such as the financial services industry, management makes extensive use of IT to conduct business. It may therefore be more likely that there are risks related to certain accounting estimates for which substantive procedures alone cannot provide sufficient appropriate audit evidence.

A88. Circumstances when risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level may exist include:

- When controls are necessary to mitigate risks relating to the initiation, recording, processing, or reporting of information obtained from outside of the general and subsidiary ledgers.
- Information supporting one or more assertions is electronically initiated, recorded, processed, or reported. This is likely to be the case when there is a high volume of transactions or data, or a complex model is used, requiring the extensive use of information technology to ensure

the accuracy and completeness of the information. A complex expected credit loss provision may be required for a financial institution or utility entity. For example, in the case of a utility entity, the data used in developing the expected credit loss provision may comprise many small balances resulting from a high volume of transactions. In these circumstances, the auditor may conclude that sufficient appropriate audit evidence cannot be obtained without testing controls around the model used to develop the expected credit loss provision.

In such cases, the sufficiency and appropriateness of the audit evidence may depend on the effectiveness of controls over the accuracy and completeness of the information.

- A89. As part of the audit of the financial statements for certain entities (such as a bank or insurer), the auditor also may be required by law or regulation to undertake additional procedures in relation to, or to provide an assurance conclusion on, internal control. In these and other similar circumstances, the auditor may be able to use information obtained in performing such procedures as audit evidence, subject to determining whether subsequent changes have occurred that may affect its relevance to the audit.

*Significant Risks* (Ref: Para. 20)

- A90. When the auditor's further audit procedures in response to a significant risk consist only of substantive procedures, ISA 330<sup>46</sup> requires that those procedures include tests of details. Such tests of details may be designed and performed under each of the approaches described in paragraph 18 of this ISA based on the auditor's professional judgment in the circumstances. Examples of tests of details for significant risks related to accounting estimates include:

- Examination, for example, examining contracts to corroborate terms or assumptions.
- Recalculation, for example, verifying the mathematical accuracy of a model.
- Agreeing assumptions used to supporting documentation, such as third-party published information.

*Obtaining Audit Evidence from Events Occurring up to the Date of the Auditor's Report* (Ref: Para. 21)

- A91. In some circumstances, obtaining audit evidence from events occurring up to the date of the auditor's report may provide sufficient appropriate audit evidence to address the risks of material misstatement. For example, sale of the complete inventory of a discontinued product shortly after the period end may provide sufficient appropriate audit evidence relating to the estimate of its net realizable

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<sup>46</sup> ISA 330, paragraph 21

value at the period end. In other cases, it may be necessary to use this testing approach in connection with another approach in paragraph 18.

- A92. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide sufficient appropriate audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate.
- A93. Even if the auditor decides not to undertake this testing approach in respect of specific accounting estimates, the auditor is required to comply with ISA 560. ISA 560 requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified<sup>47</sup> and appropriately reflected in the financial statements.<sup>48</sup> Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under ISA 560 is particularly relevant.

*Testing How Management Made the Accounting Estimate (Ref. Para. 22)*

- A94. Testing how management made the accounting estimate may be an appropriate approach when, for example:
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is appropriate.
  - The accounting estimate is based on a large population of items of a similar nature that individually are not significant.
  - The applicable financial reporting framework specifies how management is expected to make the accounting estimate. For example, this may be the case for an expected credit loss provision.
  - The accounting estimate is derived from the routine processing of data.

Testing how management made the accounting estimate may also be an appropriate approach when neither of the other testing approaches is practical to perform, or may be an appropriate approach in combination with one of the other testing approaches.

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<sup>47</sup> ISA 560, paragraph 6

<sup>48</sup> ISA 560, paragraph 8

Changes in Methods, Significant Assumptions and the Data from Prior Periods (Ref: Para. 23(a), 24(a), 25(a))

A95. When a change from prior periods in a method, significant assumption, or the data is not based on new circumstances or new information, or when significant assumptions are inconsistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, the auditor may need to have further discussions with management about the circumstances and, in doing so, challenge management regarding the appropriateness of the assumptions used.

Indicators of Management Bias (Ref: Para. 23(b), 24(b), 25(b))

A96. When the auditor identifies indicators of possible management bias, the auditor may need a further discussion with management and may need to reconsider whether sufficient appropriate audit evidence has been obtained that the method, assumptions and data used were appropriate and supportable in the circumstances. An example of an indicator of management bias for a particular accounting estimate may be when management has developed an appropriate range for several different assumptions, and in each case the assumption used was from the end of the range that resulted in the most favorable measurement outcome.

## Methods

The selection of the method (Ref: Para. 23(a))

A97. Relevant considerations for the auditor regarding the appropriateness of the method selected in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of changes from the prior period may include:

- Whether management's rationale for the method selected is appropriate;
- Whether the method is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, other available valuation concepts or techniques, regulatory requirements, and the business, industry and environment in which the entity operates;
- When management has determined that different methods result in a range of significantly different estimates, how management has investigated the reasons for these differences; and
- Whether the change is based on new circumstances or new information. When this is not the case, the change may not be reasonable or in compliance with the applicable financial reporting framework. Arbitrary changes result in inconsistent financial statements over time and may

give rise to financial statement misstatements or may be an indicator of possible management bias. (see also paragraphs A133–A136)

These matters are important when the applicable financial reporting framework does not prescribe the method of measurement or allows multiple methods.

#### Complex modelling (Ref: Para. 23(d))

A98. A model, and the related method, is more likely to be complex when:

- Understanding and applying the method, including designing the model and selecting and using appropriate data and assumptions, requires specialized skills or knowledge;
- It is difficult to obtain data needed for use in the model because there are restrictions on the availability or observability of, or access to, data; or
- It is difficult to maintain the integrity (e.g., accuracy, consistency, or completeness) of the data and assumptions in using the model due to multiple valuation attributes, multiple relationships between them, or multiple iterations of the calculation.

A99. Matters that the auditor may consider when management uses a complex model include, for example, whether:

- The model is validated prior to usage or when there has been a change to the model, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
  - The model's theoretical soundness;
  - The model's mathematical integrity;
  - The accuracy and completeness of the model's data and assumptions; and
  - The model's output as compared to actual transactions.
- Appropriate change control policies and procedures exist.
- Management uses appropriate skills and knowledge in using the model.

These considerations may also be useful for a method that does not involve complex modelling.

A100. Management may make adjustments to the output of the model to meet the requirements of the applicable financial reporting framework. In some industries these adjustments are referred to as overlays. In the case of fair value accounting estimates, it may be relevant to consider whether adjustments to the output of the model, if any, reflect the assumptions marketplace participants would use in similar circumstances.

Maintenance of integrity of significant assumptions and the data used in applying the method (Ref: Para. 23(e))

A101. Maintaining the integrity of significant assumptions and the data in applying the method refers to the maintenance of the accuracy and completeness of the data and assumptions through all stages of information processing. A failure to maintain such integrity may result in corruption of the data and assumptions and may give rise to misstatements. In this regard, relevant considerations for the auditor may include whether the data and assumptions are subject to all changes intended by management, and not subject to any unintended changes, during activities such as input, storage, retrieval, transmission or processing.

Significant Assumptions (Ref: Para. 24)

A102. Relevant considerations for the auditor regarding the appropriateness of the significant assumptions in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of changes from the prior period may include:

- Management's rationale for the selection of the assumption;
- Whether the assumption is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, and the business, industry and environment in which the entity operates; and
- Whether a change from prior periods in selecting an assumption is based on new circumstances or new information. When it is not, the change may not be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate may give rise to material misstatements of the financial statements or may be an indicator of possible management bias (see paragraphs A133–A136).

A103. Management may evaluate alternative assumptions or outcomes of accounting estimates, which may be accomplished through a number of approaches depending on the circumstances. One possible approach is a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value, there may be variation because different market participants will use different assumptions. A sensitivity analysis may lead to the development of a number of outcome scenarios, sometimes characterized as a range of outcomes by management, and including 'pessimistic' and 'optimistic' scenarios.

A104. Through the knowledge obtained in performing the audit, the auditor may become aware of or may have obtained an understanding of assumptions used in other areas of the entity's business. Such matters may include, for example, business prospects, assumptions in strategy documents and future cash flows. Also, if the engagement partner has performed other engagements for the entity,

ISA 315 (Revised)<sup>49</sup> requires the engagement partner to consider whether information obtained from those other engagements is relevant to identifying risks of material misstatement. This information may also be useful to consider in addressing whether significant assumptions are consistent with each other and with those used in other accounting estimates.

A105. The appropriateness of the significant assumptions in the context of the requirements of the applicable financial reporting framework may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the applicable financial reporting framework may require management to do so. The nature and extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment. When applicable, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Inspection of written plans and other documentation, including, when applicable, formally approved budgets, authorizations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments and legal, regulatory, or contractual restrictions that could affect the feasibility of management's actions.
- Consideration of whether management has met the applicable documentation requirements, if any, of the applicable financial reporting framework.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that significant assumptions reflect those used by marketplace participants.

Data (Ref: Para. 25(a))

A106. Relevant considerations for the auditor regarding the appropriateness of the data selected for use in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of the changes from the prior period may include:

- Management's rationale for the selection of the data;
- Whether the data is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial

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<sup>49</sup> ISA 315 (Revised), paragraph 8

reporting framework, and the business, industry and environment in which the entity operates; and

- Whether the change from prior periods in the sources or items of data selected or data selected, is based on new circumstances or new information. When it is not, it is unlikely to be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to financial statement misstatements or may be an indicator of possible management bias (see paragraphs A133–A136).

Relevance and reliability of the data (Ref: Para. 25(c))

A107. When using information produced by the entity, ISA 500 requires the auditor to evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances, to obtain audit evidence about the accuracy and completeness of the information and evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.<sup>50</sup>

Complex legal or contractual terms (Ref: Para. 25(d))

A108. Procedures that the auditor may consider when the accounting estimate is based on complex legal or contractual terms include:

- Considering whether specialized skills or knowledge are needed to understand or interpret the contract;
- Inquiring of the entity's legal counsel regarding the legal or contractual terms; and
- Inspecting the underlying contracts to:
  - Evaluate, the underlying business purpose for the transaction or agreement; and
  - Consider whether the terms of the contracts are consistent with management's explanations.

Management's Selection of a Point Estimate and Related Disclosures about Estimation Uncertainty

Management's steps to understand and address estimation uncertainty (Ref: Para. 26(a))

A109. Relevant considerations regarding whether management has taken appropriate steps to understand and address estimation uncertainty may include whether management has:

- (a) Understood the estimation uncertainty, through identifying the sources, and assessing the degree of inherent variability in the measurement

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<sup>50</sup> ISA 500, paragraph 9

outcomes and the resulting range of reasonably possible measurement outcomes;

- (b) Identified the degree to which, in the measurement process, complexity or subjectivity affect the risk of material misstatement, and addressed the resulting potential for misstatement through applying:
  - (i) Appropriate skills and knowledge in making accounting estimates; and
  - (ii) Professional judgment, including by identifying and addressing susceptibility to management bias; and
- (c) Addressed estimation uncertainty through appropriately selecting management's point estimate and related disclosures that describe the estimation uncertainty.

The selection of management's point estimate and related disclosures of estimation uncertainty (Ref: Para. 26(b))

A110. Matters that may be relevant regarding the selection of management's point estimate and the development of related disclosures about estimation uncertainty include whether:

- The methods and data used were selected appropriately, including when alternative methods for making the accounting estimate and alternative sources of data were available.
- Valuation attributes used were appropriate and complete.
- The assumptions used were selected from a range of reasonably possible amounts and were supported by appropriate data that is relevant and reliable.
- The data used was appropriate, relevant and reliable, and the integrity of that data was maintained.
- The calculations were applied in accordance with the method and were mathematically accurate.
- Management's point estimate is appropriately chosen from the reasonably possible measurement outcomes.
- The related disclosures appropriately describe the amount as an estimate and explain the nature and limitations of the estimation process, including the variability of the reasonably possible measurement outcomes.

A111. Relevant considerations for the auditor regarding the appropriateness of management's point estimate, may include:

- When the requirements of the applicable financial reporting framework prescribe the point estimate that is to be used after consideration of

the alternative outcomes and assumptions, or prescribes a specific measurement method, whether management has followed the requirements of the applicable financial reporting framework.

- When the applicable financial reporting framework has not specified how to select an amount from reasonably possible measurement outcomes, whether management has exercised judgment, taking into account the requirements of the applicable financial reporting framework.

A112. Relevant considerations for the auditor regarding management's disclosures about estimation uncertainty include the requirements of the applicable financial reporting framework, which may require disclosures:

- That describe the amount as an estimate and explain the nature and limitations of the process for making it, including the variability in reasonably possible measurement outcomes. The framework also may require additional disclosures to meet a disclosure objective.<sup>51</sup>
- About significant accounting policies related to accounting estimates. Depending on the circumstances, relevant accounting policies may include matters such as the specific principles, bases, conventions, rules and practices applied in preparing and presenting accounting estimates in the financial statements.
- About significant or critical judgments (for example, those that had the most significant effect on the amounts recognized in the financial statements) as well as significant forward-looking assumptions or other sources of estimation uncertainty.

In certain circumstances, additional disclosures beyond those explicitly required by the financial reporting framework may be needed in order to achieve fair presentation, or in the case of a compliance framework, for the financial statements not to be misleading.

A113. The greater the degree to which an accounting estimate is subject to estimation uncertainty, the more likely the risks of material misstatement will be assessed as higher and therefore the more persuasive the audit evidence needs to be to determine, in accordance with paragraph 35, whether management's point estimate and related disclosures about estimation uncertainty are reasonable in the context of the applicable financial reporting framework, or are misstated.

A114. If the auditor's consideration of estimation uncertainty associated with an accounting estimate, and its related disclosure, is a matter that required significant auditor attention, then this may constitute a key audit matter.<sup>52</sup>

<sup>51</sup> IFRS 13, *Fair Value Measurement*, paragraph 92

<sup>52</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

When Management Has Not Taken Appropriate Steps to Understand and Address Estimation Uncertainty (Ref: Para. 27)

- A115. When the auditor determines that management has not taken appropriate steps to understand and address estimation uncertainty, additional procedures that the auditor may request management to perform to understand estimation uncertainty may include, for example, consideration of alternative assumptions or the performance of a sensitivity analysis.
- A116. In considering whether it is practicable to develop a point estimate or range, matters the auditor may need to take into account include whether the auditor could do so without compromising independence requirements. This may include relevant ethical requirements that address prohibitions on assuming management responsibilities.
- A117. If, after considering management's response, the auditor determines that it is not practicable to develop an auditor's point estimate or range, the auditor is required to evaluate the implications for the audit or the auditor's opinion on the financial statements in accordance with paragraph 34.

*Developing an Auditor's Point Estimate or Using an Auditor's Range* (Ref: Para. 28–29)

- A118. Developing an auditor's point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty may be an appropriate approach when, for example:
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is not expected to be effective.
  - The entity's controls within and over management's process for making accounting estimates are not well designed or properly implemented.
  - Events or transactions between the period end and the date of the auditor's report have not been properly taken into account, when it is appropriate for management to do so, and such events or transactions appear to contradict management's point estimate.
  - There are appropriate alternative assumptions or sources of relevant data that can be used in developing an auditor's point estimate or a range.
  - Management has not taken appropriate steps to understand or address the estimation uncertainty (see paragraph 27).
- A119. The decision to develop a point estimate or range also may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the

use of a discounted probability-weighted expected value, or the most likely outcome).

A120. The auditor's decision as to whether to develop a point estimate rather than a range may depend on the nature of the estimate and the auditor's judgment in the circumstances. For example, the nature of the estimate may be such that there is expected to be less variability in the reasonably possible outcomes. In these circumstances, developing a point estimate may be an effective approach, particularly when it can be developed with a higher degree of precision.

A121. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a different model than the one used by management, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Using management's model but developing alternative assumptions or data sources to those used by management.
- Using the auditor's own method but developing alternative assumptions to those used by management.
- Employing or engaging a person with specialized expertise to develop or execute a model, or to provide relevant assumptions.
- Consideration of other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

A122. The auditor also may develop a point estimate or range for only part of the accounting estimate (for example, for a particular assumption, or when only a certain part of the accounting estimate is giving rise to the risk of material misstatement).

A123. When using the auditor's own methods, assumptions or data to develop a point estimate or range, the auditor may obtain evidence about the appropriateness of management's methods, assumptions or data. For example, if the auditor uses the auditor's own assumptions in developing a range to evaluate the reasonableness of management's point estimate, the auditor may also develop a view about whether management's judgments in selecting the significant assumptions used in making the accounting estimate give rise to indicators of possible management bias.

A124. The requirement in paragraph 29(a) for the auditor to determine that the range includes only amounts that are supported by sufficient appropriate audit evidence does not mean that the auditor is expected to obtain audit evidence to support each possible outcome in the range individually. Rather, the auditor is likely to obtain evidence to determine that the points at both ends of the range are reasonable in the circumstances, thereby supporting that amounts falling between those two points also are reasonable.

A125. The size of the auditor's range may be multiples of materiality for the financial statements as a whole, particularly when materiality is based on operating results (for example, pre-tax income) and this measure is relatively small in relation to assets or other balance sheet measures. This situation is more likely to arise in circumstances when the estimation uncertainty associated with the accounting estimate is itself multiples of materiality, which is more common for certain types of accounting estimates or in certain industries, such as insurance or banking, where a high degree of estimation uncertainty is more typical and there may be specific requirements in the applicable financial reporting framework in that regard. Based on the procedures performed and audit evidence obtained in accordance with the requirements of this ISA, the auditor may conclude that a range that is multiples of materiality is, in the auditor's judgment, appropriate in the circumstances. When this is the case, the auditor's evaluation of the reasonableness of the disclosures about estimation uncertainty becomes increasingly important, particularly whether such disclosures appropriately convey the high degree of estimation uncertainty and the range of possible outcomes. Paragraphs A139–A144 include additional considerations that may be relevant in these circumstances.

*Other Considerations Relating to Audit Evidence* (Ref: Para. 30)

A126. Information to be used as audit evidence, regarding risks of material misstatement relating to accounting estimates, may have been produced by the entity, prepared using the work of a management's expert, or provided by an external information source.

External Information Sources

A127. As explained in ISA 500,<sup>53</sup> the reliability of information from an external information source is influenced by its source, its nature, and the circumstances under which it is obtained. Consequently, the nature and extent of the auditor's further audit procedures to consider the reliability of the information used in making an accounting estimate may vary depending on the nature of these factors. For example:

- When market or industry data, prices, or pricing related data, are obtained from a single external information source, specializing in such information, the auditor may seek a price from an alternative independent source with which to compare.
- When market or industry data, prices, or pricing related data, are obtained from multiple independent external information sources and points to consensus across those sources, the auditor may need to obtain less evidence about the reliability of the data from an individual source.
- When information obtained from multiple information sources points to divergent market views the auditor may seek to understand the reasons

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<sup>53</sup> ISA 500, Paragraph A35

for the diversity in views. The diversity may result from the use of different methods, assumptions, or data. For example, one source may be using current prices and another source using future prices. When the diversity relates to estimation uncertainty, the auditor is required by paragraph 26(b) to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, the disclosures in the financial statements that describe the estimation uncertainty are reasonable. In such cases professional judgment is also important in considering information about the methods, assumptions or data applied.

- When information obtained from an external information source has been developed by that source using its own model(s). Paragraph A43 of ISA 500 provides relevant guidance.

A128. For fair value accounting estimates, additional considerations of the relevance and reliability of information obtained from external information sources may include:

- (a) Whether fair values are based on trades of the same instrument or active market quotations;
- (b) When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable;
- (c) When there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed including whether the inputs developed and used represent the assumptions that market participants would use when pricing the asset or liability, if applicable; and
- (d) When the fair value measurement is based on a broker quote, whether the broker quote:
  - (i) Is from a market maker who transacts in the same type of financial instrument;
  - (ii) Is binding or nonbinding, with more weight placed on quotes based on binding offers; and
  - (iii) Reflects market conditions as of the date of the financial statements, when required by the applicable financial reporting framework.

A129. When information from an external information source is used as audit evidence, a relevant consideration for the auditor may be whether information can be obtained, or whether the information is sufficiently detailed, to understand the methods, assumptions and other data used by the external information source. This may be limited in some respects and consequently influence the auditor's

consideration of the nature, timing and extent of procedures to perform. For example, pricing services often provide information about their methods and assumptions by asset class rather than individual securities. Brokers often provide only limited information about their inputs and assumptions when providing broker indicative quotes for individual securities. Paragraph A44 of ISA 500 provides guidance with respect to restrictions placed by the external information source on the provision of supporting information.

#### Management's Expert

A130. Assumptions relating to accounting estimates that are made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate. Accordingly, the auditor applies the relevant requirements in this ISA to those assumptions.

A131. If the work of a management's expert involves the use of methods or sources of data relating to accounting estimates, or developing or providing findings or conclusions relating to a point estimate or related disclosures for inclusion in the financial statements, the requirements in paragraphs 21–29 of this ISA may assist the auditor in applying paragraph 8(c) of ISA 500.

#### Service Organizations

A132. ISA 402<sup>54</sup> deals with the auditor's understanding of the services provided by a service organization, including internal control, as well as the auditor's responses to assessed risks of material misstatement. When the entity uses the services of a service organization in making accounting estimates, the requirements and guidance in ISA 402 may therefore assist the auditor in applying the requirements of this ISA.

#### Indicators of Possible Management Bias (Ref: Para. 32)

A133. Management bias may be difficult to detect at an account level and may only be identified by the auditor when considering groups of accounting estimates, all accounting estimates in aggregate, or when observed over a number of accounting periods. For example, if accounting estimates included in the financial statements are considered to be individually reasonable but management's point estimates consistently trend toward one end of the auditor's range of reasonable outcomes that provide a more favorable financial reporting outcome for management, such circumstances may indicate possible bias by management.

A134. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, when management has made a subjective assessment that there has been a change in circumstances.

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<sup>54</sup> ISA 402, Audit Considerations Relating to an Entity Using a Service Organization

- Selection or development of significant assumptions or the data that yield a point estimate favorable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

When such indicators are identified, there may be a risk of material misstatement either at the assertion or financial statement level. Indicators of possible management bias themselves do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. However, in some cases the audit evidence may point to a misstatement rather than simply an indicator of management bias.

A135. Indicators of possible management bias may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate. The auditor may also need to consider the implications for other aspects of the audit, including the need to further question the appropriateness of management's judgments in making accounting estimates. Further, indicators of possible management bias may affect the auditor's conclusion as to whether the financial statements as a whole are free from material misstatement, as discussed in ISA 700 (Revised).<sup>55</sup>

A136. In addition, in applying ISA 240, the auditor is required to evaluate whether management's judgments and decisions in making the accounting estimates included in the financial statements indicate a possible bias that may represent a material misstatement due to fraud.<sup>56</sup> Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, which may include intentionally understating or overstating accounting estimates. Indicators of possible management bias that may also be a fraud risk factor, may cause the auditor to reassess whether the auditor's risk assessments, in particular the assessment of fraud risks, and related responses remain appropriate.

### **Overall Evaluation Based on Audit Procedures Performed (Ref: Para. 33)**

A137. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures.<sup>57</sup> In relation to accounting estimates, information may come to the auditor's attention through performing procedures to obtain audit evidence that differs significantly from the information on which the risk assessment was based. For example, the auditor may have identified that the only reason for an assessed risk of material misstatement is the subjectivity involved in making the accounting estimate. However, while performing procedures to respond to the assessed risks of material misstatement, the auditor may discover that the accounting estimate is more complex than originally contemplated, which

<sup>55</sup> ISA 700 (Revised), paragraph 11

<sup>56</sup> ISA 240, paragraph 33(b)

<sup>57</sup> ISA 330, paragraph A60

may call into question the assessment of the risk of material misstatement (for example, the inherent risk may need to be re-assessed on the higher end of the spectrum of inherent risk due to the effect of complexity) and therefore the auditor may need to perform additional further audit procedures to obtain sufficient appropriate audit evidence.<sup>58</sup>

A138. With respect to accounting estimates that have not been recognized, a particular focus of the auditor's evaluation may be on whether the recognition criteria of the applicable financial reporting framework have in fact been met. When an accounting estimate has not been recognized, and the auditor concludes that this treatment is appropriate, some financial reporting frameworks may require disclosure of the circumstances in the notes to the financial statements.

Determining Whether the Accounting Estimates are Reasonable or Misstated (Ref: Para. 9, 35)

A139. In determining whether, based on the audit procedures performed and evidence obtained, management's point estimate and related disclosures are reasonable, or are misstated:

- When the audit evidence supports a range, the size of the range may be wide and, in some circumstances, may be multiples of materiality for the financial statements as a whole (see also paragraph A125). Although a wide range may be appropriate in the circumstances, it may indicate that it is important for the auditor to reconsider whether sufficient appropriate audit evidence has been obtained regarding the reasonableness of the amounts within the range.
- The audit evidence may support a point estimate that differs from management's point estimate. In such circumstances, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement.
- The audit evidence may support a range that does not include management's point estimate. In such circumstances, the misstatement is the difference between management's point estimate and the nearest point of the auditor's range.

A140. Paragraphs A110–A114 provide guidance to assist the auditor in evaluating management's selection of a point estimate and related disclosures to be included in the financial statements.

A141. When the auditor's further audit procedures include testing how management made the accounting estimate or developing an auditor's point estimate or range, the auditor is required to obtain sufficient appropriate audit evidence about disclosures that describe estimation uncertainty in accordance with paragraphs 26(b) and 29(b) and other disclosures in accordance with paragraph

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<sup>58</sup> See also ISA 315 (Revised), paragraph 31.

31. The auditor then considers the audit evidence obtained about disclosures as part of the overall evaluation, in accordance with paragraph 35, of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

A142. ISA 450 also provides guidance regarding qualitative disclosures<sup>59</sup> and when misstatements in disclosures could be indicative of fraud.<sup>60</sup>

A143. When the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation<sup>61</sup> includes the consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the related notes, represent the transactions and events in a manner that achieves fair presentation. For example, when an accounting estimate is subject to a higher degree of estimation uncertainty, the auditor may determine that additional disclosures are necessary to achieve fair presentation. If management does not include such additional disclosures, the auditor may conclude that the financial statements are materially misstated.

A144. ISA 705 (Revised)<sup>62</sup> provides guidance on the implications for the auditor's opinion when the auditor believes that management's disclosures in the financial statements are inadequate or misleading, including, for example, with respect to estimation uncertainty.

### **Written Representations (Ref: Para. 37)**

A145. Written representations about specific accounting estimates may include representations:

- That the significant judgments made in making the accounting estimates have taken into account all relevant information of which management is aware.
- About the consistency and appropriateness in the selection or application of the methods, assumptions and data used by management in making the accounting estimates.
- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, when relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates, including disclosures describing estimation uncertainty, are complete and are reasonable in the context of the applicable financial reporting framework.

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<sup>59</sup> ISA 450, paragraph A17

<sup>60</sup> ISA 450, paragraph A22

<sup>61</sup> ISA 700 (Revised), paragraph 14

<sup>62</sup> ISA 705 (Revised), paragraphs 22–23

- That appropriate specialized skills or expertise has been applied in making the accounting estimates.
- That no subsequent event requires adjustment to the accounting estimates and related disclosures included in the financial statements.
- When accounting estimates are not recognized or disclosed in the financial statements, about the appropriateness of management's decision that the recognition or disclosure criteria of the applicable financial reporting framework have not been met.

### **Communication with Those Charged With Governance, Management or Other Relevant Parties** (Ref: Para. 38)

A146. In applying ISA 260 (Revised), the auditor communicates with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices relating to accounting estimates and related disclosures.<sup>63</sup> Appendix 2 includes matters specific to accounting estimates that the auditor may consider communicating to those charged with governance.

A147. ISA 265 requires the auditor to communicate in writing to those charged with governance significant deficiencies in internal control identified during the audit.<sup>64</sup> Such significant deficiencies may include those related to controls over:

- (a) The selection and application of significant accounting policies, and the selection and application of methods, assumptions and data;
- (b) Risk management and related systems;
- (c) Data integrity, including when data is obtained from an external information source; and
- (d) The use, development and validation of models, including models obtained from an external provider, and any adjustments that may be required.

A148. In addition to communicating with those charged with governance, the auditor may be permitted or required to communicate directly with regulators or prudential supervisors. Such communication may be useful throughout the audit or at particular stages, such as when planning the audit or when finalizing the auditor's report. For example, in some jurisdictions, financial institution regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, expected credit losses, and insurance reserves while other regulators may seek to understand the auditor's views on significant aspects of the entity's operations including

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<sup>63</sup> ISA 260 (Revised), paragraph 16(a)

<sup>64</sup> ISA 265, paragraph 9

the entity's costs estimates. This communication may be helpful to the auditor in identifying, assessing and responding to risks of material misstatement.

**Documentation** (Ref: Para. 39)

A149. ISA 315 (Revised)<sup>65</sup> and ISA 330<sup>66</sup> provide requirements and guidance on documenting the auditor's understanding of the entity, risk assessments and responses to assessed risks. This guidance is based on the requirements and guidance in ISA 230.<sup>67</sup> In the context of auditing accounting estimates, the auditor is required to prepare audit documentation about key elements of the auditor's understanding of the entity and its environment related to accounting estimates. In addition, the auditor's judgments about the assessed risks of material misstatement related to accounting estimates, and the auditor's responses, may likely be further supported by documentation of communications with those charged with governance and management.

A150. In documenting the linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level, in accordance with ISA 330, this ISA requires that the auditor take into account the reasons given to the risks of material misstatement at the assertion level. Those reasons may relate to one or more inherent risk factors or the auditor's assessment of control risk. However, the auditor is not required to document how every inherent risk factor was taken into account in identifying and assessing the risks of material misstatement in relation to each accounting estimate.

A151. The auditor also may consider documenting:

- When management's application of the method involves complex modeling, whether management's judgments have been applied consistently and, when applicable, that the design of the model meets the measurement objective of the applicable financial reporting framework.
- When the selection and application of methods, significant assumptions, or the data is affected by complexity to a higher degree, the auditor's judgments in determining whether specialized skills or knowledge are required to perform the risk assessment procedures, to design and perform procedures responsive to those risks, or to evaluate the audit evidence obtained. In these circumstances, the documentation also may include how the required skills or knowledge were applied.

A152. Paragraph A7 of ISA 230 notes that, although there may be no single way in which the auditor's exercise of professional skepticism is documented, the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism. For example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates

<sup>65</sup> ISA 315 (Revised), paragraphs 32 and A152–A155

<sup>66</sup> ISA 330, paragraphs 28 and A63

<sup>67</sup> ISA 230, paragraph 8(c)

and contradicts management's assertions, the documentation may include how the auditor evaluated that evidence, including the professional judgments made in forming a conclusion as to the sufficiency and appropriateness of the audit evidence obtained. Examples of other requirements in this ISA for which documentation may provide evidence of the exercise of professional skepticism by the auditor include:

- Paragraph 13(d), regarding how the auditor has applied an understanding in developing the auditor's own expectation of the accounting estimates and related disclosures to be included in the entity's financial statements and how that expectation compares with the entity's financial statements prepared by management;
- Paragraph 18, which requires further audit procedures to be designed and performed to obtain sufficient appropriate evidence in a manner that is not biased toward obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory;
- Paragraphs 23(b), 24(b), 25(b) and 32, which address indicators of possible management bias; and
- Paragraph 34, which addresses the auditor's consideration of all relevant audit evidence, whether corroborative or contradictory.

**Appendix 1**

(Ref: Para. 2, 4, 12(c), A8, A66)

**Inherent Risk Factors****Introduction**

1. In identifying, assessing and responding to the risks of material misstatement at the assertion level for an accounting estimate and related disclosures, this ISA requires the auditor to take into account the degree to which the accounting estimate is subject to estimation uncertainty, and the degree to which the selection and application of the methods, assumptions and data used in making the accounting estimate, and the selection of management's point estimate and related disclosures for inclusion in the financial statements, are affected by complexity, subjectivity or other inherent risk factors.
2. Inherent risk related to an accounting estimate is the susceptibility of an assertion about the accounting estimate to material misstatement, before consideration of controls. Inherent risk results from inherent risk factors, which give rise to challenges in appropriately making the accounting estimate. This Appendix provides further explanation about the nature of the inherent risk factors of estimation uncertainty, subjectivity and complexity, and their inter-relationships, in the context of making accounting estimates and selecting management's point estimate and related disclosures for inclusion in the financial statements.

**Measurement Basis**

3. The measurement basis and the nature, condition and circumstances of the financial statement item give rise to relevant valuation attributes. When the cost or price of the item cannot be directly observed, an accounting estimate is required to be made by applying an appropriate method and using appropriate data and assumptions. The method may be specified by the applicable financial reporting framework, or is selected by management, to reflect the available knowledge about how the relevant valuation attributes would be expected to influence the cost or price of the item on the measurement basis.

**Estimation Uncertainty**

4. Susceptibility to a lack of precision in measurement is often referred to in accounting frameworks as measurement uncertainty. Estimation uncertainty is defined in this ISA as susceptibility to an inherent lack of precision in measurement. It arises when the required monetary amount for a financial statement item that is recognized or disclosed in the financial statements cannot be measured with precision through direct observation of the cost or price. When direct observation is not possible, the next most precise alternative measurement strategy is to apply a method that reflects the available knowledge

about cost or price for the item on the relevant measurement basis, using observable data about relevant valuation attributes.

5. However, constraints on the availability of such knowledge or data may limit the verifiability of such inputs to the measurement process and therefore limit the precision of measurement outcomes. Furthermore, most accounting frameworks acknowledge that there are practical constraints on the information that should be taken into account, such as when the cost of obtaining it would exceed the benefits. The lack of precision in measurement arising from these constraints is inherent because it cannot be eliminated from the measurement process. Accordingly, such constraints are sources of estimation uncertainty. Other sources of measurement uncertainty that may occur in the measurement process are, at least in principle, capable of elimination if the method is applied appropriately and therefore are sources of potential misstatement rather than estimation uncertainty.
6. When estimation uncertainty relates to uncertain future inflows or outflows of economic benefits that will ultimately result from the underlying asset or liability, the outcome of these flows will only be observable after the date of the financial statements. Depending on the nature of the applicable measurement basis and on the nature, condition and circumstances of the financial statement item, this outcome may be directly observable before the financial statements are finalized or may only be directly observable at a later date. For some accounting estimates, there may be no directly observable outcome at all.
7. Some uncertain outcomes may be relatively easy to predict with a high level of precision for an individual item. For example, the useful life of a production machine may be easily predicted if sufficient technical information is available about its average useful life. When it is not possible to predict a future outcome, such as an individual's life expectancy based on actuarial assumptions, with reasonable precision, it may still be possible to predict that outcome for a group of individuals with greater precision. Measurement bases may, in some cases, indicate a portfolio level as the relevant unit of account for measurement purposes, which may reduce inherent estimation uncertainty.

### **Complexity**

8. Complexity (i.e., the complexity inherent in the process of making an accounting estimate, before consideration of controls) gives rise to inherent risk. Inherent complexity may arise when:
  - There are many valuation attributes with many or non-linear relationships between them.
  - Determining appropriate values for one or more valuation attributes requires multiple data sets.
  - More assumptions are required in making the accounting estimate, or when there are correlations between the required assumptions.

- The data used is inherently difficult to identify, capture, access or understand.
9. Complexity may be related to the complexity of the method and of the computational process or model used to apply it. For example, complexity in the model may reflect the need to apply probability-based valuation concepts or techniques, option pricing formulae or simulation techniques to predict uncertain future outcomes or hypothetical behaviors. Similarly, the computational process may require data from multiple sources, or multiple data sets to support the making of an assumption or the application of sophisticated mathematical or statistical concepts.
10. The greater the complexity, the more likely it is that management will need to apply specialized skills or knowledge in making an accounting estimate or engage a management's expert, for example in relation to:
- Valuation concepts and techniques that could be used in the context of the measurement basis and objectives or other requirements of the applicable financial reporting framework and how to apply those concepts or techniques;
  - The underlying valuation attributes that may be relevant given the nature of the measurement basis and the nature, condition and circumstances of the financial statement items for which accounting estimates are being made; or
  - Identifying appropriate sources of data from internal sources (including from sources outside the general or subsidiary ledgers) or from external information sources, determining how to address potential difficulties in obtaining data from such sources or in maintaining its integrity in applying the method, or understanding the relevance and reliability of that data.
11. Complexity relating to data may arise, for example, in the following circumstances:
- (a) When data is difficult to obtain or when it relates to transactions that are not generally accessible. Even when such data is accessible, for example through an external information source, it may be difficult to consider the relevance and reliability of the data, unless the external information source discloses adequate information about the underlying data sources it has used and about any data processing that has been performed.
  - (b) When data reflecting an external information source's views about future conditions or events, which may be relevant in developing support for an assumption, is difficult to understand without transparency about the rationale and information taken into account in developing those views.
  - (c) When certain types of data are inherently difficult to understand because they require an understanding of technically complex business or legal

concepts, such as may be required to properly understand data that comprises the terms of legal agreements about transactions involving complex financial instruments or insurance products.

## Subjectivity

12. Subjectivity (i.e., the subjectivity inherent in the process of making an accounting estimate, before consideration of controls) reflects inherent limitations in the knowledge or data reasonably available about valuation attributes. When such limitations exist, the applicable financial reporting framework may reduce the degree of subjectivity by providing a required basis for making certain judgments. Such requirements may, for example, set explicit or implied objectives relating to measurement, disclosure, the unit of account, or the application of a cost constraint. The applicable financial reporting framework may also highlight the importance of such judgments through requirements for disclosures about those judgments.
13. Management judgment is generally needed in determining some or all of the following matters, which often involve subjectivity:
  - To the extent not specified under the requirements of the applicable financial reporting framework, the appropriate valuation approaches, concepts, techniques and factors to use in the estimation method, having regard to available knowledge;
  - To the extent valuation attributes are observable when there are various potential sources of data, the appropriate sources of data to use;
  - To the extent valuation attributes are not observable, the appropriate assumptions or range of assumptions to make, having regard to the best available data, including, for example, market views;
  - The range of reasonably possible outcomes from which to select management's point estimate, and the relative likelihood that certain points within that range would be consistent with the objectives of the measurement basis required by the applicable financial reporting framework; and
  - The selection of management's point estimate, and the related disclosures to be made, in the financial statements.
14. Making assumptions about future events or conditions involves the use of judgment, the difficulty of which varies with the degree to which those events or conditions are uncertain. The precision with which it is possible to predict uncertain future events or conditions depends on the degree to which those events or conditions are determinable based on knowledge, including knowledge of past conditions, events and related outcomes. The lack of precision also contributes to estimation uncertainty, as described above.
15. With respect to future outcomes, assumptions will only need to be made for those features of the outcome that are uncertain. For example, in considering

the measurement of a possible impairment of a receivable for a sale of goods at the balance sheet date, the amount of the receivable may be unequivocally established and directly observable in the related transaction documents. What may be uncertain is the amount, if any, for loss due to impairment. In this case, assumptions may only be required about the likelihood of loss and about the amount and timing of any such loss.

16. However, in other cases, the amounts of cash flows embodied in the rights relating to an asset may be uncertain. In those cases, assumptions may have to be made about both the amounts of the underlying rights to cash flows and about potential losses due to impairment.
17. It may be necessary for management to consider information about past conditions and events, together with current trends and expectations about future developments. Past conditions and events provide historical information that may highlight repeating historical patterns that can be extrapolated in evaluating future outcomes. Such historical information may also indicate changing patterns of such behavior over time (cycles or trends). These may suggest that the underlying historical patterns of behavior have been changing in somewhat predictable ways that may also be extrapolated in evaluating future outcomes. Other types of information may also be available that indicate possible changes in historical patterns of such behavior or in related cycles or trends. Difficult judgments may be needed about the predictive value of such information.
18. The extent and nature (including the degree of subjectivity involved) of the judgments taken in making the accounting estimates may create opportunity for management bias in making decisions about the course of action that, according to management, is appropriate in making the accounting estimate. When there is also a high level of complexity or a high level of estimation uncertainty, or both, the risk of, and opportunity for, management bias or fraud may also be increased.

### **Relationship of Estimation Uncertainty to Subjectivity and Complexity**

19. Estimation uncertainty gives rise to inherent variation in the possible methods, data sources and assumptions that could be used to make an accounting estimate. This gives rise to subjectivity, and hence, the need for the use of judgment in making the accounting estimate. Such judgments are required in selecting the appropriate methods and data sources, in making the assumptions, and in selecting management's point estimate and related disclosures for inclusion in the financial statements. These judgments are made in the context of the recognition, measurement, presentation and disclosure requirements of the applicable financial reporting framework. However, because there are constraints on the availability and accessibility of knowledge or information to support these judgments, they are subjective in nature.
20. Subjectivity in such judgments creates the opportunity for unintentional or intentional management bias in making them. Many accounting frameworks require that information prepared for inclusion in the financial statements

should be neutral (i.e., that it should not be biased). Given that bias can, at least in principle, be eliminated from the estimation process, sources of potential bias in the judgments made to address subjectivity are sources of potential misstatement rather than sources of estimation uncertainty.

21. The inherent variation in the possible methods, data sources and assumptions that could be used to make an accounting estimate (see paragraph 19) also gives rise to variation in the possible measurement outcomes. The size of the range of reasonably possible measurement outcomes results from the degree of estimation uncertainty and is often referred to as the sensitivity of the accounting estimate. In addition to determining measurement outcomes, an estimation process also involves analyzing the effect of inherent variations in the possible methods, data sources and assumptions on the range of reasonably possible measurement outcomes (referred to as sensitivity analysis).
22. Developing a financial statement presentation for an accounting estimate, which, when required by the applicable financial reporting framework, achieves faithful representation (i.e., complete, neutral and free from error) includes making appropriate judgments in selecting a management point estimate that is appropriately chosen from within the range of reasonably possible measurement outcomes and related disclosures that appropriately describe the estimation uncertainty. These judgments may themselves involve subjectivity, depending on the nature of the requirements in the applicable financial reporting framework that address these matters. For example, the applicable financial reporting framework may require a specific basis (such as a probability weighted average or a best estimate) for the selection of the management point estimate. Similarly, it may require specific disclosures or disclosures that meet specified disclosure objectives or additional disclosures that are required to achieve fair presentation in the circumstances.
23. Although an accounting estimate that is subject to a higher degree of estimation uncertainty may be less precisely measurable than one subject to a lower degree of estimation uncertainty, the accounting estimate may still have sufficient relevance for users of the financial statements to be recognized in the financial statements if, when required by the applicable financial reporting framework, a faithful representation of the item can be achieved. In some cases, estimation uncertainty may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be recognized in the financial statements. Even in these circumstances, there may still be relevant disclosure requirements, for example to disclose the point estimate or range of reasonably possible measurement outcomes and information describing the estimation uncertainty and constraints in recognizing the item. The requirements of the applicable financial reporting framework that apply in these circumstances may be specified to a greater or lesser degree. Accordingly, in these circumstances, there may be additional judgments that involve subjectivity to be made.

**Appendix 2**

(Ref: Para. A146)

**Communications with Those Charged with Governance**

Matters that the auditor may consider communicating with those charged with governance with respect to the auditor's views about significant qualitative aspects of the entity's accounting practices related to accounting estimates and related disclosures include:

- (a) How management identifies transactions, other events and conditions that may give rise to the need for, or changes in, accounting estimates and related disclosures.
- (b) Risks of material misstatement.
- (c) The relative materiality of the accounting estimates to the financial statements as a whole;
- (d) Management's understanding (or lack thereof) regarding the nature and extent of, and the risks associated with, accounting estimates;
- (e) Whether management has applied appropriate specialized skills or knowledge or engaged appropriate experts.
- (f) The auditor's views about differences between the auditor's point estimate or range and management's point estimate.
- (g) The auditor's views about the appropriateness of the selection of accounting policies related to accounting estimates and presentation of accounting estimates in the financial statements.
- (h) Indicators of possible management bias.
- (i) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates
- (j) When there has been a change from the prior period in the methods for making the accounting estimate, why, as well as the outcome of accounting estimates in prior periods.
- (k) Whether management's methods for making the accounting estimates, including when management has used a model, are appropriate in the context of the measurement objectives, the nature, conditions and circumstances, and other requirements of the applicable financial reporting framework.

- (l) The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions;
- (m) Whether significant assumptions are consistent with each other and with those used in other accounting estimates, or with assumptions used in other areas of the entity's business activities.
- (n) When relevant to the appropriateness of the significant assumptions or the appropriate application of the applicable financial reporting framework, whether management has the intent to carry out specific courses of action and has the ability to do so.
- (o) How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
- (p) Whether the data and significant assumptions used by management in making the accounting estimates are appropriate in the context of the applicable financial reporting framework.
- (q) The relevance and reliability of information obtained from an external information source.
- (r) Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to data obtained from an external information source or valuations performed by management or a management's expert.
- (s) Significant differences in judgments between the auditor and management or a management's expert regarding valuations.
- (t) The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the estimation uncertainty associated with accounting estimates.
- (u) The reasonableness of disclosures about estimation uncertainty in the financial statements.
- (v) Whether management's decisions relating to the recognition, measurement, presentation and disclosure of the accounting estimates and related disclosures in the financial statements are in accordance with the applicable financial reporting framework.

**INTERNATIONAL STANDARD ON AUDITING 550**  
**RELATED PARTIES**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 550, *Related Parties*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

# Introduction

## Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to related party relationships and transactions in an audit of financial statements. Specifically, it expands on how ISA 315 (Revised),<sup>1</sup> ISA 330,<sup>2</sup> and ISA 240<sup>3</sup> are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.

## Nature of Related Party Relationships and Transactions

2. Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:
  - Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
  - Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
  - Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

## Responsibilities of the Auditor

3. Because related parties are not independent of each other, many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework.

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<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>2</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>3</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

4. Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions: (Ref: Para. A1)
- (a) Achieve fair presentation (for fair presentation frameworks); or (Ref: Para. A2)
  - (b) Are not misleading (for compliance frameworks). (Ref: Para. A3)
5. In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether one or more fraud risk factors are present as required by ISA 240,<sup>4</sup> because fraud may be more easily committed through related parties.
6. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.<sup>5</sup> In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:
- Management may be unaware of the existence of all related party relationships and transactions, particularly if the applicable financial reporting framework does not establish related party requirements.
  - Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.
7. Planning and performing the audit with professional skepticism as required by ISA 200<sup>6</sup> is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this ISA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

### Effective Date

8. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.\*

### Objectives

9. The objectives of the auditor are:

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<sup>4</sup> ISA 240, paragraph 25

<sup>5</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraphs A53–A54

<sup>6</sup> ISA 200, paragraph 15

- (a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:
  - (i) To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
  - (ii) To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:
    - a. Achieve fair presentation (for fair presentation frameworks); or
    - b. Are not misleading (for compliance frameworks); and
- (b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

## Definitions

10. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Arm's length transaction – A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.
  - (b) Related party – A party that is either: (Ref: Para. A4–A7)
    - (i) A related party as defined in the applicable financial reporting framework; or
    - (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
      - a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
      - b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
      - c. Another entity that is under common control with the reporting entity through having:

- i. Common controlling ownership;
- ii. Owners who are close family members; or
- iii. Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

## Requirements

### Risk Assessment Procedures and Related Activities

11. As part of the risk assessment procedures and related activities that ISA 315 (Revised) and ISA 240 require the auditor to perform during the audit,<sup>7</sup> the auditor shall perform the audit procedures and related activities set out in paragraphs 12–17 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions. (Ref: Para. A8)

#### *Understanding the Entity's Related Party Relationships and Transactions*

12. The engagement team discussion that ISA 315 (Revised) and ISA 240 require<sup>8</sup> shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. (Ref: Para. A9–A10)
13. The auditor shall inquire of management regarding:
- (a) The identity of the entity's related parties, including changes from the prior period; (Ref: Para. A11–A14)
  - (b) The nature of the relationships between the entity and these related parties; and
  - (c) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.
14. The auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to: (Ref: Para. A15–A20)
- (a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;

<sup>7</sup> ISA 315 (Revised), paragraph 5; ISA 240, paragraph 17

<sup>8</sup> ISA 315 (Revised), paragraph 10; ISA 240, paragraph 16

- (b) Authorize and approve significant transactions and arrangements with related parties; and (Ref: Para. A21)
- (c) Authorize and approve significant transactions and arrangements outside the normal course of business.

*Maintaining Alertness for Related Party Information When Reviewing Records or Documents*

15. During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. (Ref: Para. A22–A23)

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank and legal confirmations obtained as part of the auditor’s procedures;
  - (b) Minutes of meetings of shareholders and of those charged with governance; and
  - (c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.
16. If the auditor identifies significant transactions outside the entity’s normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about: (Ref: Para. A24–A25)
- (a) The nature of these transactions; and (Ref: Para. A26)
  - (b) Whether related parties could be involved. (Ref: Para. A27)

*Sharing Related Party Information with the Engagement Team*

17. The auditor shall share relevant information obtained about the entity’s related parties with the other members of the engagement team. (Ref: Para. A28)

**Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions**

18. In meeting the ISA 315 (Revised) requirement to identify and assess the risks of material misstatement,<sup>9</sup> the auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the auditor shall treat identified significant related

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<sup>9</sup> ISA 315 (Revised), paragraph 25

party transactions outside the entity's normal course of business as giving rise to significant risks.

19. If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with ISA 240. (Ref: Para. A6, A29–A30)

### **Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions**

20. As part of the ISA 330 requirement that the auditor respond to assessed risks,<sup>10</sup> the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21–24. (Ref: Para. A31–A34)

#### *Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions*

21. If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.
22. If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:
- (a) Promptly communicate the relevant information to the other members of the engagement team; (Ref: Para. A35)
  - (b) Where the applicable financial reporting framework establishes related party requirements:
    - (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and
    - (ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
  - (c) Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions; (Ref: Para. A36)

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<sup>10</sup> ISA 330, paragraphs 5–6

- (d) Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and
- (e) If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit. (Ref: Para. A37)

*Identified Significant Related Party Transactions outside the Entity's Normal Course of Business*

23. For identified significant related party transactions outside the entity's normal course of business, the auditor shall:
- (a) Inspect the underlying contracts or agreements, if any, and evaluate whether:
    - (i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;<sup>11</sup> (Ref: Para. A38–A39)
    - (ii) The terms of the transactions are consistent with management's explanations; and
    - (iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
  - (b) Obtain audit evidence that the transactions have been appropriately authorized and approved. (Ref: Para. A40–A41)

*Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction*

24. If management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion. (Ref: Para. A42–A45)

**Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions**

25. In forming an opinion on the financial statements in accordance with ISA 700 (Revised),<sup>12</sup> the auditor shall evaluate: (Ref: Para. A46)

<sup>11</sup> ISA 240, paragraph 33(c)

<sup>12</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 10–15

- (a) Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and (Ref: Para. A47)
- (b) Whether the effects of the related party relationships and transactions:
  - (i) Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or
  - (ii) Cause the financial statements to be misleading (for compliance frameworks).

### Written Representations

26. Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that: (Ref: Para. A48–A49)
- (a) They have disclosed to the auditor the identity of the entity’s related parties and all the related party relationships and transactions of which they are aware; and
  - (b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

### Communication with Those Charged with Governance

27. Unless all of those charged with governance are involved in managing the entity,<sup>13</sup> the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity’s related parties. (Ref: Para. A50)

### Documentation

28. The auditor shall include in the audit documentation the names of the identified related parties and the nature of the related party relationships.<sup>14</sup>

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## Application and Other Explanatory Material

### Responsibilities of the Auditor

*Financial Reporting Frameworks That Establish Minimal Related Party Requirements* (Ref: Para. 4)

- A1. An applicable financial reporting framework that establishes minimal related party requirements is one that defines the meaning of a related party but

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<sup>13</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

<sup>14</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and paragraph A6

that definition has a substantially narrower scope than the definition set out in paragraph 10(b)(ii) of this ISA, so that a requirement in the framework to disclose related party relationships and transactions would apply to substantially fewer related party relationships and transactions.

*Fair Presentation Frameworks* (Ref: Para. 4(a))

- A2. In the context of a fair presentation framework,<sup>15</sup> related party relationships and transactions may cause the financial statements to fail to achieve fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the financial statements. For instance, fair presentation may not be achieved if the sale of a property by the entity to a controlling shareholder at a price above or below fair market value has been accounted for as a transaction involving a profit or loss for the entity when it may constitute a contribution or return of capital or the payment of a dividend.

*Compliance Frameworks* (Ref: Para. 4(b))

- A3. In the context of a compliance framework, whether related party relationships and transactions cause the financial statements to be misleading as discussed in ISA 700 (Revised) depends upon the particular circumstances of the engagement. For example, even if non-disclosure of related party transactions in the financial statements is in compliance with the framework and applicable law or regulation, the financial statements could be misleading if the entity derives a very substantial portion of its revenue from transactions with related parties, and that fact is not disclosed. However, it will be extremely rare for the auditor to consider financial statements that are prepared and presented in accordance with a compliance framework to be misleading if in accordance with ISA 210<sup>16</sup> the auditor determined that the framework is acceptable.<sup>17</sup>

**Definition of a Related Party** (Ref: Para. 10(b))

- A4. Many financial reporting frameworks discuss the concepts of control and significant influence. Although they may discuss these concepts using different terms, they generally explain that:
- (a) Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities; and
  - (b) Significant influence (which may be gained by share ownership, statute or agreement) is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies.

<sup>15</sup> ISA 200, paragraph 13(a), defines the meaning of fair presentation and compliance frameworks.

<sup>16</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

<sup>17</sup> ISA 700 (Revised), paragraph A17

- A5. The existence of the following relationships may indicate the presence of control or significant influence:
- (a) Direct or indirect equity holdings or other financial interests in the entity.
  - (b) The entity's holdings of direct or indirect equity or other financial interests in other entities.
  - (c) Being part of those charged with governance or key management (that is, those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).
  - (d) Being a close family member of any person referred to in subparagraph (c).
  - (e) Having a significant business relationship with any person referred to in subparagraph (c).

*Related Parties with Dominant Influence*

- A6. Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management. Consideration of such behavior is relevant when identifying and assessing the risks of material misstatement due to fraud, as further explained in paragraphs A29–A30.

*Special-Purpose Entities as Related Parties*

- A7. In some circumstances, a special-purpose entity<sup>18</sup> may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special-purpose entity's equity.

**Risk Assessment Procedures and Related Activities**

*Risks of Material Misstatement Associated with Related Party Relationships and Transactions (Ref: Para. 11)*

Considerations Specific to Public Sector Entities

- A8. The public sector auditor's responsibilities regarding related party relationships and transactions may be affected by the audit mandate, or by obligations on public sector entities arising from law, regulation or other authority. Consequently, the public sector auditor's responsibilities may not be limited to addressing the risks of material misstatement associated with related party relationships and transactions, but may also include a broader responsibility to address the risks of non-compliance with law, regulation and other authority governing public sector bodies that lay down specific requirements in the conduct of business with related parties. Further, the public sector auditor may need to have regard

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<sup>18</sup> ISA 315 (Revised), paragraphs A34–A35, provides guidance regarding the nature of a special-purpose entity.

to public sector financial reporting requirements for related party relationships and transactions that may differ from those in the private sector.

*Understanding the Entity's Related Party Relationships and Transactions*

Discussion among the Engagement Team (Ref: Para. 12)

- A9. Matters that may be addressed in the discussion among the engagement team include:
- The nature and extent of the entity's relationships and transactions with related parties (using, for example, the auditor's record of identified related parties updated after each audit).
  - An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
  - The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (for example, a complex organizational structure, use of special-purpose entities for off-balance sheet transactions, or an inadequate information system).
  - The records or documents that may indicate the existence of related party relationships or transactions.
  - The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.
- A10. In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:
- How special-purpose entities controlled by management might be used to facilitate earnings management.
  - How transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

The Identity of the Entity's Related Parties (Ref: Para. 13(a))

- A11. Where the applicable financial reporting framework establishes related party requirements, information regarding the identity of the entity's related parties is likely to be readily available to management because the entity's information systems will need to record, process and summarize related party relationships and transactions to enable the entity to meet the accounting and disclosure requirements of the framework. Management is therefore likely to have a

comprehensive list of related parties and changes from the prior period. For recurring engagements, making the inquiries provides a basis for comparing the information supplied by management with the auditor's record of related parties noted in previous audits.

A12. However, where the framework does not establish related party requirements, the entity may not have such information systems in place. Under such circumstances, it is possible that management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by paragraph 13 still applies because management may be aware of parties that meet the related party definition set out in this ISA. In such a case, however, the auditor's inquiries regarding the identity of the entity's related parties are likely to form part of the auditor's risk assessment procedures and related activities performed in accordance with ISA 315 (Revised) to obtain information regarding:

- The entity's ownership and governance structures;
- The types of investments that the entity is making and plans to make; and
- The way the entity is structured and how it is financed.

In the particular case of common control relationships, as management is more likely to be aware of such relationships if they have economic significance to the entity, the auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or shares resources to a significant degree, are related parties.

A13. In the context of a group audit, ISA 600 requires the group engagement team to provide each component auditor with a list of related parties prepared by group management and any other related parties of which the group engagement team is aware.<sup>19</sup> Where the entity is a component within a group, this information provides a useful basis for the auditor's inquiries of management regarding the identity of the entity's related parties.

A14. The auditor may also obtain some information regarding the identity of the entity's related parties through inquiries of management during the engagement acceptance or continuance process.

The Entity's Controls over Related Party Relationships and Transactions (Ref: Para. 14)

A15. Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions, and the entity's controls over such relationships and transactions. These may include, to the extent that they do not form part of management:

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<sup>19</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph 40(e)

- Those charged with governance;
- Personnel in a position to initiate, process, or record transactions that are both significant and outside the entity's normal course of business, and those who supervise or monitor such personnel;
- The internal audit function;
- In-house legal counsel; and
- The chief ethics officer or equivalent person.

A16. The audit is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged and understand that they have responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, and for such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.<sup>20</sup> Accordingly, where the framework establishes related party requirements, the preparation of the financial statements requires management, with oversight from those charged with governance, to design, implement and maintain adequate controls over related party relationships and transactions so that these are identified and appropriately accounted for and disclosed in accordance with the framework. In their oversight role, those charged with governance monitor how management is discharging its responsibility for such controls. Regardless of any related party requirements the framework may establish, those charged with governance may, in their oversight role, obtain information from management to enable them to understand the nature and business rationale of the entity's related party relationships and transactions.

A17. In meeting the ISA 315 (Revised) requirement to obtain an understanding of the control environment,<sup>21</sup> the auditor may consider features of the control environment relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as:

- Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.
- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions.
- The assignment of responsibilities within the entity for identifying, recording, summarizing, and disclosing related party transactions.

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<sup>20</sup> ISA 200, paragraph A4

<sup>21</sup> ISA 315 (Revised), paragraph 14

- Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the entity's normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions (for example, by seeking advice from external professional advisors).
- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management.
- Periodic reviews by the internal audit function, where applicable.
- Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel.
- The existence of whistle-blowing policies and procedures, where applicable.

A18. Controls over related party relationships and transactions within some entities may be deficient or non-existent for a number of reasons, such as:

- The low importance attached by management to identifying and disclosing related party relationships and transactions.
- The lack of appropriate oversight by those charged with governance.
- An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive, for example, the existence of transactions involving family members of management.
- An insufficient understanding by management of the related party requirements of the applicable financial reporting framework.
- The absence of disclosure requirements under the applicable financial reporting framework.

Where such controls are ineffective or non-existent, the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions. If this were the case, the auditor would, in accordance with ISA 705 (Revised),<sup>22</sup> consider the implications for the audit, including the opinion in the auditor's report.

A19. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.<sup>23</sup> The risk of management override of controls is higher if management has relationships that involve control or significant influence with parties with which the entity does business

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<sup>22</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

<sup>23</sup> ISA 240, paragraphs 32 and A4

because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by (a) directing the entity, against its interests, to conclude transactions for the benefit of these parties, or (b) colluding with such parties or controlling their actions. Examples of possible fraud include:

- Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.
- Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value.
- Engaging in complex transactions with related parties, such as special-purpose entities, that are structured to misrepresent the financial position or financial performance of the entity.

#### Considerations specific to smaller entities

A20. Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions. An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of available relevant documentation.

#### Authorization and approval of significant transactions and arrangements (Ref: Para. 14(b))

A21. Authorization involves the granting of permission by a party or parties with the appropriate authority (whether management, those charged with governance or the entity's shareholders) for the entity to enter into specific transactions in accordance with pre-determined criteria, whether judgmental or not. Approval involves those parties' acceptance of the transactions the entity has entered into as having satisfied the criteria on which authorization was granted. Examples of controls the entity may have established to authorize and approve significant transactions and arrangements with related parties or significant transactions and arrangements outside the normal course of business include:

- Monitoring controls to identify such transactions and arrangements for authorization and approval.
- Approval of the terms and conditions of the transactions and arrangements by management, those charged with governance or, where applicable, shareholders.

*Maintaining Alertness for Related Party Information When Reviewing Records or Documents*

Records or Documents That the Auditor May Inspect (Ref: Para. 15)

A22. During the audit, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:

- Third-party confirmations obtained by the auditor (in addition to bank and legal confirmations).
- Entity income tax returns.
- Information supplied by the entity to regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Reports of the internal audit function.
- Documents associated with the entity's filings with a securities regulator (for example, prospectuses).

Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions (Ref: Para. 15)

A23. An arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as:

- The establishment of a business relationship through appropriate vehicles or structures.
- The conduct of certain types of transactions under specific terms and conditions.
- The provision of designated services or financial support.

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include:

- Participation in unincorporated partnerships with other parties.
- Agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business.
- Guarantees and guarantor relationships.

Identification of Significant Transactions outside the Normal Course of Business  
(Ref: Para. 16)

A24. Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement.

A25. Examples of transactions outside the entity's normal course of business may include:

- Complex equity transactions, such as corporate restructurings or acquisitions.
- Transactions with offshore entities in jurisdictions with weak corporate laws.
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Sales transactions with unusually large discounts or returns.
- Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- Transactions under contracts whose terms are changed before expiry.

Understanding the nature of significant transactions outside the normal course of business (Ref: Para. 16(a))

A26. Inquiring into the nature of the significant transactions outside the entity's normal course of business involves obtaining an understanding of the business rationale of the transactions, and the terms and conditions under which these have been entered into.

Inquiring into whether related parties could be involved (Ref: Para. 16(b))

A27. A related party could be involved in a significant transaction outside the entity's normal course of business not only by directly influencing the transaction through

being a party to the transaction, but also by indirectly influencing it through an intermediary. Such influence may indicate the presence of a fraud risk factor.

*Sharing Related Party Information with the Engagement Team* (Ref: Para. 17)

A28. Relevant related party information that may be shared among the engagement team members includes, for example:

- The identity of the entity's related parties.
- The nature of the related party relationships and transactions.
- Significant or complex related party relationships or transactions that may require special audit consideration, in particular transactions in which management or those charged with governance are financially involved.

**Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions**

*Fraud Risk Factors Associated with a Related Party with Dominant Influence* (Ref: Para. 19)

A29. Domination of management by a single person or small group of persons without compensating controls is a fraud risk factor.<sup>24</sup> Indicators of dominant influence exerted by a related party include:

- The related party has vetoed significant business decisions taken by management or those charged with governance.
- Significant transactions are referred to the related party for final approval.
- There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party.
- Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.

Dominant influence may also exist in some cases if the related party has played a leading role in founding the entity and continues to play a leading role in managing the entity.

A30. In the presence of other risk factors, the existence of a related party with dominant influence may indicate significant risks of material misstatement due to fraud. For example:

- An unusually high turnover of senior management or professional advisors may suggest unethical or fraudulent business practices that serve the related party's purposes.

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<sup>24</sup> ISA 240, Appendix 1

- The use of business intermediaries for significant transactions for which there appears to be no clear business justification may suggest that the related party could have an interest in such transactions through control of such intermediaries for fraudulent purposes.
- Evidence of the related party's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates may suggest the possibility of fraudulent financial reporting.

### **Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions (Ref: Para. 20)**

- A31. The nature, timing and extent of the further audit procedures that the auditor may select to respond to the assessed risks of material misstatement associated with related party relationships and transactions depend upon the nature of those risks and the circumstances of the entity.<sup>25</sup>
- A32. Examples of substantive audit procedures that the auditor may perform when the auditor has assessed a significant risk that management has not appropriately accounted for or disclosed specific related party transactions in accordance with the applicable financial reporting framework (whether due to fraud or error) include:
- Confirming or discussing specific aspects of the transactions with intermediaries such as banks, law firms, guarantors, or agents, where practicable and not prohibited by law, regulation or ethical rules.
  - Confirming the purposes, specific terms or amounts of the transactions with the related parties (this audit procedure may be less effective where the auditor judges that the entity is likely to influence the related parties in their responses to the auditor).
  - Where applicable, reading the financial statements or other relevant financial information, if available, of the related parties for evidence of the accounting of the transactions in the related parties' accounting records.
- A33. If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a related party with dominant influence, the auditor may, in addition to the general requirements of ISA 240, perform audit procedures such as the following to obtain an understanding of the business relationships that such a related party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive audit procedures:

<sup>25</sup> ISA 330 provides further guidance on considering the nature, timing and extent of further audit procedures. ISA 240 establishes requirements and provides guidance on appropriate responses to assessed risks of material misstatement due to fraud.

- Inquiries of, and discussion with, management and those charged with governance.
- Inquiries of the related party.
- Inspection of significant contracts with the related party.
- Appropriate background research, such as through the Internet or specific external business information databases.
- Review of employee whistle-blowing reports where these are retained.

A34. Depending upon the results of the auditor's risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone in relation to the risks of material misstatement associated with related party relationships and transactions. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the ISA 330 requirement to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls,<sup>26</sup> the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.

*Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions*

Communicating Newly Identified Related Party Information to the Engagement Team (Ref: Para. 22(a))

A35. Communicating promptly any newly identified related parties to the other members of the engagement team assists them in determining whether this information affects the results of, and conclusions drawn from, risk assessment procedures already performed, including whether the risks of material misstatement need to be reassessed.

Substantive Procedures Relating to Newly Identified Related Parties or Significant Related Party Transactions (Ref: Para. 22(c))

A36. Examples of substantive audit procedures that the auditor may perform relating to newly identified related parties or significant related party transactions include:

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<sup>26</sup> ISA 330, paragraph 8(b)

- Making inquiries regarding the nature of the entity's relationships with the newly identified related parties, including (where appropriate and not prohibited by law, regulation or ethical rules) inquiring of parties outside the entity who are presumed to have significant knowledge of the entity and its business, such as legal counsel, principal agents, major representatives, consultants, guarantors, or other close business partners.
- Conducting an analysis of accounting records for transactions with the newly identified related parties. Such an analysis may be facilitated using computer-assisted audit techniques.
- Verifying the terms and conditions of the newly identified related party transactions, and evaluating whether the transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

#### Intentional Non-Disclosure by Management (Ref: Para. 22(e))

A37. The requirements and guidance in ISA 240 regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant where management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor. The auditor may also consider whether it is necessary to re-evaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.

#### *Identified Significant Related Party Transactions outside the Entity's Normal Course of Business*

#### Evaluating the Business Rationale of Significant Related Party Transactions (Ref: Para. 23)

A38. In evaluating the business rationale of a significant related party transaction outside the entity's normal course of business, the auditor may consider the following:

- Whether the transaction:
  - Is overly complex (for example, it may involve multiple related parties within a consolidated group).
  - Has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms.
  - Lacks an apparent logical business reason for its occurrence.
  - Involves previously unidentified related parties.
  - Is processed in an unusual manner.
- Whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance.

- Whether management is placing more emphasis on a particular accounting treatment rather than giving due regard to the underlying economics of the transaction.
- If management's explanations are materially inconsistent with the terms of the related party transaction, the auditor is required, in accordance with ISA 500,<sup>27</sup> to consider the reliability of management's explanations and representations on other significant matters.

A39. The auditor may also seek to understand the business rationale of such a transaction from the related party's perspective, as this may help the auditor to better understand the economic reality of the transaction and why it was carried out. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

#### Authorization and Approval of Significant Related Party Transactions (Ref: Para. 23(b))

A40. Authorization and approval by management, those charged with governance, or, where applicable, the shareholders of significant related party transactions outside the entity's normal course of business may provide audit evidence that these have been duly considered at the appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not subject to such authorization and approval, in the absence of rational explanations based on discussion with management or those charged with governance, may indicate risks of material misstatement due to fraud or error. In these circumstances, the auditor may need to be alert for other transactions of a similar nature. Authorization and approval alone, however, may not be sufficient in concluding whether risks of material misstatement due to fraud are absent because authorization and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to the dominant influence of a related party.

#### Considerations specific to smaller entities

A41. A smaller entity may not have the same controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser degree on authorization and approval for audit evidence regarding the validity of significant related party transactions outside the entity's normal course of business. Instead, the auditor may consider performing other audit procedures such as inspecting relevant documents, confirming specific aspects of the transactions with relevant parties, or observing the owner-manager's involvement with the transactions.

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<sup>27</sup> ISA 500, *Audit Evidence*, paragraph 11

*Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction (Ref: Para. 24)*

- A42. Although audit evidence may be readily available regarding how the price of a related party transaction compares to that of a similar arm's length transaction, there are ordinarily practical difficulties that limit the auditor's ability to obtain audit evidence that all other aspects of the transaction are equivalent to those of the arm's length transaction. For example, although the auditor may be able to confirm that a related party transaction has been conducted at a market price, it may be impracticable to confirm whether other terms and conditions of the transaction (such as credit terms, contingencies and specific charges) are equivalent to those that would ordinarily be agreed between independent parties. Accordingly, there may be a risk that management's assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction may be materially misstated.
- A43. The preparation of the financial statements requires management to substantiate an assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction. Management's support for the assertion may include:
- Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.
  - Engaging an external expert to determine a market value and to confirm market terms and conditions for the transaction.
  - Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market.
- A44. Evaluating management's support for this assertion may involve one or more of the following:
- Considering the appropriateness of management's process for supporting the assertion.
  - Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
  - Evaluating the reasonableness of any significant assumptions on which the assertion is based.
- A45. Some financial reporting frameworks require the disclosure of related party transactions not conducted on terms equivalent to those prevailing in arm's length transactions. In these circumstances, if management has not disclosed a related party transaction in the financial statements, there may be an implicit assertion that the transaction was conducted on terms equivalent to those prevailing in an arm's length transaction.

## **Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions**

### *Materiality Considerations in Evaluating Misstatements* (Ref: Para. 25)

A46. ISA 450 requires the auditor to consider both the size and the nature of a misstatement, and the particular circumstances of its occurrence, when evaluating whether the misstatement is material.<sup>28</sup> The significance of the transaction to the financial statement users may not depend solely on the recorded amount of the transaction but also on other specific relevant factors, such as the nature of the related party relationship.

### *Evaluation of Related Party Disclosures* (Ref: Para. 25(a))

A47. Evaluating the related party disclosures in the context of the disclosure requirements of the applicable financial reporting framework means considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if:

- (a) The business rationale and the effects of the transactions on the financial statements are unclear or misstated; or
- (b) Key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.

### **Written Representations** (Ref: Para. 26)

A48. Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:

- When they have approved specific related party transactions that (a) materially affect the financial statements, or (b) involve management.
- When they have made specific oral representations to the auditor on details of certain related party transactions.
- When they have financial or other interests in the related parties or the related party transactions.

A49. The auditor may also decide to obtain written representations regarding specific assertions that management may have made, such as a representation that specific related party transactions do not involve undisclosed side agreements.

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<sup>28</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11(a). Paragraph A21 of ISA 450 provides guidance on the circumstances that may affect the evaluation of a misstatement.

**Communication with Those Charged with Governance** (Ref: Para. 27)

A50. Communicating significant matters arising during the audit<sup>29</sup> in connection with the entity's related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Examples of significant related party matters include:

- Non-disclosure (whether intentional or not) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware.
- The identification of significant related party transactions that have not been appropriately authorized and approved, which may give rise to suspected fraud.
- Disagreement with management regarding the accounting for and disclosure of significant related party transactions in accordance with the applicable financial reporting framework.
- Non-compliance with applicable law or regulations prohibiting or restricting specific types of related party transactions.
- Difficulties in identifying the party that ultimately controls the entity.

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<sup>29</sup> ISA 230, paragraph A8, provides further guidance on the nature of significant matters arising during the audit.

# INTERNATIONAL STANDARD ON AUDITING 560

## SUBSEQUENT EVENTS

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 560, *Subsequent Events*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. It does not deal with matters relating to the auditor's responsibilities for other information obtained after the date of the auditor's report, which are addressed in ISA 720 (Revised).<sup>1</sup> However, such other information may bring to light a subsequent event that is within the scope of this ISA. (Ref: Para. A1)

### Subsequent Events

2. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events.<sup>2</sup> Such financial reporting frameworks ordinarily identify two types of events:
  - (a) Those that provide evidence of conditions that existed at the date of the financial statements; and
  - (b) Those that provide evidence of conditions that arose after the date of the financial statements.

ISA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.<sup>3</sup>

### Effective Date

3. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objectives

4. The objectives of the auditor are:
  - (a) To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework; and

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<sup>1</sup> ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

<sup>2</sup> For example, International Accounting Standard (IAS) 10, *Events After the Reporting Period*, deals with the treatment in financial statements of events, both favorable and unfavorable, that occur between the date of the financial statements (referred to as the "end of the reporting period" in the IAS) and the date when the financial statements are authorized for issue.

<sup>3</sup> ISA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*, paragraph A66

- (b) To respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

## Definitions

- 5. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Date of the financial statements – The date of the end of the latest period covered by the financial statements.
  - (b) Date of approval of the financial statements – The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognized authority have asserted that they have taken responsibility for those financial statements. (Ref: Para. A2)
  - (c) Date of the auditor's report – The date the auditor dates the report on the financial statements in accordance with ISA 700. (Ref: Para. A3)
  - (d) Date the financial statements are issued – The date that the auditor's report and audited financial statements are made available to third parties. (Ref: Para. A4–A5)
  - (e) Subsequent events – Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

## Requirements

### Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report

- 6. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (Ref: Para. A6)
- 7. The auditor shall perform the procedures required by paragraph 6 so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following: (Ref: Para. A7–A8)
  - (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements. (Ref: Para. A9)
  - (c) Reading minutes, if any, of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available. (Ref: Para. A10)
  - (d) Reading the entity's latest subsequent interim financial statements, if any.
8. If, as a result of the procedures performed as required by paragraphs 6 and 7, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements in accordance with the applicable financial reporting framework.

#### *Written Representations*

9. The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with ISA 580<sup>4</sup> that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

#### **Facts Which Become Known to the Auditor after the Date of the Auditor's Report but before the Date the Financial Statements Are Issued**

10. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall: (Ref: Para. A11-A12)
- (a) Discuss the matter with management and, where appropriate, those charged with governance;
  - (b) Determine whether the financial statements need amendment and, if so,
  - (c) Inquire how management intends to address the matter in the financial statements.
11. If management amends the financial statements, the auditor shall:
- (a) Carry out the audit procedures necessary in the circumstances on the amendment.

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<sup>4</sup> ISA 580, *Written Representations*

- (b) Unless the circumstances in paragraph 12 apply:
- (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor's report; and
  - (ii) Provide a new auditor's report on the amended financial statements. The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.
12. Where law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent event or events causing that amendment and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events required in paragraph 11(b)(i) to that amendment. In such cases, the auditor shall either:
- (a) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or (Ref: Para. A13)
  - (b) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph<sup>5</sup> or Other Matter paragraph that conveys that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.
13. In some jurisdictions, management may not be required by law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor's report. However, if management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then: (Ref: Para. A14–A15)
- (a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by ISA 705 (Revised)<sup>6</sup> and then provide the auditor's report; or
  - (b) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments,

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<sup>5</sup> See ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

<sup>6</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

the auditor shall take appropriate action to seek to prevent reliance on the auditor's report. (Ref. Para: A16–A17)

### **Facts Which Become Known to the Auditor after the Financial Statements Have Been Issued**

14. After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, if, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
  - (a) Discuss the matter with management and, where appropriate, those charged with governance;
  - (b) Determine whether the financial statements need amendment; and, if so,
  - (c) Inquire how management intends to address the matter in the financial statements. (Ref: Para. A18)
  
15. If management amends the financial statements, the auditor shall: (Ref: Para. A19)
  - (a) Carry out the audit procedures necessary in the circumstances on the amendment.
  - (b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.
  - (c) Unless the circumstances in paragraph 12 apply:
    - (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor's report, and date the new auditor's report no earlier than the date of approval of the amended financial statements; and
    - (ii) Provide a new auditor's report on the amended financial statements.
  - (d) When the circumstances in paragraph 12 apply, amend the auditor's report, or provide a new auditor's report as required by paragraph 12.
  
16. The auditor shall include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.
  
17. If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor

believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity,<sup>7</sup> those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report. (Ref: Para. A20)

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## Application and Other Explanatory Material

### Scope of this ISA (Ref: Para. 1)

- A1. When the audited financial statements are included in other documents subsequent to the issuance of the financial statements (other than annual reports that would be within the scope of ISA 720 (Revised)), the auditor may have additional responsibilities relating to subsequent events that the auditor may need to consider, such as legal or regulatory requirements involving the offering of securities to the public in jurisdictions in which the securities are being offered. For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those referred to in paragraphs 6 and 7 performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.<sup>8</sup>

### Definitions

#### *Date of Approval of the Financial Statements* (Ref: Para. 5(b))

- A2. In some jurisdictions, law or regulation identifies the individuals or bodies (for example, management or those charged with governance) that are responsible for concluding that all the statements that comprise the financial statements, including the related notes, have been prepared, and specifies the necessary approval process. In other jurisdictions, the approval process is not prescribed in law or regulation and the entity follows its own procedures in preparing and finalizing its financial statements in view of its management and governance structures. In some jurisdictions, final approval of the financial statements by shareholders is required. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements has been obtained. The date of approval of the financial statements for purposes of the

<sup>7</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

<sup>8</sup> See ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 2.

ISAs is the earlier date on which those with the recognized authority determine that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for those financial statements.

*Date of the Auditor's Report* (Ref: Para. 5(c))

- A3. The auditor's report cannot be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements, including evidence that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for those financial statements.<sup>9</sup> Consequently, the date of the auditor's report cannot be earlier than the date of approval of the financial statements as defined in paragraph 5(b). A time period may elapse due to administrative issues between the date of the auditor's report as defined in paragraph 5(c) and the date the auditor's report is provided to the entity.

*Date the Financial Statements Are Issued* (Ref: Para. 5(d))

- A4. The date the financial statements are issued generally depends on the regulatory environment of the entity. In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

Considerations Specific to Public Sector Entities

- A5. In the case of the public sector, the date the financial statements are issued may be the date the audited financial statements and the auditor's report thereon are presented to the legislature or otherwise made public.

**Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report** (Ref: Para. 6–9)

- A6. Depending on the auditor's risk assessment, the audit procedures required by paragraph 6 may include procedures, necessary to obtain sufficient appropriate audit evidence, involving the review or testing of accounting records or transactions occurring between the date of the financial statements and the date of the auditor's report. The audit procedures required by paragraphs 6 and 7 are in addition to procedures that the auditor may perform for other purposes that, nevertheless, may provide evidence about subsequent events (for example, to obtain audit evidence for account balances as at the date of the financial

<sup>9</sup> ISA 700, paragraph 41. In some cases, law or regulation also identifies the point in the financial statement reporting process at which the audit is expected to be complete.

statements, such as cutoff procedures or procedures in relation to subsequent receipts of accounts receivable).

- A7. Paragraph 7 stipulates certain audit procedures in this context that the auditor is required to perform pursuant to paragraph 6. The subsequent events procedures that the auditor performs may, however, depend on the information that is available and, in particular, the extent to which the accounting records have been prepared since the date of the financial statements. Where the accounting records are not up-to-date, and accordingly no interim financial statements (whether for internal or external purposes) have been prepared, or minutes of meetings of management or those charged with governance have not been prepared, relevant audit procedures may take the form of inspection of available books and records, including bank statements. Paragraph A8 gives examples of some of the additional matters that the auditor may consider in the course of these inquiries.
- A8. In addition to the audit procedures required by paragraph 7, the auditor may consider it necessary and appropriate to:
- Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements;
  - Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or
  - Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

*Inquiry* (Ref: Para. 7(b))

- A9. In inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:
- Whether new commitments, borrowings or guarantees have been entered into.
  - Whether sales or acquisitions of assets have occurred or are planned.
  - Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
  - Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
  - Whether there have been any developments regarding contingencies.

- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements, as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- Whether any events have occurred that are relevant to the recoverability of assets.

*Reading Minutes* (Ref. Para. 7(c))

Considerations Specific to Public Sector Entities

A10. In the public sector, the auditor may read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available.

### **Facts Which Become Known to the Auditor after the Date of the Auditor's Report but before the Date the Financial Statements Are Issued**

*Implications of Other Information Obtained after the Date of the Auditor's Report* (Ref: Para. 10)

A11. While the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report but before the date the financial statements are issued, ISA 720 (Revised) contains requirements and guidance with respect to other information obtained after the date of the auditor's report, which might include other information obtained after the date of the auditor's report, but before the date the financial statements are issued.

*Management Responsibility towards Auditor* (Ref: Para. 10)

A12. As explained in ISA 210, the terms of the audit engagement include the agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.<sup>10</sup>

*Dual Dating* (Ref: Para. 12(a))

A13. When, in the circumstances described in paragraph 12(a), the auditor amends the auditor's report to include an additional date restricted to that amendment, the date of the auditor's report on the financial statements prior to their subsequent amendment by management remains unchanged because this date

<sup>10</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph A24

informs the reader as to when the audit work on those financial statements was completed. However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to that date were restricted to the subsequent amendment of the financial statements. The following is an illustration of such an additional date:

(Date of auditor's report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y).

*No Amendment of Financial Statements by Management* (Ref: Para. 13)

- A14. In some jurisdictions, management may not be required by law, regulation or the financial reporting framework to issue amended financial statements. This is often the case when issuance of the financial statements for the following period is imminent, provided appropriate disclosures are made in such statements.

*Considerations Specific to Public Sector Entities*

- A15. In the public sector, the actions taken in accordance with paragraph 13 when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor's report.

*Auditor Action to Seek to Prevent Reliance on Auditor's Report* (Ref: Para. 13(b))

- A16. The auditor may need to fulfill additional legal obligations even when the auditor has notified management not to issue the financial statements and management has agreed to this request.
- A17. Where management has issued the financial statements despite the auditor's notification not to issue the financial statements to third parties, the auditor's course of action to prevent reliance on the auditor's report on the financial statements depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

**Facts Which Become Known to the Auditor after the Financial Statements Have Been Issued**

*Implications of Other Information Received After the Financial Statements Have Been Issued* (Ref: Para.14)

- A18. The auditor's obligations regarding other information received after the date of the auditor's report are addressed in ISA 720 (Revised). While the auditor has no obligation to perform any audit procedures regarding the financial statements after the financial statements have been issued, ISA 720 (Revised) contains requirements and guidance with respect to other information obtained after the date of the auditor's report.

*No Amendment of Financial Statements by Management (Ref: Para. 15)*

## Considerations Specific to Public Sector Entities

A19. In some jurisdictions, entities in the public sector may be prohibited from issuing amended financial statements by law or regulation. In such circumstances, the appropriate course of action for the auditor may be to report to the appropriate statutory body.

*Auditor Action to Seek to Prevent Reliance on Auditor's Report (Ref: Para. 17)*

A20. Where the auditor believes that management, or those charged with governance, have failed to take the necessary steps to prevent reliance on the auditor's report on financial statements previously issued by the entity despite the auditor's prior notification that the auditor will take action to seek to prevent such reliance, the auditor's course of action depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

**INTERNATIONAL STANDARD ON AUDITING 570  
(REVISED)**

**GOING CONCERN**

(Effective for audits of financial statements for periods ending  
on or after December 15, 2016)

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## GOING CONCERN

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International Standard on Auditing (ISA) 570 (Revised), *Going Concern*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report. (Ref: Para. A1)

### Going Concern Basis of Accounting

2. Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis of accounting is relevant (e.g., the going concern basis of accounting is not relevant for some financial statements prepared on a tax basis in particular jurisdictions). When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. (Ref: Para. A2)

### Responsibility for Assessment of the Entity's Ability to Continue as a Going Concern

3. Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. For example, International Accounting Standard (IAS) 1 requires management to make an assessment of an entity's ability to continue as a going concern.<sup>1</sup> The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may also be set out in law or regulation.
4. In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, where the going concern basis of accounting is a fundamental principle in the preparation of financial statements as discussed in paragraph 2, the preparation of the financial statements requires management to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.
5. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently

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<sup>1</sup> IAS 1, *Presentation of Financial Statements*, paragraphs 25–26

uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

### *Responsibilities of the Auditor*

6. The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.
7. However, as described in ISA 200,<sup>2</sup> the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

### **Effective Date**

8. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2016.

### **Objectives**

9. The objectives of the auditor are:

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<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraphs A53–A54

- (a) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;
- (b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
- (c) To report in accordance with this ISA.

## Requirements

### Risk Assessment Procedures and Related Activities

10. When performing risk assessment procedures as required by ISA 315 (Revised),<sup>3</sup> the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and: (Ref: Para. A3–A6)
  - (a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or
  - (b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.
11. The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. (Ref: Para. A7)

### Evaluating Management's Assessment

12. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. (Ref: Para. A8–A10, A12–A13)
13. In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management's assessment of the entity's ability to continue as a going concern

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<sup>3</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 5

covers less than twelve months from the date of the financial statements as defined in ISA 560,<sup>4</sup> the auditor shall request management to extend its assessment period to at least twelve months from that date. (Ref: Para. A11–A13)

14. In evaluating management’s assessment, the auditor shall consider whether management’s assessment includes all relevant information of which the auditor is aware as a result of the audit.

### **Period beyond Management’s Assessment**

15. The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management’s assessment that may cast significant doubt on the entity’s ability to continue as a going concern. (Ref: Para. A14–A15)

### **Additional Audit Procedures When Events or Conditions Are Identified**

16. If events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern (hereinafter referred to as “material uncertainty”) through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include: (Ref: Para. A16)
  - (a) Where management has not yet performed an assessment of the entity’s ability to continue as a going concern, requesting management to make its assessment.
  - (b) Evaluating management’s plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management’s plans are feasible in the circumstances. (Ref: Para. A17)
  - (c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management’s plans for future actions: (Ref: Para. A18–A19)
    - (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and
    - (ii) Determining whether there is adequate support for the assumptions underlying the forecast.
  - (d) Considering whether any additional facts or information have become available since the date on which management made its assessment.

<sup>4</sup> ISA 560, *Subsequent Events*, paragraph 5(a)

- (e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans. (Ref: Para. A20)

### **Auditor Conclusions**

- 17. The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.
- 18. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for: (Ref: Para. A21–A22)
  - (a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or
  - (b) In the case of a compliance framework, the financial statements not to be misleading.

#### *Adequacy of Disclosures When Events or Conditions Have Been Identified and a Material Uncertainty Exists*

- 19. If the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements: (Ref: Para. A22–A23)
  - (a) Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and
  - (b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

#### *Adequacy of Disclosures When Events or Conditions Have Been Identified but No Material Uncertainty Exists*

- 20. If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions. (Ref: Para. A24–A25)

**Implications for the Auditor's Report***Use of Going Concern Basis of Accounting Is Inappropriate*

21. If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion. (Ref: Para. A26–A27)

*Use of Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists***Adequate Disclosure of a Material Uncertainty Is Made in the Financial Statements**

22. If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to: (Ref: Para. A28–A31, A34)
- (a) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 19; and
  - (b) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

**Adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements**

23. If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall: (Ref: Para. A32–A34)
- (a) Express a qualified opinion or adverse opinion, as appropriate, in accordance with ISA 705 (Revised)<sup>5</sup>; and
  - (b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

**Management Unwilling to Make or Extend Its Assessment**

24. If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report. (Ref: Para. A35)

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<sup>5</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

## Communication with Those Charged with Governance

25. Unless all those charged with governance are involved in managing the entity,<sup>6</sup> the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance shall include the following:
- (a) Whether the events or conditions constitute a material uncertainty;
  - (b) Whether management's use of the going concern basis of accounting is appropriate in the preparation of the financial statements;
  - (c) The adequacy of related disclosures in the financial statements; and
  - (d) Where applicable, the implications for the auditor's report.

## Significant Delay in the Approval of Financial Statements

26. If there is significant delay in the approval of the financial statements by management or those charged with governance after the date of the financial statements, the auditor shall inquire as to the reasons for the delay. If the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform those additional audit procedures necessary, as described in paragraph 16, as well as consider the effect on the auditor's conclusion regarding the existence of a material uncertainty, as described in paragraph 18.

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## Application and Other Explanatory Material

### Scope of this ISA (Ref: Para 1)

- A1. ISA 701<sup>7</sup> deals with the auditor's responsibility to communicate key audit matters in the auditor's report. That ISA acknowledges that, when ISA 701 applies, matters relating to going concern may be determined to be key audit matters, and explains that a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern is, by its nature, a key audit matter.<sup>8</sup>

### Going Concern Basis of Accounting (Ref: Para. 2)

#### *Considerations Specific to Public Sector Entities*

- A2. Management's use of the going concern basis of accounting is also relevant to public sector entities. For example, International Public Sector Accounting Standard (IPSAS) 1 addresses the issue of the ability of public sector entities to

<sup>6</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

<sup>7</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

<sup>8</sup> See paragraphs 15 and A41 of ISA 701.

continue as going concerns.<sup>9</sup> Going concern risks may arise, but are not limited to, situations where public sector entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatization. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern in the public sector may include situations where the public sector entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by the public sector entity.

### **Risk Assessment Procedures and Related Activities**

*Events or Conditions That May Cast Significant Doubt on the Entity's Ability to Continue as a Going Concern* (Ref: Para. 10)

- A3. The following are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

#### Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

#### Operating

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.

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<sup>9</sup> IPSAS 1, *Presentation of Financial Statements*, paragraphs 38–41

- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counterbalanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, re-scheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

- A4. The risk assessment procedures required by paragraph 10 help the auditor to determine whether management's use of the going concern basis of accounting is likely to be an important issue and its impact on planning the audit. These procedures also allow for more timely discussions with management, including a discussion of management's plans and resolution of any identified going concern issues.

Considerations Specific to Smaller Entities (Ref: Para. 10)

- A5. The size of an entity may affect its ability to withstand adverse conditions. Small entities may be able to respond quickly to exploit opportunities, but may lack reserves to sustain operations.
- A6. Conditions of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, as well as the possible loss of a principal supplier, major customer, key employee, or the right to operate under a license, franchise or other legal agreement.

*Remaining Alert throughout the Audit for Audit Evidence about Events or Conditions*  
(Ref: Para. 11)

- A7. ISA 315 (Revised) requires the auditor to revise the auditor's risk assessment and modify the further planned audit procedures accordingly when additional

audit evidence is obtained during the course of the audit that affects the auditor's assessment of risk.<sup>10</sup> If events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are identified after the auditor's risk assessments are made, in addition to performing the procedures in paragraph 16, the auditor's assessment of the risks of material misstatement may need to be revised. The existence of such events or conditions may also affect the nature, timing and extent of the auditor's further procedures in response to the assessed risks. ISA 330<sup>11</sup> establishes requirements and provides guidance on this issue.

## Evaluating Management's Assessment

*Management's Assessment and Supporting Analysis and the Auditor's Evaluation*  
(Ref: Para. 12)

- A8. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of management's use of the going concern basis of accounting.
- A9. It is not the auditor's responsibility to rectify the lack of analysis by management. In some circumstances, however, the lack of detailed analysis by management to support its assessment may not prevent the auditor from concluding whether management's use of the going concern basis of accounting is appropriate in the circumstances. For example, when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether management's use of the going concern basis of accounting in the preparation of the financial statements is appropriate in the circumstances.
- A10. In other circumstances, evaluating management's assessment of the entity's ability to continue as a going concern, as required by paragraph 12, may include an evaluation of the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future action and whether management's plans are feasible in the circumstances.

*The Period of Management's Assessment* (Ref: Para. 13)

- A11. Most financial reporting frameworks requiring an explicit management assessment specify the period for which management is required to take into account all available information.<sup>12</sup>

<sup>10</sup> ISA 315 (Revised), paragraph 31

<sup>11</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>12</sup> For example, IAS 1 defines this as a period that should be at least, but is not limited to, twelve months from the end of the reporting period.

*Considerations Specific to Smaller Entities* (Ref: Para. 12–13)

- A12. In many cases, the management of smaller entities may not have prepared a detailed assessment of the entity's ability to continue as a going concern, but instead may rely on in-depth knowledge of the business and anticipated future prospects. Nevertheless, in accordance with the requirements of this ISA, the auditor needs to evaluate management's assessment of the entity's ability to continue as a going concern. For smaller entities, it may be appropriate to discuss the medium and long-term financing of the entity with management, provided that management's contentions can be corroborated by sufficient documentary evidence and are not inconsistent with the auditor's understanding of the entity. Therefore, the requirement in paragraph 13 for the auditor to request management to extend its assessment may, for example, be satisfied by discussion, inquiry and inspection of supporting documentation, for example, orders received for future supply, evaluated as to their feasibility or otherwise substantiated.
- A13. Continued support by owner-managers is often important to smaller entity's ability to continue as a going concern. Where a small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating a loan to the entity in favor of banks or other creditors, or the owner-manager supporting a loan for the entity by providing a guarantee with his or her personal assets as collateral. In such circumstances, the auditor may obtain appropriate documentary evidence of the subordination of the owner-manager's loan or of the guarantee. Where an entity is dependent on additional support from the owner-manager, the auditor may evaluate the owner-manager's ability to meet the obligation under the support arrangement. In addition, the auditor may request written confirmation of the terms and conditions attaching to such support and the owner-manager's intention or understanding.

**Period beyond Management's Assessment** (Ref: Para. 15)

- A14. As required by paragraph 11, the auditor remains alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management's use of the going concern basis of accounting in preparing the financial statements. Since the degree of uncertainty associated with the outcome of an event or condition increases as the event or condition is further into the future, in considering events or conditions further in the future, the indications of going concern issues need to be significant before the auditor needs to consider taking further action. If such events or conditions are identified, the auditor may need to request management to evaluate the potential significance of the event or condition on its assessment of the entity's ability to continue as a going concern. In these circumstances, the procedures in paragraph 16 apply.

A15. Other than inquiry of management, the auditor does not have a responsibility to perform any other audit procedures to identify events or conditions that may cast significant doubt on the entity's ability to continue as a going concern beyond the period assessed by management, which, as discussed in paragraph 13, would be at least twelve months from the date of the financial statements.

**Additional Audit Procedures When Events or Conditions Are Identified** (Ref: Para.16)

A16. Audit procedures that are relevant to the requirement in paragraph 16 may include the following:

- Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- Analyzing and discussing the entity's latest available interim financial statements.
- Reading the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Evaluating the entity's plans to deal with unfilled customer orders.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.
- Determining the adequacy of support for any planned disposals of assets.

*Evaluating Management's Plans for Future Actions* (Ref: Para. 16(b))

A17. Evaluating management's plans for future actions may include inquiries of management as to its plans for future action, including, for example, its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.

*The Period of Management's Assessment* (Ref: Para. 16(c))

A18. In addition to the procedures required in paragraph 16(c), the auditor may compare:

- The prospective financial information for recent prior periods with historical results; and
- The prospective financial information for the current period with results achieved to date.

A19. Where management's assumptions include continued support by third parties, whether through the subordination of loans, commitments to maintain or provide additional funding, or guarantees, and such support is important to an entity's ability to continue as a going concern, the auditor may need to consider requesting written confirmation (including of terms and conditions) from those third parties and to obtain evidence of their ability to provide such support.

*Written Representations* (Ref: Para. 16(e))

A20. The auditor may consider it appropriate to obtain specific written representations beyond those required in paragraph 16 in support of audit evidence obtained regarding management's plans for future actions in relation to its going concern assessment and the feasibility of those plans.

**Auditor Conclusions***Material Uncertainty Related to Events or Conditions that May Cast Significant Doubt on the Entity's Ability to Continue as a Going Concern* (Ref: Para. 18)

A21. The phrase "material uncertainty" is used in IAS 1 in discussing the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements. In some other financial reporting frameworks the phrase "significant uncertainty" is used in similar circumstances.

*Adequacy of Disclosure when Events or Conditions Have Been Identified and a Material Uncertainty Exists*

A22. Paragraph 18 explains that a material uncertainty exists when the magnitude of the potential impact of the events or conditions and the likelihood of occurrence is such that appropriate disclosure is necessary to achieve fair presentation (for fair presentation frameworks) or for the financial statements not to be misleading (for compliance frameworks). The auditor is required by paragraph 18 to conclude whether such a material uncertainty exists regardless of whether or how the applicable financial reporting framework defines a material uncertainty.

A23. Paragraph 19 requires the auditor to determine whether the financial statement disclosures address the matters set forth in that paragraph. This determination is in addition to the auditor determining whether disclosures about a material

uncertainty, required by the applicable financial reporting framework, are adequate. Disclosures required by some financial reporting frameworks that are in addition to matters set forth in paragraph 19 may include disclosures about:

- Management's evaluation of the significance of the events or conditions relating to the entity's ability to meet its obligations; or
- Significant judgments made by management as part of its assessment of the entity's ability to continue as a going concern.

Some financial reporting frameworks may provide additional guidance regarding management's consideration of disclosures about the magnitude of the potential impact of the principal events or conditions, and the likelihood and timing of their occurrence.

*Adequacy of Disclosures When Events or Conditions Have Been Identified but No Material Uncertainty Exists* (Ref: Para. 20)

A24. Even when no material uncertainty exists, paragraph 20 requires the auditor to evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosure about events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Some financial reporting frameworks may address disclosures about:

- Principal events or conditions;
- Management's evaluation of the significance of those events or conditions in relation to the entity's ability to meet its obligations;
- Management's plans that mitigate the effect of these events or conditions; or
- Significant judgments made by management as part of its assessment of the entity's ability to continue as a going concern.

A25. When the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation includes the consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.<sup>13</sup> Depending on the facts and circumstances, the auditor may determine that additional disclosures are necessary to achieve fair presentation. This may be the case, for example, when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained, the auditor concludes that no material uncertainty exists, and no disclosures are explicitly required by the applicable financial reporting framework regarding these circumstances.

<sup>13</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 14

## Implications for the Auditor's Report

### *Use of Going Concern Basis of Accounting is Inappropriate* (Ref: Para. 21)

- A26. If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the financial statements is inappropriate, the requirement in paragraph 21 for the auditor to express an adverse opinion applies regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern basis of accounting.
- A27. When the use of the going concern basis of accounting is not appropriate in the circumstances, management may be required, or may elect, to prepare the financial statements on another basis (e.g., liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the other basis of accounting is acceptable in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein about the basis of accounting on which the financial statements are prepared, but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in accordance with ISA 706 (Revised)<sup>14</sup> in the auditor's report to draw the user's attention to that alternative basis of accounting and the reasons for its use.

### *Use of the Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists* (Ref: Para. 22–23)

- A28. The identification of a material uncertainty is a matter that is important to users' understanding of the financial statements. The use of a separate section with a heading that includes reference to the fact that a material uncertainty related to going concern exists alerts users to this circumstance.
- A29. The Appendix to this ISA provides illustrations of the statements that are required to be included in the auditor's report on the financial statements when International Financial Reporting Standards (IFRSs) is the applicable financial reporting framework. If an applicable financial reporting framework other than IFRSs is used, the illustrative statements presented in the Appendix to this ISA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.
- A30. Paragraph 22 establishes the minimum information required to be presented in the auditor's report in each of the circumstances described. The auditor may provide additional information to supplement the required statements, for example to explain:

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<sup>14</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

- That the existence of a material uncertainty is fundamental to users' understanding of the financial statements;<sup>15</sup> or
- How the matter was addressed in the audit (see also paragraph A1).

#### Adequate Disclosure of a Material Uncertainty Is Made in the Financial Statements (Ref: Para. 22)

A31. Illustration 1 of the Appendix to this ISA is an example of an auditor's report when the auditor has obtained sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern basis of accounting but a material uncertainty exists and disclosure is adequate in the financial statements. The Appendix of ISA 700 (Revised) also includes illustrative wording to be included in the auditor's report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

#### Adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements (Ref: Para. 23)

A32. Illustrations 2 and 3 of the Appendix to this ISA are examples of auditor's reports containing qualified and adverse opinions, respectively, when the auditor has obtained sufficient appropriate audit evidence regarding the appropriateness of the management's use of the going concern basis of accounting but adequate disclosure of a material uncertainty is not made in the financial statements.

A33. In situations involving multiple uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate in extremely rare cases to express a disclaimer of opinion instead of including the statements required by paragraph 22. ISA 705 (Revised) provides guidance on this issue.<sup>16</sup>

#### Communication with Regulators (Ref: Para. 22–23)

A34. When the auditor of a regulated entity considers that it may be necessary to include a reference to going concern matters in the auditor's report, the auditor may have a duty to communicate with the applicable regulatory, enforcement or supervisory authorities.

#### Management Unwilling to Make or Extend Its Assessment (Ref: Para. 24)

A35. In certain circumstances, the auditor may believe it necessary to request management to make or extend its assessment. If management is unwilling to do so, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements, such as audit evidence regarding the existence of plans management has put in place or the existence of other mitigating factors.

<sup>15</sup> ISA 706 (Revised), paragraph A2

<sup>16</sup> ISA 705 (Revised), paragraph 10

## **Appendix**

(Ref: Para. A29, A31–A32)

### **Illustrations of Auditor’s Reports Relating to Going Concern**

- Illustration 1: An auditor’s report containing an unmodified opinion when the auditor has concluded that a material uncertainty exists and disclosure in the financial statements is adequate.
- Illustration 2: An auditor’s report containing a qualified opinion when the auditor has concluded that a material uncertainty exists and that the financial statements are materially misstated due to inadequate disclosure.
- Illustration 3: An auditor’s report containing an adverse opinion when the auditor has concluded that a material uncertainty exists and the financial statements omit the required disclosures relating to a material uncertainty.

### **Illustration 1 – Unmodified Opinion When a Material Uncertainty Exists and Disclosure in the Financial Statements Is Adequate**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- **Audit of a complete set of financial statements of a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600<sup>1</sup> does not apply).**
- **The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.<sup>2</sup>**
- **The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern. The disclosure of the material uncertainty in the financial statements is adequate.**
- **Key audit matters have been communicated in accordance with ISA 701.**
- **The auditor has obtained all of the other information prior to the date of the auditor’s report and has not yet identified a material misstatement of the other information.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.**

<sup>1</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

<sup>2</sup> ISA 210, *Agreeing the Terms of Audit Engagements*

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>3</sup>

#### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

#### Material Uncertainty Related to Going Concern

We draw attention to Note XXX in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

#### Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters

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<sup>3</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Material Uncertainty Related to Going Concern* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

*[Description of each key audit matter in accordance with ISA 701.]*

**Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

*[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 1 in Appendix 2 of ISA 720 (Revised).]*

**Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>4</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).<sup>5</sup>]*

**Auditor’s Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).<sup>21</sup>]*

**Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

The engagement partner on the audit resulting in this independent auditor’s report is *[name]*.

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>4</sup> Throughout these illustrative auditor’s reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

<sup>5</sup> Paragraphs 34 and 39 of ISA 700 (Revised) require wording to be included in the auditor’s report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

**Illustration 2 – Qualified Opinion When a Material Uncertainty Exists and the Financial Statements Are Materially Misstated Due to Inadequate Disclosure**

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- **Audit of a complete set of financial statements of a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).**
- **The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Note yy to the financial statements discusses the magnitude of financing arrangements, the expiration and the total financing arrangements; however the financial statements do not include discussion on the impact or the availability of refinancing or characterize this situation as a material uncertainty.**
- **The financial statements are materially misstated due to the inadequate disclosure of the material uncertainty. A qualified opinion is being expressed because the auditor concluded that the effects on the financial statements of this inadequate disclosure are material but not pervasive to the financial statements.**
- **Key audit matters have been communicated in accordance with ISA 701.**
- **The auditor has obtained all of the other information prior to the date of the auditor's report and the matter giving rise to the qualified opinion on the financial statements also affects the other information.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>6</sup>

#### Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the incomplete disclosure of the information referred to in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects (or *give a true and fair view of*), the financial position of the Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Qualified Opinion

As discussed in Note yy, the Company’s financing arrangements expire and amounts outstanding are payable on March 19, 20X2. The Company has been unable to conclude re-negotiations or obtain replacement financing. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company’s ability to continue as a going concern. The financial statements do not adequately disclose this matter.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

#### Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]

[*Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 6 in Appendix 2 of ISA 720 (Revised). The last paragraph of the other*

<sup>6</sup> The sub-title “Report on the Audit of the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.

*information section in Illustration 6 would be customized to describe the specific matter giving rise to the qualified opinion that also affects the other information.]*

### **Key Audit Matters**

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

*[Descriptions of each key audit matter in accordance with ISA 701.]*

### **Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>7</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).<sup>8</sup>]*

### **Auditor’s Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).<sup>24</sup>]*

### **Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

The engagement partner on the audit resulting in this independent auditor’s report is *[name]*.

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>7</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>8</sup> Paragraphs 34 and 39 of ISA 700 (Revised) require wording to be included in the auditor’s report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

**Illustration 3 – Adverse Opinion When a Material Uncertainty Exists and Is Not Disclosed in the Financial Statements**

For purposes of the illustrative auditor’s report, the following circumstances are assumed:

- **Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).**
- **The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern, and the Company is considering bankruptcy. The financial statements omit the required disclosures relating to the material uncertainty. An adverse opinion is being expressed because the effects on the financial statements of such omission are material and pervasive.**
- **The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.**
- **The auditor has obtained all of the other information prior to the date of the auditor’s report and the matter giving rise to the adverse opinion on the financial statements also affects the other information.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>9</sup>

#### Adverse Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, because of the omission of the information mentioned in the *Basis for Adverse Opinion* section of our report, the accompanying financial statements do not present fairly (or *do not give a true and fair view of*), the financial position of the Company as at December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Adverse Opinion

The Company’s financing arrangements expired and the amount outstanding was payable on December 31, 20X1. The Company has been unable to conclude re-negotiations or obtain replacement financing and is considering filing for bankruptcy. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company’s ability to continue as a going concern. The financial statements do not adequately disclose this fact.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

#### Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]

[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 7 in Appendix 2 of ISA 720 (Revised). The last paragraph of the Other

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<sup>9</sup> The sub-title “Report on the Audit of the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.

*Information section in Illustration 7 would be customized to describe the specific matter giving rise to the adverse opinion that also affects the other information.]*

**Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>10</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).<sup>11</sup>]*

**Auditor’s Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

**Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>10</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction  
<sup>11</sup> Paragraphs 34 and 39 of ISA 700 (Revised) require wording to be included in the auditor’s report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

**INTERNATIONAL STANDARD ON AUDITING 580**  
**WRITTEN REPRESENTATIONS**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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Appendix 1: List of ISAs Containing Requirements for Written Representations

Appendix 2: Illustrative Representation Letter

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International Standard on Auditing (ISA) 580, *Written Representations*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance in an audit of financial statements.
2. Appendix 1 lists other ISAs containing subject-matter specific requirements for written representations. The specific requirements for written representations of other ISAs do not limit the application of this ISA.

### Written Representations as Audit Evidence

3. Audit evidence is the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.<sup>1</sup> Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. (Ref: Para. A1)
4. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

### Effective Date

5. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

## Objectives

6. The objectives of the auditor are:
  - (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
  - (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations if determined necessary by the auditor or required by other ISAs; and
  - (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or

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<sup>1</sup> ISA 500, *Audit Evidence*, paragraph 5(c)

if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

## Definitions

7. For purposes of the ISAs, the following term has the meaning attributed below:

**Written representation** – A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

8. For purposes of this ISA, references to “management” should be read as “management and, where appropriate, those charged with governance.” Furthermore, in the case of a fair presentation framework, management is responsible for the preparation and *fair* presentation of the financial statements in accordance with the applicable financial reporting framework; or the preparation of financial statements *that give a true and fair view* in accordance with the applicable financial reporting framework.

## Requirements

### Management from whom Written Representations Requested

9. The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (Ref: Para. A2–A6)

### Written Representations about Management’s Responsibilities

#### *Preparation of the Financial Statements*

10. The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement.<sup>2</sup> (Ref: Para. A7–A9, A14, A22)

#### *Information Provided and Completeness of Transactions*

11. The auditor shall request management to provide a written representation that:
- (a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement;<sup>3</sup> and
  - (b) All transactions have been recorded and are reflected in the financial statements. (Ref: Para. A7–A9, A14, A22)

<sup>2</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(b)(i)

<sup>3</sup> ISA 210, paragraph 6(b)(iii)

*Description of Management's Responsibilities in the Written Representations*

12. Management's responsibilities shall be described in the written representations required by paragraphs 10 and 11 in the manner in which these responsibilities are described in the terms of the audit engagement.

**Other Written Representations**

13. Other ISAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. (Ref: Para. A10–A13, A14, A22)

**Date of and Period(s) Covered by Written Representations**

14. The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report. (Ref: Para. A15–A18)

**Form of Written Representations**

15. The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required by paragraphs 10 or 11, the relevant matters covered by such statements need not be included in the representation letter. (Ref: Para. A19–A21)

**Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided***Doubt as to the Reliability of Written Representations*

16. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A24–A25)
17. In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A23)

18. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with ISA 705 (Revised),<sup>4</sup> having regard to the requirement in paragraph 20 of this ISA.

*Requested Written Representations Not Provided*

19. If management does not provide one or more of the requested written representations, the auditor shall:
- (a) Discuss the matter with management;
  - (b) Reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
  - (c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with ISA 705 (Revised), having regard to the requirement in paragraph 20 of this ISA.

*Written Representations about Management's Responsibilities*

20. The auditor shall disclaim an opinion on the financial statements in accordance with ISA 705 (Revised) if:
- (a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by paragraphs 10 and 11 are not reliable; or
  - (b) Management does not provide the written representations required by paragraphs 10 and 11. (Ref: Para. A26–A27)

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## **Application and Other Explanatory Material**

### **Written Representations as Audit Evidence (Ref: Para. 3)**

- A1. Written representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

### **Management from whom Written Representations Requested (Ref: Para. 9)**

- A2. Written representations are requested from those responsible for the preparation of the financial statements. Those individuals may vary depending on the

<sup>4</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

governance structure of the entity, and relevant law or regulation; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation of the financial statements.

- A3. Due to its responsibility for the preparation of the financial statements, and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing the financial statements and the assertions therein on which to base the written representations.
- A4. In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:
- An actuary responsible for actuarially determined accounting measurements.
  - Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
  - Internal counsel who may provide information essential to provisions for legal claims.
- A5. In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.
- A6. To reinforce the need for management to make informed representations, the auditor may request that management include in the written representations confirmation that it has made such inquiries as it considered appropriate to place it in the position to be able to make the requested written representations. It is not expected that such inquiries would usually require a formal internal process beyond those already established by the entity.

#### **Written Representations about Management's Responsibilities (Ref: Para. 10–11)**

- A7. Audit evidence obtained during the audit that management has fulfilled the responsibilities referred to in paragraphs 10 and 11 is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other

audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities. For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.

A8. The written representations required by paragraphs 10 and 11 draw on the agreed acknowledgement and understanding of management of its responsibilities in the terms of the audit engagement by requesting confirmation that it has fulfilled them. The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations. This is common in certain jurisdictions, but in any event may be particularly appropriate when:

- Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- The terms of the audit engagement were prepared in a previous year;
- There is any indication that management misunderstands those responsibilities; or
- Changes in circumstances make it appropriate to do so.

Consistent with the requirement of ISA 210,<sup>5</sup> such reconfirmation of management's acknowledgement and understanding of its responsibilities is not made subject to the best of management's knowledge and belief (as discussed in paragraph A5 of this ISA).

#### *Considerations Specific to Public Sector Entities*

A9. The mandates for audits of the financial statements of public sector entities may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of a public sector entity is conducted may give rise to additional written representations. These may include written representations confirming that transactions and events have been carried out in accordance with law, regulation or other authority.

#### **Other Written Representations (Ref: Para. 13)**

##### *Additional Written Representations about the Financial Statements*

A10. In addition to the written representation required by paragraph 10, the auditor may consider it necessary to request other written representations about the financial statements. Such written representations may supplement, but do not form part of, the written representation required by paragraph 10. They may include representations about the following:

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<sup>5</sup> ISA 210, paragraph 6(b)

- Whether the selection and application of accounting policies are appropriate; and
- Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework:
  - Plans or intentions that may affect the carrying value or classification of assets and liabilities;
  - Liabilities, both actual and contingent;
  - Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
  - Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

*Additional Written Representations about Information Provided to the Auditor*

A11. In addition to the written representation required by paragraph 11, the auditor may consider it necessary to request management to provide a written representation that it has communicated to the auditor all deficiencies in internal control of which management is aware.

*Written Representations about Specific Assertions*

A12. When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:

- The entity's past history in carrying out its stated intentions.
- The entity's reasons for choosing a particular course of action.
- The entity's ability to pursue a specific course of action.
- The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

A13. In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion. For example, if the intent of management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

**Communicating a Threshold Amount** (Ref: Para. 10–11, 13)

A14. ISA 450 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.<sup>6</sup> The auditor may determine a threshold above which misstatements cannot be regarded as clearly trivial. In the same way, the auditor may consider communicating to management a threshold for purposes of the requested written representations.

**Date of and Period(s) Covered by Written Representations** (Ref: Para. 14)

A15. Because written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

A16. In some circumstances, it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

A17. The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

A18. Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

**Form of Written Representations** (Ref: Para. 15)

A19. Written representations are required to be included in a representation letter addressed to the auditor. In some jurisdictions, however, management may be required by law or regulation to make a written public statement about its responsibilities. Although such statement is a representation to the users of the financial statements, or to relevant authorities, the auditor may determine that it is an appropriate form of written representation in respect of some or all of

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<sup>6</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 5

the representations required by paragraph 10 or 11. Consequently, the relevant matters covered by such statement need not be included in the representation letter. Factors that may affect the auditor's determination include:

- Whether the statement includes confirmation of the fulfillment of the responsibilities referred to in paragraphs 10 and 11.
- Whether the statement has been given or approved by those from whom the auditor requests the relevant written representations.
- Whether a copy of the statement is provided to the auditor as near as practicable to, but not after, the date of the auditor's report on the financial statements (see paragraph 14).

A20. A formal statement of compliance with law or regulation, or of approval of the financial statements, would not contain sufficient information for the auditor to be satisfied that all necessary representations have been consciously made. The expression of management's responsibilities in law or regulation is also not a substitute for the requested written representations.

A21. Appendix 2 provides an illustrative example of a representation letter.

### **Communication with Those Charged with Governance** (Ref: Para. 10–11, 13)

A22. ISA 260 (Revised) requires the auditor to communicate with those charged with governance the written representations which the auditor has requested from management.<sup>7</sup>

### **Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided**

*Doubt as to the Reliability of Written Representations* (Ref: Para. 16–17)

A23. In the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and determine the nature, timing and extent of further audit procedures to respond to the assessed risks.

A24. Concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, may cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. In such a case, the auditor may consider withdrawing from the engagement, where withdrawal is possible under applicable law or regulation, unless those charged with governance put in place appropriate corrective measures. Such measures, however, may not be sufficient to enable the auditor to issue an unmodified audit opinion.

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<sup>7</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 16(c)(ii)

A25. ISA 230 requires the auditor to document significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.<sup>8</sup> The auditor may have identified significant issues relating to the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, but concluded that the written representations are nevertheless reliable. In such a case, this significant matter is documented in accordance with ISA 230.

*Written Representations about Management's Responsibilities* (Ref: Para. 20)

A26. As explained in paragraph A7, the auditor is not able to judge solely on other audit evidence whether management has fulfilled the responsibilities referred to in paragraphs 10 and 11. Therefore, if, as described in paragraph 20(a), the auditor concludes that the written representations about these matters are unreliable, or if management does not provide those written representations, the auditor is unable to obtain sufficient appropriate audit evidence. The possible effects on the financial statements of such inability are not confined to specific elements, accounts or items of the financial statements and are hence pervasive. ISA 705 (Revised) requires the auditor to disclaim an opinion on the financial statements in such circumstances.<sup>9</sup>

A27. A written representation that has been modified from that requested by the auditor does not necessarily mean that management did not provide the written representation. However, the underlying reason for such modification may affect the opinion in the auditor's report. For example:

- The written representation about management's fulfillment of its responsibility for the preparation of the financial statements may state that management believes that, except for material non-compliance with a particular requirement of the applicable financial reporting framework, the financial statements are prepared in accordance with that framework. The requirement in paragraph 20 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effect of the non-compliance on the opinion in the auditor's report in accordance with ISA 705 (Revised).
- The written representation about the responsibility of management to provide the auditor with all relevant information agreed in the terms of the audit engagement may state that management believes that, except for information destroyed in a fire, it has provided the auditor with such information. The requirement in paragraph 20 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effects of the pervasiveness of the information destroyed in the fire on the financial statements and the effect thereof on the opinion in the auditor's report in accordance with ISA 705 (Revised).

<sup>8</sup> ISA 230, *Audit Documentation*, paragraphs 8(c) and 10

<sup>9</sup> ISA 705 (Revised), paragraph 9

**Appendix 1**

(Ref. Para. 2)

**List of ISAs Containing Requirements for Written Representations**

This appendix identifies paragraphs in other ISAs that require subject-matter specific written representations. The list is not a substitute for considering the requirements and related application and other explanatory material in ISAs.

- ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraph 40
- ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraph 17
- ISA 450, *Evaluation of Misstatements Identified during the Audit* – paragraph 14
- ISA 501, *Audit Evidence—Specific Considerations for Selected Items* – paragraph 12
- ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* – paragraph 37
- ISA 550, *Related Parties* – paragraph 26
- ISA 560, *Subsequent Events* – paragraph 9
- ISA 570 (Revised), *Going Concern* – paragraph 16(e)
- ISA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* – paragraph 9
- ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information* – paragraph 13(c)

**Appendix 2**

(Ref: Para. A21)

**Illustrative Representation Letter**

The following illustrative letter includes written representations that are required by this and other ISAs. It is assumed in this illustration that the applicable financial reporting framework is International Financial Reporting Standards; the requirement of ISA 570 (Revised)<sup>1</sup> to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor)

(Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20XX<sup>2</sup> for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view*) in accordance with International Financial Reporting Standards.

We confirm that (, *to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*):

*Financial Statements*

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with International Financial Reporting Standards; in particular the financial statements are fairly presented (or *give a true and fair view*) in accordance therewith.
- The methods, the data, and the significant assumptions used in making accounting estimates and their related disclosures are appropriate to achieve recognition, measurement or disclosure that is reasonable in the context of the applicable financial reporting framework. (ISA 540 (Revised))
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards. (ISA 550)

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<sup>1</sup> ISA 570 (Revised), *Going Concern*

<sup>2</sup> Where the auditor reports on more than one period, the auditor adjusts the date so that the letter pertains to all periods covered by the auditor's report.

- All events subsequent to the date of the financial statements and for which International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed. (ISA 560)
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (ISA 450)
- [Any other matters that the auditor may consider appropriate (see paragraph A10 of this ISA).]

*Information Provided*

- We have provided you with:<sup>3</sup>

Access to all information of which we are aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;

Additional information that you have requested from us for the purpose of the audit; and

Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (ISA 240)
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements. (ISA 240)
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (ISA 240)
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (ISA 250)

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<sup>3</sup> If the auditor has included other matters relating to management's responsibilities in the audit engagement letter in accordance with ISA 210, *Agreeing the Terms of Audit Engagements*, consideration may be given to including these matters in the written representations from management or those charged with governance.

WRITTEN REPRESENTATIONS

- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (ISA 550)
- [Any other matters that the auditor may consider necessary (see paragraph A11 of this ISA).]

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Management

Management

**INTERNATIONAL STANDARD ON AUDITING 600  
SPECIAL CONSIDERATIONS—AUDITS OF GROUP  
FINANCIAL STATEMENTS (INCLUDING THE  
WORK OF COMPONENT AUDITORS)**

(Effective for audits of group financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. The International Standards on Auditing (ISAs) apply to group audits. This ISA deals with special considerations that apply to group audits, in particular those that involve component auditors.
2. An auditor may find this ISA, adapted as necessary in the circumstances, useful when that auditor involves other auditors in the audit of financial statements that are not group financial statements. For example, an auditor may involve another auditor to observe the inventory count or inspect physical fixed assets at a remote location.
3. A component auditor may be required by statute, regulation or for another reason, to express an audit opinion on the financial statements of a component. The group engagement team may decide to use the audit evidence on which the audit opinion on the financial statements of the component is based to provide audit evidence for the group audit, but the requirements of this ISA nevertheless apply. (Ref: Para. A1)
4. In accordance with ISA 220,<sup>1</sup> the group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively have the appropriate competence and capabilities. The group engagement partner is also responsible for the direction, supervision and performance of the group audit engagement.
5. The group engagement partner applies the requirements of ISA 220 regardless of whether the group engagement team or a component auditor performs the work on the financial information of a component. This ISA assists the group engagement partner to meet the requirements of ISA 220 where component auditors perform work on the financial information of components.
6. Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatements.<sup>2</sup> In a group audit, this includes the risk that the component auditor may not detect a misstatement in the financial information of the component that could cause a material misstatement of the group financial statements, and the risk that the group engagement team may not detect this misstatement. This ISA explains the matters that the group engagement team considers when determining the nature, timing and extent of its involvement in the risk assessment procedures and further audit procedures performed by the component auditors on the financial information of the components. The purpose of this involvement is to obtain sufficient appropriate audit evidence on which to base the audit opinion on the group financial statements.

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<sup>1</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraphs 14–15

<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A34

## Effective Date

7. This ISA is effective for audits of group financial statements for periods beginning on or after December 15, 2009.

## Objectives

8. The objectives of the auditor are:
  - (a) To determine whether to act as the auditor of the group financial statements; and
  - (b) If acting as the auditor of the group financial statements:
    - (i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and
    - (ii) To obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

## Definitions

9. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Component – An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements. (Ref: Para. A2–A4)
  - (b) Component auditor – An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit. (Ref: Para. A7)
  - (c) Component management – Management responsible for the preparation of the financial information of a component.
  - (d) Component materiality – The materiality for a component determined by the group engagement team.
  - (e) Group – All the components whose financial information is included in the group financial statements. A group always has more than one component.
  - (f) Group audit – The audit of group financial statements.
  - (g) Group audit opinion – The audit opinion on the group financial statements.

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- (h) Group engagement partner – The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor’s report on the group financial statements that is issued on behalf of the firm. Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team. This ISA does not, however, deal with the relationship between joint auditors or the work that one joint auditor performs in relation to the work of the other joint auditor.
  - (i) Group engagement team – Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.
  - (j) Group financial statements – Financial statements that include the financial information of more than one component. The term “group financial statements” also refers to combined financial statements aggregating the financial information prepared by components that have no parent but are under common control.
  - (k) Group management – Management responsible for the preparation of the group financial statements.
  - (l) Group-wide controls – Controls designed, implemented and maintained by group management over group financial reporting.
  - (m) Significant component – A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements. (Ref: Para. A5–A6)
10. Reference to “the applicable financial reporting framework” means the financial reporting framework that applies to the group financial statements. Reference to “the consolidation process” includes:
- (a) The recognition, measurement, presentation, and disclosure of the financial information of the components in the group financial statements by way of consolidation, proportionate consolidation, or the equity or cost methods of accounting; and
  - (b) The aggregation in combined financial statements of the financial information of components that have no parent but are under common control.

## Requirements

### Responsibility

11. The group engagement partner is responsible for the direction, supervision and performance of the group audit engagement in compliance with professional standards and applicable legal and regulatory requirements, and whether the auditor's report that is issued is appropriate in the circumstances.<sup>3</sup> As a result, the auditor's report on the group financial statements shall not refer to a component auditor, unless required by law or regulation to include such reference. If such reference is required by law or regulation, the auditor's report shall indicate that the reference does not diminish the group engagement partner's or the group engagement partner's firm's responsibility for the group audit opinion. (Ref: Para. A8–A9)

### Acceptance and Continuance

12. In applying ISA 220, the group engagement partner shall determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained in relation to the consolidation process and the financial information of the components on which to base the group audit opinion. For this purpose, the group engagement team shall obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components. Where component auditors will perform work on the financial information of such components, the group engagement partner shall evaluate whether the group engagement team will be able to be involved in the work of those component auditors to the extent necessary to obtain sufficient appropriate audit evidence. (Ref: Para. A10–A12)
13. If the group engagement partner concludes that:
  - (a) it will not be possible for the group engagement team to obtain sufficient appropriate audit evidence due to restrictions imposed by group management; and
  - (b) the possible effect of this inability will result in a disclaimer of opinion on the group financial statements,<sup>4</sup>the group engagement partner shall either:
  - (a) in the case of a new engagement, not accept the engagement, or, in the case of a continuing engagement, withdraw from the engagement, where withdrawal is possible under applicable law or regulation; or
  - (b) where law or regulation prohibits an auditor from declining an engagement or where withdrawal from an engagement is not otherwise possible, having performed the audit of the group financial statements to the extent possible, disclaim an opinion on the group financial statements. (Ref: Para. A13–A19)

<sup>3</sup> ISA 220, paragraph 15

<sup>4</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

### *Terms of Engagement*

14. The group engagement partner shall agree on the terms of the group audit engagement in accordance with ISA 210.<sup>5</sup> (Ref: Para. A20–A21)

### **Overall Audit Strategy and Audit Plan**

15. The group engagement team shall establish an overall group audit strategy and shall develop a group audit plan in accordance with ISA 300.<sup>6</sup>
16. The group engagement partner shall review the overall group audit strategy and group audit plan. (Ref: Para. A22)

### **Understanding the Group, Its Components, and Their Environments**

17. The auditor is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment.<sup>7</sup> The group engagement team shall:
- (a) Enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage; and
  - (b) Obtain an understanding of the consolidation process, including the instructions issued by group management to components. (Ref: Para. A23–A29)
18. The group engagement team shall obtain an understanding that is sufficient to:
- (a) Confirm or revise its initial identification of components that are likely to be significant; and
  - (b) Assess the risks of material misstatement of the group financial statements, whether due to fraud or error.<sup>8</sup> (Ref: Para. A30–A31)

### **Understanding the Component Auditor**

19. If the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of the following: (Ref: Para. A32–A35)
- (a) Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent. (Ref: Para. A37)
  - (b) The component auditor's professional competence. (Ref: Para. A38)

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<sup>5</sup> ISA 210, *Agreeing the Terms of Audit Engagements*

<sup>6</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraphs 7–12

<sup>7</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>8</sup> ISA 315 (Revised)

- (c) Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.
  - (d) Whether the component auditor operates in a regulatory environment that actively oversees auditors. (Ref: Para. A36)
20. If a component auditor does not meet the independence requirements that are relevant to the group audit, or the group engagement team has serious concerns about the other matters listed in paragraph 19(a)–(c), the group engagement team shall obtain sufficient appropriate audit evidence relating to the financial information of the component without requesting that component auditor to perform work on the financial information of that component. (Ref: Para. A39–A41)

### Materiality

21. The group engagement team shall determine the following: (Ref: Para. A42)
- (a) Materiality for the group financial statements as a whole when establishing the overall group audit strategy.
  - (b) If, in the specific circumstances of the group, there are particular classes of transactions, account balances or disclosures in the group financial statements for which misstatements of lesser amounts than materiality for the group financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the group financial statements, the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.
  - (c) Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality shall be lower than materiality for the group financial statements as a whole. (Ref: Para. A43–A44)
  - (d) The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements. (Ref: Para. A45)
22. Where component auditors will perform an audit for purposes of the group audit, the group engagement team shall evaluate the appropriateness of performance materiality determined at the component level. (Ref: Para. A46)
23. If a component is subject to audit by statute, regulation or other reason, and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team shall determine whether:
- (a) materiality for the component financial statements as a whole; and
  - (b) performance materiality at the component level
- meet the requirements of this ISA.

## Responding to Assessed Risks

24. The auditor is required to design and implement appropriate responses to address the assessed risks of material misstatement of the financial statements.<sup>9</sup> The group engagement team shall determine the type of work to be performed by the group engagement team, or the component auditors on its behalf, on the financial information of the components (see paragraphs 26–29). The group engagement team shall also determine the nature, timing and extent of its involvement in the work of the component auditors (see paragraphs 30–31).
25. If the nature, timing and extent of the work to be performed on the consolidation process or the financial information of the components are based on an expectation that group-wide controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, the group engagement team shall test, or request a component auditor to test, the operating effectiveness of those controls.

### *Determining the Type of Work to Be Performed on the Financial Information of Components* (Ref: Para. A47)

#### Significant Components

26. For a component that is significant due to its individual financial significance to the group, the group engagement team, or a component auditor on its behalf, shall perform an audit of the financial information of the component using component materiality.
27. For a component that is significant because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, the group engagement team, or a component auditor on its behalf, shall perform one or more of the following:
- (a) An audit of the financial information of the component using component materiality.
  - (b) An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements. (Ref: Para. A48)
  - (c) Specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements. (Ref: Para. A49)

#### Components that Are Not Significant Components

28. For components that are not significant components, the group engagement team shall perform analytical procedures at group level. (Ref: Para. A50)
29. If the group engagement team does not consider that sufficient appropriate audit evidence on which to base the group audit opinion will be obtained from:

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<sup>9</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

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- (a) the work performed on the financial information of significant components;
- (b) the work performed on group-wide controls and the consolidation process; and
- (c) the analytical procedures performed at group level,

the group engagement team shall select components that are not significant components and shall perform, or request a component auditor to perform, one or more of the following on the financial information of the individual components selected: (Ref: Para. A51–A53)

- An audit of the financial information of the component using component materiality.
- An audit of one or more account balances, classes of transactions or disclosures.
- A review of the financial information of the component using component materiality.
- Specified procedures.

The group engagement team shall vary the selection of components over a period of time.

*Involvement in the Work Performed by Component Auditors* (Ref: Para. A54–A55)

Significant Components—Risk Assessment

30. If a component auditor performs an audit of the financial information of a significant component, the group engagement team shall be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements. The nature, timing and extent of this involvement are affected by the group engagement team's understanding of the component auditor, but at a minimum shall include:
- (a) Discussing with the component auditor or component management those of the component's business activities that are significant to the group;
  - (b) Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error; and
  - (c) Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum that reflects the component auditor's conclusion with regard to the identified significant risks.

### Identified Significant Risks of Material Misstatement of the Group Financial Statements—Further Audit Procedures

31. If significant risks of material misstatement of the group financial statements have been identified in a component on which a component auditor performs the work, the group engagement team shall evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the group financial statements. Based on its understanding of the component auditor, the group engagement team shall determine whether it is necessary to be involved in the further audit procedures.

### Consolidation Process

32. In accordance with paragraph 17, the group engagement team obtains an understanding of group-wide controls and the consolidation process, including the instructions issued by group management to components. In accordance with paragraph 25, the group engagement team, or component auditor at the request of the group engagement team, tests the operating effectiveness of group-wide controls if the nature, timing and extent of the work to be performed on the consolidation process are based on an expectation that group-wide controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.
33. The group engagement team shall design and perform further audit procedures on the consolidation process to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process. This shall include evaluating whether all components have been included in the group financial statements.
34. The group engagement team shall evaluate the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications, and shall evaluate whether any fraud risk factors or indicators of possible management bias exist. (Ref: Para. A56)
35. If the financial information of a component has not been prepared in accordance with the same accounting policies applied to the group financial statements, the group engagement team shall evaluate whether the financial information of that component has been appropriately adjusted for purposes of preparing and presenting the group financial statements.
36. The group engagement team shall determine whether the financial information identified in the component auditor's communication (see paragraph 41(c)) is the financial information that is incorporated in the group financial statements.
37. If the group financial statements include the financial statements of a component with a financial reporting period-end that differs from that of the group, the group engagement team shall evaluate whether appropriate adjustments have

been made to those financial statements in accordance with the applicable financial reporting framework.

### **Subsequent Events**

38. Where the group engagement team or component auditors perform audits on the financial information of components, the group engagement team or the component auditors shall perform procedures designed to identify events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements, and that may require adjustment to or disclosure in the group financial statements.
39. Where component auditors perform work other than audits of the financial information of components, the group engagement team shall request the component auditors to notify the group engagement team if they become aware of subsequent events that may require an adjustment to or disclosure in the group financial statements.

### **Communication with the Component Auditor**

40. The group engagement team shall communicate its requirements to the component auditor on a timely basis. This communication shall set out the work to be performed, the use to be made of that work, and the form and content of the component auditor's communication with the group engagement team. It shall also include the following: (Ref: Para. A57, A58, A60)
  - (a) A request that the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, confirms that the component auditor will cooperate with the group engagement team. (Ref: Para. A59)
  - (b) The ethical requirements that are relevant to the group audit and, in particular, the independence requirements.
  - (c) In the case of an audit or review of the financial information of the component, component materiality (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.
  - (d) Identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor. The group engagement team shall request the component auditor to communicate on a timely basis any other identified significant risks of material misstatement of the group financial statements, due to fraud or error, in the component, and the component auditor's responses to such risks.

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- (e) A list of related parties prepared by group management, and any other related parties of which the group engagement team is aware. The group engagement team shall request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team. The group engagement team shall determine whether to identify such additional related parties to other component auditors.
41. The group engagement team shall request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. Such communication shall include: (Ref: Para. A60)
- (a) Whether the component auditor has complied with ethical requirements that are relevant to the group audit, including independence and professional competence;
  - (b) Whether the component auditor has complied with the group engagement team's requirements;
  - (c) Identification of the financial information of the component on which the component auditor is reporting;
  - (d) Information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group financial statements;
  - (e) A list of uncorrected misstatements of the financial information of the component (the list need not include misstatements that are below the threshold for clearly trivial misstatements communicated by the group engagement team (see paragraph 40(c));
  - (f) Indicators of possible management bias;
  - (g) Description of any identified significant deficiencies in internal control at the component level;
  - (h) Other significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level or others where the fraud resulted in a material misstatement of the financial information of the component;
  - (i) Any other matters that may be relevant to the group audit, or that the component auditor wishes to draw to the attention of the group engagement team, including exceptions noted in the written representations that the component auditor requested from component management; and
  - (j) The component auditor's overall findings, conclusions or opinion.

## **Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained**

### *Evaluating the Component Auditor's Communication and Adequacy of their Work*

42. The group engagement team shall evaluate the component auditor's communication (see paragraph 41). The group engagement team shall:
- (a) Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and
  - (b) Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation. (Ref: Para. A61)
43. If the group engagement team concludes that the work of the component auditor is insufficient, the group engagement team shall determine what additional procedures are to be performed, and whether they are to be performed by the component auditor or by the group engagement team.

### *Sufficiency and Appropriateness of Audit Evidence*

44. The auditor is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.<sup>10</sup> The group engagement team shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion. (Ref: Para. A62)
45. The group engagement partner shall evaluate the effect on the group audit opinion of any uncorrected misstatements (either identified by the group engagement team or communicated by component auditors) and any instances where there has been an inability to obtain sufficient appropriate audit evidence. (Ref: Para. A63)

## **Communication with Group Management and Those Charged with Governance of the Group**

### *Communication with Group Management*

46. The group engagement team shall determine which identified deficiencies in internal control to communicate to those charged with governance and group management in accordance with ISA 265.<sup>11</sup> In making this determination, the group engagement team shall consider:

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<sup>10</sup> ISA 200, paragraph 17

<sup>11</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

- (a) Deficiencies in group-wide internal control that the group engagement team has identified;
  - (b) Deficiencies in internal control that the group engagement team has identified in internal controls at components; and
  - (c) Deficiencies in internal control that component auditors have brought to the attention of the group engagement team.
47. If fraud has been identified by the group engagement team or brought to its attention by a component auditor (see paragraph 41(h)), or information indicates that a fraud may exist, the group engagement team shall communicate this on a timely basis to the appropriate level of group management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref. Para. A64)
48. A component auditor may be required by statute, regulation or for another reason, to express an audit opinion on the financial statements of a component. In that case, the group engagement team shall request group management to inform component management of any matter of which the group engagement team becomes aware that may be significant to the financial statements of the component, but of which component management may be unaware. If group management refuses to communicate the matter to component management, the group engagement team shall discuss the matter with those charged with governance of the group. If the matter remains unresolved, the group engagement team, subject to legal and professional confidentiality considerations, shall consider whether to advise the component auditor not to issue the auditor's report on the financial statements of the component until the matter is resolved. (Ref: Para. A65)

*Communication with Those Charged with Governance of the Group*

49. The group engagement team shall communicate the following matters with those charged with governance of the group, in addition to those required by ISA 260 (Revised)<sup>12</sup> and other ISAs: (Ref: Para. A66)
- (a) An overview of the type of work to be performed on the financial information of the components.
  - (b) An overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components.
  - (c) Instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work.

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<sup>12</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

- (d) Any limitations on the group audit, for example, where the group engagement team’s access to information may have been restricted.
- (e) Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where the fraud resulted in a material misstatement of the group financial statements.

### **Documentation**

50. The group engagement team shall include in the audit documentation the following matters:<sup>13</sup>
- (a) An analysis of components, indicating those that are significant, and the type of work performed on the financial information of the components.
  - (b) The nature, timing and extent of the group engagement team’s involvement in the work performed by the component auditors on significant components including, where applicable, the group engagement team’s review of relevant parts of the component auditors’ audit documentation and conclusions thereon.
  - (c) Written communications between the group engagement team and the component auditors about the group engagement team’s requirements.

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## **Application and Other Explanatory Material**

### **Components Subject to Audit by Statute, Regulation or Other Reason (Ref: Para. 3)**

- A1. Factors that may affect the group engagement team’s decision whether to use an audit required by statute, regulation or for another reason to provide audit evidence for the group audit include the following:
- Differences in the financial reporting framework applied in preparing the financial statements of the component and that applied in preparing the group financial statements.
  - Differences in the auditing and other standards applied by the component auditor and those applied in the audit of the group financial statements.
  - Whether the audit of the financial statements of the component will be completed in time to meet the group reporting timetable.

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<sup>13</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

## Definitions

### *Component* (Ref: Para. 9(a))

- A2. The structure of a group affects how components are identified. For example, the group financial reporting system may be based on an organizational structure that provides for financial information to be prepared by a parent and one or more subsidiaries, joint ventures, or investees accounted for by the equity or cost methods of accounting; by a head office and one or more divisions or branches; or by a combination of both. Some groups, however, may organize their financial reporting system by function, process, product or service (or by groups of products or services), or geographic locations. In these cases, the entity or business activity for which group or component management prepares financial information that is included in the group financial statements may be a function, process, product or service (or group of products or services), or geographic location.
- A3. Various levels of components may exist within the group financial reporting system, in which case it may be more appropriate to identify components at certain levels of aggregation rather than individually.
- A4. Components aggregated at a certain level may constitute a component for purposes of the group audit; however, such a component may also prepare group financial statements that incorporate the financial information of the components it encompasses (that is, a subgroup). This ISA may therefore be applied by different group engagement partners and teams for different subgroups within a larger group.

### *Significant Component* (Ref: Para. 9(m))

- A5. As the individual financial significance of a component increases, the risks of material misstatement of the group financial statements ordinarily increase. The group engagement team may apply a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. Identifying a benchmark and determining a percentage to be applied to it involve the exercise of professional judgment. Depending on the nature and circumstances of the group, appropriate benchmarks might include group assets, liabilities, cash flows, profit or turnover. For example, the group engagement team may consider that components exceeding 15% of the chosen benchmark are significant components. A higher or lower percentage may, however, be deemed appropriate in the circumstances.
- A6. The group engagement team may also identify a component as likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances (that is, risks that require special audit consideration<sup>14</sup>). For example, a component could be responsible for foreign

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<sup>14</sup> ISA 315 (Revised), paragraphs 27–29

exchange trading and thus expose the group to a significant risk of material misstatement, even though the component is not otherwise of individual financial significance to the group.

*Component Auditor* (Ref: Para. 9(b))

- A7. A member of the group engagement team may perform work on the financial information of a component for the group audit at the request of the group engagement team. Where this is the case, such a member of the engagement team is also a component auditor.

**Responsibility** (Ref: Para. 11)

- A8. Although component auditors may perform work on the financial information of the components for the group audit and as such are responsible for their overall findings, conclusions or opinions, the group engagement partner or the group engagement partner's firm is responsible for the group audit opinion.
- A9. When the group audit opinion is modified because the group engagement team was unable to obtain sufficient appropriate audit evidence in relation to the financial information of one or more components, the Basis for Modification paragraph in the auditor's report on the group financial statements describes the reasons for that inability without referring to the component auditor, unless such a reference is necessary for an adequate explanation of the circumstances.<sup>15</sup>

**Acceptance and Continuance**

*Obtaining an Understanding at the Acceptance or Continuance Stage* (Ref: Para. 12)

- A10. In the case of a new engagement, the group engagement team's understanding of the group, its components, and their environments may be obtained from:
- Information provided by group management;
  - Communication with group management; and
  - Where applicable, communication with the previous group engagement team, component management, or component auditors.
- A11. The group engagement team's understanding may include matters such as the following:
- The group structure, including both the legal and organizational structure (that is, how the group financial reporting system is organized).
  - Components' business activities that are significant to the group, including the industry and regulatory, economic and political environments in which those activities take place.
  - The use of service organizations, including shared service centers.

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<sup>15</sup> ISA 705 (Revised), paragraph 20

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- A description of group-wide controls.
- The complexity of the consolidation process.
- Whether component auditors that are not from the group engagement partner's firm or network will perform work on the financial information of any of the components, and group management's rationale for appointing more than one auditor.
- Whether the group engagement team:
  - Will have unrestricted access to those charged with governance of the group, group management, those charged with governance of the component, component management, component information, and the component auditors (including relevant audit documentation sought by the group engagement team); and
  - Will be able to perform necessary work on the financial information of the components.

A12. In the case of a continuing engagement, the group engagement team's ability to obtain sufficient appropriate audit evidence may be affected by significant changes, for example:

- Changes in the group structure (for example, acquisitions, disposals, reorganizations, or changes in how the group financial reporting system is organized).
- Changes in components' business activities that are significant to the group.
- Changes in the composition of those charged with governance of the group, group management, or key management of significant components.
- Concerns the group engagement team has with regard to the integrity and competence of group or component management.
- Changes in group-wide controls.
- Changes in the applicable financial reporting framework.

*Expectation to Obtain Sufficient Appropriate Audit Evidence* (Ref: Para. 13)

A13. A group may consist only of components not considered significant components. In these circumstances, the group engagement partner can reasonably expect to obtain sufficient appropriate audit evidence on which to base the group audit opinion if the group engagement team will be able to:

- (a) Perform the work on the financial information of some of these components; and
- (b) Be involved in the work performed by component auditors on the financial information of other components to the extent necessary to obtain sufficient appropriate audit evidence.

*Access to Information* (Ref: Para. 13)

- A14. The group engagement team's access to information may be restricted by circumstances that cannot be overcome by group management, for example, laws relating to confidentiality and data privacy, or denial by the component auditor of access to relevant audit documentation sought by the group engagement team. It may also be restricted by group management.
- A15. Where access to information is restricted by circumstances, the group engagement team may still be able to obtain sufficient appropriate audit evidence; however, this is less likely as the significance of the component increases. For example, the group engagement team may not have access to those charged with governance, management, or the auditor (including relevant audit documentation sought by the group engagement team) of a component that is accounted for by the equity method of accounting. If the component is not a significant component, and the group engagement team has a complete set of financial statements of the component, including the auditor's report thereon, and has access to information kept by group management in relation to that component, the group engagement team may conclude that this information constitutes sufficient appropriate audit evidence in relation to that component. If the component is a significant component, however, the group engagement team will not be able to comply with the requirements of this ISA relevant in the circumstances of the group audit. For example, the group engagement team will not be able to comply with the requirement in paragraphs 30–31 to be involved in the work of the component auditor. The group engagement team will not, therefore, be able to obtain sufficient appropriate audit evidence in relation to that component. The effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of ISA 705 (Revised).
- A16. The group engagement team will not be able to obtain sufficient appropriate audit evidence if group management restricts the access of the group engagement team or a component auditor to the information of a significant component.
- A17. Although the group engagement team may be able to obtain sufficient appropriate audit evidence if such restriction relates to a component considered not a significant component, the reason for the restriction may affect the group audit opinion. For example, it may affect the reliability of group management's responses to the group engagement team's inquiries and group management's representations to the group engagement team.
- A18. Law or regulation may prohibit the group engagement partner from declining or withdrawing from an engagement. For example, in some jurisdictions the auditor is appointed for a specified period of time and is prohibited from withdrawing before the end of that period. Also, in the public sector, the option of declining or withdrawing from an engagement may not be available to the auditor due to the nature of the mandate or public interest considerations. In these circumstances, this ISA still applies to the group audit, and the effect

of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of ISA 705 (Revised).

- A19. Appendix 1 contains an example of an auditor's report containing a qualified opinion based on the group engagement team's inability to obtain sufficient appropriate audit evidence in relation to a significant component accounted for by the equity method of accounting, but where, in the group engagement team's judgment, the effect is material but not pervasive.

*Terms of Engagement* (Ref: Para. 14)

- A20. The terms of engagement identify the applicable financial reporting framework.<sup>16</sup> Additional matters may be included in the terms of a group audit engagement, such as the fact that:

- The communication between the group engagement team and the component auditors should be unrestricted to the extent possible under law or regulation;
- Important communications between the component auditors, those charged with governance of the component, and component management, including communications on significant deficiencies in internal control, should be communicated as well to the group engagement team;
- Important communications between regulatory authorities and components related to financial reporting matters should be communicated to the group engagement team; and
- To the extent the group engagement team considers necessary, it should be permitted:
  - Access to component information, those charged with governance of components, component management, and the component auditors (including relevant audit documentation sought by the group engagement team); and
  - To perform work or request a component auditor to perform work on the financial information of the components.

- A21. Restrictions imposed on:

- the group engagement team's access to component information, those charged with governance of components, component management, or the component auditors (including relevant audit documentation sought by the group engagement team); or
- the work to be performed on the financial information of the components, after the group engagement partner's acceptance of the group audit engagement, constitute an inability to obtain sufficient appropriate audit evidence that may

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<sup>16</sup> ISA 210, paragraph 8

affect the group audit opinion. In exceptional circumstances it may even lead to withdrawal from the engagement where withdrawal is possible under applicable law or regulation.

### **Overall Audit Strategy and Audit Plan** (Ref: Para. 16)

A22. The group engagement partner's review of the overall group audit strategy and group audit plan is an important part of fulfilling the group engagement partner's responsibility for the direction of the group audit engagement.

### **Understanding the Group, Its Components, and Their Environments**

*Matters about Which the Group Engagement Team Obtains an Understanding*  
(Ref: Para. 17)

A23. ISA 315 (Revised) contains guidance on matters the auditor may consider when obtaining an understanding of the industry, regulatory, and other external factors that affect the entity, including the applicable financial reporting framework; the nature of the entity; objectives and strategies and related business risks; and measurement and review of the entity's financial performance.<sup>17</sup> Appendix 2 of this ISA contains guidance on matters specific to a group, including the consolidation process.

*Instructions Issued by Group Management to Components* (Ref: Para. 17)

A24. To achieve uniformity and comparability of financial information, group management ordinarily issues instructions to components. Such instructions specify the requirements for financial information of the components to be included in the group financial statements and often include financial reporting procedures manuals and a reporting package. A reporting package ordinarily consists of standard formats for providing financial information for incorporation in the group financial statements. Reporting packages generally do not, however, take the form of complete financial statements prepared and presented in accordance with the applicable financial reporting framework.

A25. The instructions ordinarily cover:

- The accounting policies to be applied;
- Statutory and other disclosure requirements applicable to the group financial statements, including:
  - The identification and reporting of segments;
  - Related party relationships and transactions;
  - Intra-group transactions and unrealized profits;
  - Intra-group account balances; and
- A reporting timetable.

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<sup>17</sup> ISA 315 (Revised), paragraphs A25–A49

A26. The group engagement team’s understanding of the instructions may include the following:

- The clarity and practicality of the instructions for completing the reporting package.
- Whether the instructions:
  - Adequately describe the characteristics of the applicable financial reporting framework;
  - Provide for disclosures that are sufficient to comply with the requirements of the applicable financial reporting framework, for example, disclosure of related party relationships and transactions, and segment information;
  - Provide for the identification of consolidation adjustments, for example, intra-group transactions and unrealized profits, and intra-group account balances; and
  - Provide for the approval of the financial information by component management.

*Fraud* (Ref: Para. 17)

A27. The auditor is required to identify and assess the risks of material misstatement of the financial statements due to fraud, and to design and implement appropriate responses to the assessed risks.<sup>18</sup> Information used to identify the risks of material misstatement of the group financial statements due to fraud may include the following:

- Group management’s assessment of the risks that the group financial statements may be materially misstated as a result of fraud.
- Group management’s process for identifying and responding to the risks of fraud in the group, including any specific fraud risks identified by group management, or account balances, classes of transactions, or A27 for which a risk of fraud is likely.
- Whether there are particular components for which a risk of fraud is likely.
- How those charged with governance of the group monitor group management’s processes for identifying and responding to the risks of fraud in the group, and the controls group management has established to mitigate these risks.
- Responses of those charged with governance of the group, group management, appropriate individuals within the internal audit function (and if considered appropriate, component management, the component auditors, and others) to the group engagement team’s inquiry whether

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<sup>18</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

they have knowledge of any actual, suspected, or alleged fraud affecting a component or the group.

*Discussion among Group Engagement Team Members and Component Auditors Regarding the Risks of Material Misstatement of the Group Financial Statements, Including Risks of Fraud (Ref: Para. 17)*

A28. The key members of the engagement team are required to discuss the susceptibility of an entity to material misstatement of the financial statements due to fraud or error, specifically emphasizing the risks due to fraud. In a group audit, these discussions may also include the component auditors.<sup>19</sup> The group engagement partner's determination of who to include in the discussions, how and when they occur, and their extent, is affected by factors such as prior experience with the group.

A29. The discussions provide an opportunity to:

- Share knowledge of the components and their environments, including group-wide controls.
- Exchange information about the business risks of the components or the group.
- Exchange ideas about how and where the group financial statements may be susceptible to material misstatement due to fraud or error, how group management and component management could perpetrate and conceal fraudulent financial reporting, and how assets of the components could be misappropriated.
- Identify practices followed by group or component management that may be biased or designed to manage earnings that could lead to fraudulent financial reporting, for example, revenue recognition practices that do not comply with the applicable financial reporting framework.
- Consider known external and internal factors affecting the group that may create an incentive or pressure for group management, component management, or others to commit fraud, provide the opportunity for fraud to be perpetrated, or indicate a culture or environment that enables group management, component management, or others to rationalize committing fraud.
- Consider the risk that group or component management may override controls.
- Consider whether uniform accounting policies are used to prepare the financial information of the components for the group financial

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<sup>19</sup> ISA 240, paragraph 16; ISA 315 (Revised), paragraph 10

statements and, where not, how differences in accounting policies are identified and adjusted (where required by the applicable financial reporting framework).

- Discuss fraud that has been identified in components, or information that indicates existence of a fraud in a component.
- Share information that may indicate non-compliance with national laws or regulations, for example, payments of bribes and improper transfer pricing practices.

*Risk Factors* (Ref: Para. 18)

A30. Appendix 3 sets out examples of conditions or events that, individually or together, may indicate risks of material misstatement of the group financial statements, including risks due to fraud.

*Risk Assessment* (Ref: Para. 18)

A31. The group engagement team's assessment at group level of the risks of material misstatement of the group financial statements is based on information such as the following:

- Information obtained from the understanding of the group, its components, and their environments, and of the consolidation process, including audit evidence obtained in evaluating the design and implementation of group-wide controls and controls that are relevant to the consolidation.
- Information obtained from the component auditors.

**Understanding the Component Auditor** (Ref: Para. 19)

A32. The group engagement team obtains an understanding of a component auditor only when it plans to request the component auditor to perform work on the financial information of a component for the group audit. For example, it will not be necessary to obtain an understanding of the auditors of those components for which the group engagement team plans to perform analytical procedures at group level only.

*Group Engagement Team's Procedures to Obtain an Understanding of the Component Auditor and Sources of Audit Evidence* (Ref: Para. 19)

A33. The nature, timing and extent of the group engagement team's procedures to obtain an understanding of the component auditor are affected by factors such as previous experience with or knowledge of the component auditor, and the degree to which the group engagement team and the component auditor are subject to common policies and procedures, for example:

- Whether the group engagement team and a component auditor share:
    - Common policies and procedures for performing the work (for example, audit methodologies);
    - Common quality control policies and procedures; or
    - Common monitoring policies and procedures.
  - The consistency or similarity of:
    - Laws and regulations or legal system;
    - Professional oversight, discipline, and external quality assurance;
    - Education and training;
    - Professional organizations and standards; or
    - Language and culture.
- A34. These factors interact and are not mutually exclusive. For example, the extent of the group engagement team’s procedures to obtain an understanding of Component Auditor A, who consistently applies common quality control and monitoring policies and procedures and a common audit methodology or operates in the same jurisdiction as the group engagement partner, may be less than the extent of the group engagement team’s procedures to obtain an understanding of Component Auditor B, who is not consistently applying common quality control and monitoring policies and procedures and a common audit methodology or operates in a foreign jurisdiction. The nature of the procedures performed in relation to Component Auditors A and B may also be different.
- A35. The group engagement team may obtain an understanding of the component auditor in a number of ways. In the first year of involving a component auditor, the group engagement team may, for example:
- Evaluate the results of the quality control monitoring system where the group engagement team and component auditor are from a firm or network that operates under and complies with common monitoring policies and procedures;<sup>20</sup>
  - Visit the component auditor to discuss the matters in paragraph 19(a)–(c);
  - Request the component auditor to confirm the matters referred to in paragraph 19(a)–(c) in writing. Appendix 4 contains an example of written confirmations by a component auditor;
  - Request the component auditor to complete questionnaires about the matters in paragraph 19(a)–(c);

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<sup>20</sup> As required by ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraph 54, or national requirements that are at least as demanding.

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- Discuss the component auditor with colleagues in the group engagement partner’s firm, or with a reputable third party that has knowledge of the component auditor; or
- Obtain confirmations from the professional body or bodies to which the component auditor belongs, the authorities by which the component auditor is licensed, or other third parties.

In subsequent years, the understanding of the component auditor may be based on the group engagement team’s previous experience with the component auditor. The group engagement team may request the component auditor to confirm whether anything in relation to the matters listed in paragraph 19(a)–(c) has changed since the previous year.

A36. Where independent oversight bodies have been established to oversee the auditing profession and monitor the quality of audits, awareness of the regulatory environment may assist the group engagement team in evaluating the independence and competence of the component auditor. Information about the regulatory environment may be obtained from the component auditor or information provided by the independent oversight bodies.

*Ethical Requirements that Are Relevant to the Group Audit* (Ref: Para. 19(a))

A37. When performing work on the financial information of a component for a group audit, the component auditor is subject to ethical requirements that are relevant to the group audit. Such requirements may be different or in addition to those applying to the component auditor when performing a statutory audit in the component auditor’s jurisdiction. The group engagement team therefore obtains an understanding whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit, sufficient to fulfill the component auditor’s responsibilities in the group audit.

*The Component Auditor’s Professional Competence* (Ref: Para. 19(b))

A38. The group engagement team’s understanding of the component auditor’s professional competence may include whether the component auditor:

- Possesses an understanding of auditing and other standards applicable to the group audit that is sufficient to fulfill the component auditor’s responsibilities in the group audit;
- Possesses the special skills (for example, industry specific knowledge) necessary to perform the work on the financial information of the particular component; and
- Where relevant, possesses an understanding of the applicable financial reporting framework that is sufficient to fulfill the component auditor’s responsibilities in the group audit (instructions issued by group management to components often describe the characteristics of the applicable financial reporting framework).

*Application of the Group Engagement Team's Understanding of a Component Auditor*  
(Ref: Para. 20)

- A39. The group engagement team cannot overcome the fact that a component auditor is not independent by being involved in the work of the component auditor or by performing additional risk assessment or further audit procedures on the financial information of the component.
- A40. However, the group engagement team may be able to overcome less than serious concerns about the component auditor's professional competency (for example, lack of industry specific knowledge), or the fact that the component auditor does not operate in an environment that actively oversees auditors, by being involved in the work of the component auditor or by performing additional risk assessment or further audit procedures on the financial information of the component.
- A41. Where law or regulation prohibits access to relevant parts of the audit documentation of the component auditor, the group engagement team may request the component auditor to overcome this by preparing a memorandum that covers the relevant information.

**Materiality** (Ref: Para. 21–23)

- A42. The auditor is required:<sup>21</sup>
- (a) When establishing the overall audit strategy, to determine:
    - (i) Materiality for the financial statements as a whole; and
    - (ii) If, in the specific circumstances of the entity, there are particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures; and
  - (b) To determine performance materiality.

In the context of a group audit, materiality is established for both the group financial statements as a whole, and for the financial information of the components. Materiality for the group financial statements as a whole is used when establishing the overall group audit strategy.

- A43. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality is set lower than materiality for the group financial statements as a whole. Different component materiality may be established for different

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<sup>21</sup> ISA 320, *Materiality in Planning and Performing an Audit*, paragraphs 10–11

components. Component materiality need not be an arithmetical portion of the materiality for the group financial statements as a whole and, consequently, the aggregate of component materiality for the different components may exceed the materiality for the group financial statements as a whole. Component materiality is used when establishing the overall audit strategy for a component.

- A44. Component materiality is determined for those components whose financial information will be audited or reviewed as part of the group audit in accordance with paragraphs 26, 27(a) and 29. Component materiality is used by the component auditor to evaluate whether uncorrected detected misstatements are material, individually or in the aggregate.
- A45. A threshold for misstatements is determined in addition to component materiality. Misstatements identified in the financial information of the component that are above the threshold for misstatements are communicated to the group engagement team.
- A46. In the case of an audit of the financial information of a component, the component auditor (or group engagement team) determines performance materiality at the component level. This is necessary to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial information of the component exceeds component materiality. In practice, the group engagement team may set component materiality at this lower level. Where this is the case, the component auditor uses component materiality for purposes of assessing the risks of material misstatement of the financial information of the component and to design further audit procedures in response to assessed risks as well as for evaluating whether detected misstatements are material individually or in the aggregate.

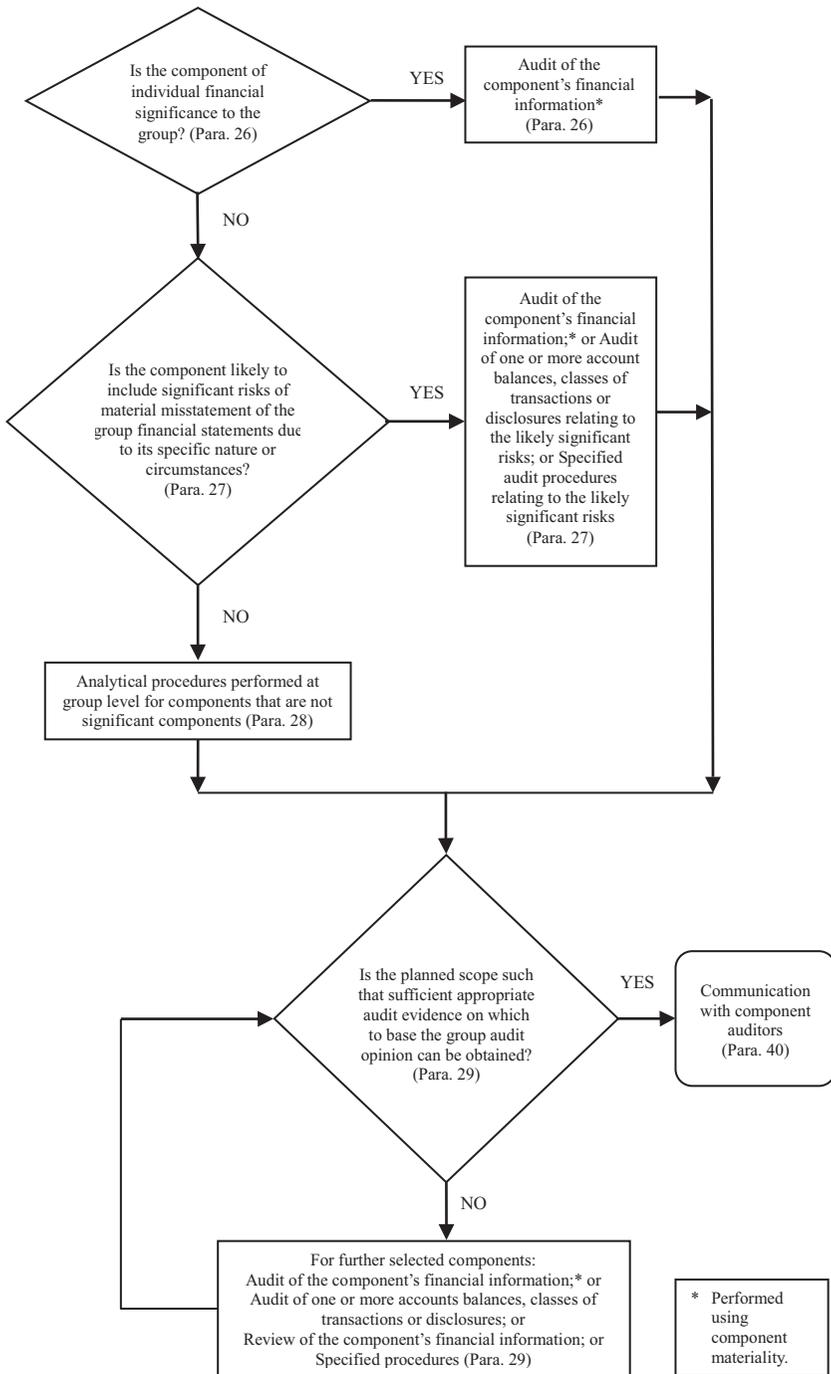
### **Responding to Assessed Risks**

#### *Determining the Type of Work to Be Performed on the Financial Information of Components (Ref: Para. 26–27)*

- A47. The group engagement team's determination of the type of work to be performed on the financial information of a component and its involvement in the work of the component auditor is affected by:
- (a) The significance of the component;
  - (b) The identified significant risks of material misstatement of the group financial statements;
  - (c) The group engagement team's evaluation of the design of group-wide controls and determination whether they have been implemented; and
  - (d) The group engagement team's understanding of the component auditor.

The diagram shows how the significance of the component affects the group engagement team's determination of the type of work to be performed on the financial information of the component.

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### Significant Components (Ref: Para. 27(b)–(c))

- A48. The group engagement team may identify a component as a significant component because that component is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances. In that case, the group engagement team may be able to identify the account balances, classes of transactions or disclosures affected by the likely significant risks. Where this is the case, the group engagement team may decide to perform, or request a component auditor to perform, an audit of only those account balances, classes of transactions or disclosures. For example, in the situation described in paragraph A6, the work on the financial information of the component may be limited to an audit of the account balances, classes of transactions and disclosures affected by the foreign exchange trading of that component. Where the group engagement team requests a component auditor to perform an audit of one or more specific account balances, classes of transactions or disclosures, the communication of the group engagement team (see paragraph 40) takes account of the fact that many financial statement items are interrelated.
- A49. The group engagement team may design audit procedures that respond to a likely significant risk of material misstatement of the group financial statements. For example, in the case of a likely significant risk of inventory obsolescence, the group engagement team may perform, or request a component auditor to perform, specified audit procedures on the valuation of inventory at a component that holds a large volume of potentially obsolete inventory, but that is not otherwise significant.

### Components that Are Not Significant Components (Ref: Para. 28–29)

- A50. Depending on the circumstances of the engagement, the financial information of the components may be aggregated at various levels for purposes of the analytical procedures. The results of the analytical procedures corroborate the group engagement team's conclusions that there are no significant risks of material misstatement of the aggregated financial information of components that are not significant components.
- A51. The group engagement team's decision as to how many components to select in accordance with paragraph 29, which components to select, and the type of work to be performed on the financial information of the individual components selected may be affected by factors such as the following:
- The extent of audit evidence expected to be obtained on the financial information of the significant components.
  - Whether the component has been newly formed or acquired.
  - Whether significant changes have taken place in the component.
  - Whether the internal audit function has performed work at the component and any effect of that work on the group audit.

- Whether the components apply common systems and processes.
- The operating effectiveness of group-wide controls.
- Abnormal fluctuations identified by analytical procedures performed at group level.
- The individual financial significance of, or the risk posed by, the component in comparison with other components within this category.
- Whether the component is subject to audit required by statute, regulation or for another reason.

Including an element of unpredictability in selecting components in this category may increase the likelihood of identifying material misstatement of the components' financial information. The selection of components is often varied on a cyclical basis.

- A52. A review of the financial information of a component may be performed in accordance with International Standard on Review Engagements (ISRE) 2400 (Revised)<sup>22</sup> or ISRE 2410,<sup>23</sup> adapted as necessary in the circumstances. The group engagement team may also specify additional procedures to supplement this work.
- A53. As explained in paragraph A13, a group may consist only of components that are not significant components. In these circumstances, the group engagement team can obtain sufficient appropriate audit evidence on which to base the group audit opinion by determining the type of work to be performed on the financial information of the components in accordance with paragraph 29. It is unlikely that the group engagement team will obtain sufficient appropriate audit evidence on which to base the group audit opinion if the group engagement team, or a component auditor, only tests group-wide controls and performs analytical procedures on the financial information of the components.

*Involvement in the Work Performed by Component Auditors* (Ref: Para. 30–31)

- A54. Factors that may affect the group engagement team's involvement in the work of the component auditor include:
- (a) The significance of the component;
  - (b) The identified significant risks of material misstatement of the group financial statements; and
  - (c) The group engagement team's understanding of the component auditor.

In the case of a significant component or identified significant risks, the group engagement team performs the procedures described in paragraphs 30–31. In the case of a component that is not a significant component, the nature, timing and

<sup>22</sup> ISRE 2400 (Revised), *Engagements to Review Historical Financial Statements*

<sup>23</sup> ISRE 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*

extent of the group engagement team's involvement in the work of the component auditor will vary based on the group engagement team's understanding of that component auditor. The fact that the component is not a significant component becomes secondary. For example, even though a component is not considered a significant component, the group engagement team nevertheless may decide to be involved in the component auditor's risk assessment, because it has less than serious concerns about the component auditor's professional competency (for example, lack of industry specific knowledge), or the component auditor does not operate in an environment that actively oversees auditors.

A55. Forms of involvement in the work of a component auditor other than those described in paragraphs 30–31 and 42 may, based on the group engagement team's understanding of the component auditor, include one or more of the following:

- (a) Meeting with component management or the component auditors to obtain an understanding of the component and its environment.
- (b) Reviewing the component auditors' overall audit strategy and audit plan.
- (c) Performing risk assessment procedures to identify and assess the risks of material misstatement at the component level. These may be performed with the component auditors, or by the group engagement team.
- (d) Designing and performing further audit procedures. These may be designed and performed with the component auditors, or by the group engagement team.
- (e) Participating in the closing and other key meetings between the component auditors and component management.
- (f) Reviewing other relevant parts of the component auditors' audit documentation.

## **Consolidation Process**

*Consolidation Adjustments and Reclassifications* (Ref: Para. 34)

A56. The consolidation process may require adjustments to amounts reported in the group financial statements that do not pass through the usual transaction processing systems, and may not be subject to the same internal controls to which other financial information is subject. The group engagement team's evaluation of the appropriateness, completeness and accuracy of the adjustments may include:

- Evaluating whether significant adjustments appropriately reflect the events and transactions underlying them;
- Determining whether significant adjustments have been correctly calculated, processed and authorized by group management and, where applicable, by component management;
- Determining whether significant adjustments are properly supported and sufficiently documented; and

- Checking the reconciliation and elimination of intra-group transactions and unrealized profits, and intra-group account balances.

### **Communication with the Component Auditor** (Ref: Para. 40–41)

- A57. If effective two-way communication between the group engagement team and the component auditors does not exist, there is a risk that the group engagement team may not obtain sufficient appropriate audit evidence on which to base the group audit opinion. Clear and timely communication of the group engagement team's requirements forms the basis of effective two-way communication between the group engagement team and the component auditor.
- A58. The group engagement team's requirements are often communicated in a letter of instruction. Appendix 5 contains guidance on required and additional matters that may be included in such a letter of instruction. The component auditor's communication with the group engagement team often takes the form of a memorandum or report of work performed. Communication between the group engagement team and the component auditor, however, may not necessarily be in writing. For example, the group engagement team may visit the component auditor to discuss identified significant risks or review relevant parts of the component auditor's audit documentation. Nevertheless, the documentation requirements of this and other ISAs apply.
- A59. In cooperating with the group engagement team, the component auditor, for example, would provide the group engagement team with access to relevant audit documentation if not prohibited by law or regulation.
- A60. Where a member of the group engagement team is also a component auditor, the objective for the group engagement team to communicate clearly with the component auditor can often be achieved by means other than specific written communication. For example:
- Access by the component auditor to the overall audit strategy and audit plan may be sufficient to communicate the group engagement team's requirements set out in paragraph 40; and
  - A review of the component auditor's audit documentation by the group engagement team may be sufficient to communicate matters relevant to the group engagement team's conclusion set out in paragraph 41.

### **Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained**

#### *Reviewing the Component Auditor's Audit Documentation* (Ref: Para. 42(b))

- A61. What parts of the audit documentation of the component auditor will be relevant to the group audit may vary depending on the circumstances. Often the focus is on audit documentation that is relevant to the significant risks of material misstatement of the group financial statements. The extent of the review may be affected by the fact that the component auditor's audit documentation has been subjected to the component auditor's firm's review procedures.

*Sufficiency and Appropriateness of Audit Evidence* (Ref: Para. 44–45)

- A62. If the group engagement team concludes that sufficient appropriate audit evidence on which to base the group audit opinion has not been obtained, the group engagement team may request the component auditor to perform additional procedures. If this is not feasible, the group engagement team may perform its own procedures on the financial information of the component.
- A63. The group engagement partner’s evaluation of the aggregate effect of any misstatements (either identified by the group engagement team or communicated by component auditors) allows the group engagement partner to determine whether the group financial statements as a whole are materially misstated.

**Communication with Group Management and Those Charged with Governance of the Group**

*Communication with Group Management* (Ref: Para. 46–48)

- A64. ISA 240 contains requirements and guidance on communication of fraud to management and, where management may be involved in the fraud, to those charged with governance.<sup>24</sup>
- A65. Group management may need to keep certain material sensitive information confidential. Examples of matters that may be significant to the financial statements of the component of which component management may be unaware include the following:
- Potential litigation.
  - Plans for abandonment of material operating assets.
  - Subsequent events.
  - Significant legal agreements.

*Communication with Those Charged with Governance of the Group* (Ref: Para. 49)

- A66. The matters the group engagement team communicates to those charged with governance of the group may include those brought to the attention of the group engagement team by component auditors that the group engagement team judges to be significant to the responsibilities of those charged with governance of the group. Communication with those charged with governance of the group takes place at various times during the group audit. For example, the matters referred to in paragraph 49(a)–(b) may be communicated after the group engagement team has determined the work to be performed on the financial information of the components. On the other hand, the matter referred to in paragraph 49(c) may be communicated at the end of the audit, and the matters referred to in paragraph 49(d)–(e) may be communicated when they occur.

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<sup>24</sup> ISA 240, paragraphs 41–43

## **Illustration of Independent Auditor’s Report Where the Group Engagement Team Is Not Able to Obtain Sufficient Appropriate Audit Evidence on Which to Base the Group Audit Opinion**

Note: Throughout this illustrative auditor’s report, the Opinion section has been positioned first in accordance with ISA 700 (Revised), and the Basis for Opinion section is positioned immediately after the Opinion section. Also, the first and last sentence that was included in the extant auditor’s responsibilities section is now subsumed as part of the new Basis for Opinion section.

**For purposes of this illustrative auditor’s report, the following circumstances are assumed:**

- **Audit of a complete set of consolidated financial statements of an entity other than a listed entity using a fair presentation framework. The audit is a group audit (i.e., ISA 600 applies).**
- **The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management’s responsibility for the consolidated financial statements in ISA 210.**
- **The group engagement team is unable to obtain sufficient appropriate audit evidence relating to a significant component accounted for by the equity method (recognized at \$15 million in the statement of financial position, which reflects total assets of \$60 million) because the group engagement team did not have access to the accounting records, management, or auditor of the component.**
- **The group engagement team has read the audited financial statements of the component as at December 31, 20X1, including the auditor’s report thereon, and considered related financial information kept by group management in relation to the component.**
- **In the group engagement partner’s judgment, the effect on the group financial statements of this inability to obtain sufficient appropriate audit evidence is material but not pervasive.<sup>1</sup>**
- **The International Ethics Standards Board for Accountants’ *International***

<sup>1</sup> If, in the group engagement partner’s judgment, the effect on the group financial statements of the inability to obtain sufficient appropriate audit evidence is material and pervasive, the group engagement partner would disclaim an opinion in accordance with ISA 705 (Revised).

***Code of Ethics for Professional Accountants (including International Independence Standards) (IESBA Code) comprises all of the relevant ethical requirements that apply to the audit.***

- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).<sup>2</sup>**
- **The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.<sup>3</sup>**
- **The auditor has obtained all of the other information prior to the date of the auditor's report and the qualified opinion on the consolidated financial statements also affects the other information.**
- **Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.**
- **In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law.**

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<sup>2</sup> ISA 570 (Revised), *Going Concern*

<sup>3</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

## INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Consolidated Financial Statements<sup>4</sup>

#### Qualified Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying consolidated financial statements present fairly, in all material respects (or give a true and fair view of), the consolidated financial position of the Group as at December 31, 20X1, and (of) their consolidated financial performance and consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Qualified Opinion

ABC Company’s investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at \$15 million on the consolidated statement of financial position as at December 31, 20X1, and ABC’s share of XYZ’s net income of \$1 million is included in the consolidated statement of comprehensive income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC’s investment in XYZ as at December 31, 20X1 and ABC’s share of XYZ’s net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code), and we have fulfilled our other ethical responsibilities in accordance with the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

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<sup>4</sup> The sub-title, “Report on the Audit of the Consolidated Financial Statements” is unnecessary in circumstances when the second sub-title, “Report on Other Legal and Regulatory Requirements” is not applicable.

**Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

*[Reporting in accordance with the reporting requirements in ISA 720 (Revised)<sup>5</sup> – see Illustration 6 in Appendix 2 of ISA 720 (Revised). The last paragraph of the other information section in Illustration 6 would be customized to describe the specific matter giving rise to the qualified opinion that also affects the other information.]*

**Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements<sup>6</sup>**

*[Reporting in accordance with ISA 700 (Revised)<sup>7</sup> – see Illustration 2 in ISA 700 (Revised).]*

**Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised). The last two paragraphs which are applicable for audits of listed entities only would not be included.]*

**Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

If, in the group engagement partner’s judgment, the effect on the group financial statements of the inability to obtain sufficient appropriate audit evidence is material and pervasive, the group engagement partner would disclaim an opinion in accordance with ISA 705 (Revised).

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<sup>5</sup> ISA 720 (Revised), *The Auditor’s Responsibilities Relating to Other Information*

<sup>6</sup> Throughout these illustrative auditor’s reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

<sup>7</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

## **Examples of Matters about Which the Group Engagement Team Obtains an Understanding**

The examples provided cover a broad range of matters; however, not all matters are relevant to every group audit engagement and the list of examples is not necessarily complete.

### **Group-Wide Controls**

1. Group-wide controls may include a combination of the following:
  - Regular meetings between group and component management to discuss business developments and to review performance.
  - Monitoring of components' operations and their financial results, including regular reporting routines, which enables group management to monitor components' performance against budgets, and to take appropriate action.
  - Group management's risk assessment process, that is, the process for identifying, analyzing and managing business risks, including the risk of fraud, that may result in material misstatement of the group financial statements.
  - Monitoring, controlling, reconciling, and eliminating intra-group transactions and unrealized profits, and intra-group account balances at group level.
  - A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components.
  - A central IT system controlled by the same general IT controls for all or part of the group.
  - Control activities within an IT system that is common for all or some components.
  - Monitoring of controls, including activities of the internal audit function and self-assessment programs.
  - Consistent policies and procedures, including a group financial reporting procedures manual.
  - Group-wide programs, such as codes of conduct and fraud prevention programs.
  - Arrangements for assigning authority and responsibility to component management.

2. The internal audit function may be regarded as part of group-wide controls, for example, when the function is centralized. ISA 610 (Revised 2013)<sup>1</sup> deals with the group engagement team's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately supports the objectivity of internal auditors, the level of competence of the internal audit function, and whether the function applies a systematic and disciplined approach where the group audit team expects to use the function's work.

#### Consolidation Process

3. The group engagement team's understanding of the consolidation process may include matters such as the following:

Matters relating to the applicable financial reporting framework:

- The extent to which component management has an understanding of the applicable financial reporting framework.
- The process for identifying and accounting for components in accordance with the applicable financial reporting framework.
- The process for identifying reportable segments for segment reporting in accordance with the applicable financial reporting framework.
- The process for identifying related party relationships and related party transactions for reporting in accordance with the applicable financial reporting framework.
- The accounting policies applied to the group financial statements, changes from those of the previous financial year, and changes resulting from new or revised standards under the applicable financial reporting framework.
- The procedures for dealing with components with financial year-ends different from the group's year-end.

Matters relating to the consolidation process:

- Group management's process for obtaining an understanding of the accounting policies used by components, and, where applicable, ensuring that uniform accounting policies are used to prepare the financial information of the components for the group financial statements, and that differences in accounting policies are identified, and adjusted where required in terms of the applicable financial reporting framework. Uniform accounting policies are the specific principles, bases, conventions, rules, and practices adopted by the group, based on the applicable financial reporting framework, that the components use to report similar transactions consistently. These policies are ordinarily

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<sup>1</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 15

described in the financial reporting procedures manual and reporting package issued by group management.

- Group management’s process for ensuring complete, accurate and timely financial reporting by the components for the consolidation.
- The process for translating the financial information of foreign components into the currency of the group financial statements.
- How IT is organized for the consolidation, including the manual and automated stages of the process, and the manual and programmed controls in place at various stages of the consolidation process.
- Group management’s process for obtaining information on subsequent events.

Matters relating to consolidation adjustments:

- The process for recording consolidation adjustments, including the preparation, authorization and processing of related journal entries, and the experience of personnel responsible for the consolidation.
- The consolidation adjustments required by the applicable financial reporting framework.
- Business rationale for the events and transactions that gave rise to the consolidation adjustments.
- Frequency, nature and size of transactions between components.
- Procedures for monitoring, controlling, reconciling and eliminating intra-group transactions and unrealized profits, and intra-group account balances.
- Steps taken to arrive at the fair value of acquired assets and liabilities, procedures for amortizing goodwill (where applicable), and impairment testing of goodwill, in accordance with the applicable financial reporting framework.
- Arrangements with a majority owner or minority interests regarding losses incurred by a component (for example, an obligation of the minority interest to make good such losses).

**Appendix 3**  
(Ref: Para. A30)

**Examples of Conditions or Events that May Indicate Risks of  
Material Misstatement of the Group Financial Statements**

The examples provided cover a broad range of conditions or events; however, not all conditions or events are relevant to every group audit engagement and the list of examples is not necessarily complete.

- A complex group structure, especially where there are frequent acquisitions, disposals or reorganizations.
- Poor corporate governance structures, including decision-making processes, that are not transparent.
- Non-existent or ineffective group-wide controls, including inadequate group management information on monitoring of components' operations and their results.
- Components operating in foreign jurisdictions that may be exposed to factors such as unusual government intervention in areas such as trade and fiscal policy, and restrictions on currency and dividend movements; and fluctuations in exchange rates.
- Business activities of components that involve high risk, such as long-term contracts or trading in innovative or complex financial instruments.
- Uncertainties regarding which components' financial information require incorporation in the group financial statements in accordance with the applicable financial reporting framework, for example, whether any special-purpose entities or non-trading entities exist and require incorporation.
- Unusual related party relationships and transactions.
- Prior occurrences of intra-group account balances that did not balance or reconcile on consolidation.
- The existence of complex transactions that are accounted for in more than one component.
- Components' application of accounting policies that differ from those applied to the group financial statements.
- Components with different financial year-ends, which may be utilized to manipulate the timing of transactions.
- Prior occurrences of unauthorized or incomplete consolidation adjustments.
- Aggressive tax planning within the group, or large cash transactions with entities in tax havens.
- Frequent changes of auditors engaged to audit the financial statements of components.

## Appendix 4

(Ref: Para. A35)

### Examples of a Component Auditor's Confirmations

The following is not intended to be a standard letter. Confirmations may vary from one component auditor to another and from one period to the next.

Confirmations often are obtained before work on the financial information of the component commences.

[Component Auditor Letterhead]

[Date]

[To Group Engagement Partner]

This letter is provided in connection with your audit of the group financial statements of [name of parent] for the year ended [date] for the purpose of expressing an opinion on whether the group financial statements present fairly, in all material respects (give a true and fair view of) the financial position of the group as at [date] and (of) its financial performance and cash flows for the year then ended in accordance with [indicate applicable financial reporting framework].

We acknowledge receipt of your instructions dated [date], requesting us to perform the specified work on the financial information of [name of component] for the year ended [date].

We confirm that:

1. We will be able to comply with the instructions. / We advise you that we will not be able to comply with the following instructions [specify instructions] for the following reasons [specify reasons].
2. The instructions are clear and we understand them. / We would appreciate it if you could clarify the following instructions [specify instructions].
3. We will cooperate with you and provide you with access to relevant audit documentation.

We acknowledge that:

1. The financial information of [name of component] will be included in the group financial statements of [name of parent].
2. You may consider it necessary to be involved in the work you have requested us to perform on the financial information of [name of component] for the year ended [date].
3. You intend to evaluate and, if considered appropriate, use our work for the audit of the group financial statements of [name of parent].

SPECIAL CONSIDERATIONS—AUDITS OF GROUP FINANCIAL STATEMENTS  
(INCLUDING THE WORK OF COMPONENT AUDITORS)

In connection with the work that we will perform on the financial information of [name of component], a [describe component, for example, wholly-owned subsidiary, subsidiary, joint venture, investee accounted for by the equity or cost methods of accounting] of [name of parent], we confirm the following:

1. We have an understanding of [indicate relevant ethical requirements] that is sufficient to fulfill our responsibilities in the audit of the group financial statements, and will comply therewith. In particular, and with respect to [name of parent] and the other components in the group, we are independent within the meaning of [indicate relevant ethical requirements] and comply with the applicable requirements of [refer to rules] promulgated by [name of regulatory agency].
2. We have an understanding of International Standards on Auditing and [indicate other national standards applicable to the audit of the group financial statements] that is sufficient to fulfill our responsibilities in the audit of the group financial statements and will conduct our work on the financial information of [name of component] for the year ended [date] in accordance with those standards.
3. We possess the special skills (for example, industry specific knowledge) necessary to perform the work on the financial information of the particular component.
4. We have an understanding of [indicate applicable financial reporting framework or group financial reporting procedures manual] that is sufficient to fulfill our responsibilities in the audit of the group financial statements.

We will inform you of any changes in the above representations during the course of our work on the financial information of [name of component].

[Auditor's signature]

[Date]

[Auditor's address]

## Required and Additional Matters Included in the Group Engagement Team’s Letter of Instruction

*Matters required by this ISA to be communicated to the component auditor are shown in italicized text.*

Matters that are relevant to the planning of the work of the component auditor:

- *A request for the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, to confirm that the component auditor will cooperate with the group engagement team.*
- The timetable for completing the audit.
- Dates of planned visits by group management and the group engagement team, and dates of planned meetings with component management and the component auditor.
- A list of key contacts.
- *The work to be performed by the component auditor; the use to be made of that work, and arrangements for coordinating efforts at the initial stage of and during the audit, including the group engagement team’s planned involvement in the work of the component auditor.*
- *The ethical requirements that are relevant to the group audit and, in particular, the independence requirements, for example, where the group auditor is prohibited by law or regulation from using internal auditors to provide direct assistance, it is relevant for the group auditor to consider whether the prohibition also extends to component auditors and, if so, to address this in the communication to the component auditors.<sup>1</sup>*
- *In the case of an audit or review of the financial information of the component, component materiality (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures), and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.*
- *A list of related parties prepared by group management, and any other related parties that the group engagement team is aware of, and a request that the component auditor communicates on a timely basis to the group engagement team related parties not previously identified by group management or the group engagement team.*

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<sup>1</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph A31

SPECIAL CONSIDERATIONS—AUDITS OF GROUP FINANCIAL STATEMENTS  
(INCLUDING THE WORK OF COMPONENT AUDITORS)

- Work to be performed on intra-group transactions and unrealized profits and intra-group account balances.
- Guidance on other statutory reporting responsibilities, for example, reporting on group management's assertion on the effectiveness of internal control.
- Where time lag between completion of the work on the financial information of the components and the group engagement team's conclusion on the group financial statements is likely, specific instructions for a subsequent events review.

Matters that are relevant to the conduct of the work of the component auditor:

- The findings of the group engagement team's tests of control activities of a processing system that is common for all or some components, and tests of controls to be performed by the component auditor.
- *Identified significant risks of material misstatement of the group financial statements, due to fraud or error; that are relevant to the work of the component auditor; and a request that the component auditor communicates on a timely basis any other significant risks of material misstatement of the group financial statements, due to fraud or error; identified in the component and the component auditor's response to such risks.*
- The findings of the internal audit function, based on work performed on controls at or relevant to components.
- A request for timely communication of audit evidence obtained from performing work on the financial information of the components that contradicts the audit evidence on which the group engagement team originally based the risk assessment performed at group level.
- A request for a written representation on component management's compliance with the applicable financial reporting framework, or a statement that differences between the accounting policies applied to the financial information of the component and those applied to the group financial statements have been disclosed.
- Matters to be documented by the component auditor.

Other information

- A request that the following be reported to the group engagement team on a timely basis:
  - Significant accounting, financial reporting and auditing matters, including accounting estimates and related judgments.
  - Matters relating to the going concern status of the component.
  - Matters relating to litigation and claims.

SPECIAL CONSIDERATIONS—AUDITS OF GROUP FINANCIAL STATEMENTS  
(INCLUDING THE WORK OF COMPONENT AUDITORS)

- Significant deficiencies in internal control that the component auditor has identified during the performance of the work on the financial information of the component, and information that indicates the existence of fraud.
- A request that the group engagement team be notified of any significant or unusual events as early as possible.
- *A request that the matters listed in paragraph 41 be communicated to the group engagement team when the work on the financial information of the component is completed.*

**INTERNATIONAL STANDARD ON AUDITING 610  
(REVISED 2013)**

**USING THE WORK OF INTERNAL AUDITORS**

(Effective for audits of financial statements for periods  
ending on or after December 15, 2014)

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International Standard on Auditing (ISA) 610 (Revised 2013), *Using the Work of Internal Auditors*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the external auditor's responsibilities if using the work of internal auditors. This includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.
2. This ISA does not apply if the entity does not have an internal audit function. (Ref: Para. A2)
3. If the entity has an internal audit function, the requirements in this ISA relating to using the work of that function do not apply if:
  - (a) The responsibilities and activities of the function are not relevant to the audit; or
  - (b) Based on the auditor's preliminary understanding of the function obtained as a result of procedures performed under ISA 315 (Revised),<sup>1</sup> the external auditor does not expect to use the work of the function in obtaining audit evidence.

Nothing in this ISA requires the external auditor to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor; it remains a decision of the external auditor in establishing the overall audit strategy.

4. Furthermore, the requirements in this ISA relating to direct assistance do not apply if the external auditor does not plan to use internal auditors to provide direct assistance.
5. In some jurisdictions, the external auditor may be prohibited, or restricted to some extent, by law or regulation from using the work of the internal audit function or using internal auditors to provide direct assistance. The ISA do not override laws or regulations that govern an audit of financial statements.<sup>2</sup> Such prohibitions or restrictions will therefore not prevent the external auditor from complying with the ISA. (Ref: Para. A31)

### Relationship between ISA 315 (Revised) and ISA 610 (Revised 2013)

6. Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities and its organizational status, including the function's authority and accountability, vary widely and depend on the

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<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A57

size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

7. ISA 315 (Revised) addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment and identification and assessment of risks of material misstatement. ISA 315 (Revised)<sup>3</sup> also explains how effective communication between the internal and external auditors also creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor's work.
8. Depending on whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competency of the internal audit function, and whether the function applies a systematic and disciplined approach, the external auditor may also be able to use the work of the internal audit function in a constructive and complementary manner. This ISA addresses the external auditor's responsibilities when, based on the external auditor's preliminary understanding of the internal audit function obtained as a result of procedures performed under ISA 315 (Revised), the external auditor expects to use the work of the internal audit function as part of the audit evidence obtained.<sup>4</sup> Such use of that work modifies the nature or timing, or reduces the extent, of audit procedures to be performed directly by the external auditor.
9. In addition, this ISA also addresses the external auditor's responsibilities if considering using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.
10. There may be individuals in an entity that perform procedures similar to those performed by an internal audit function. However, unless performed by an objective and competent function that applies a systematic and disciplined approach, including quality control, such procedures would be considered internal controls and obtaining evidence regarding the effectiveness of such controls would be part of the auditor's responses to assessed risks in accordance with ISA 330.<sup>5</sup>

### **The External Auditor's Responsibility for the Audit**

11. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement. Although they may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required

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<sup>3</sup> ISA 315 (Revised), paragraph A120

<sup>4</sup> See paragraphs 15–25.

<sup>5</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

of the external auditor in an audit of financial statements in accordance with ISA 200.<sup>6</sup> This ISA, therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.

### **Effective Date**

12. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2014.

### **Objectives**

13. The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, or to use internal auditors to provide direct assistance, are:

- (a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent;

and having made that determination:

- (b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and
- (c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

### **Definitions**

14. For purposes of the ISA, the following terms have the meanings attributed below:

- (a) Internal audit function – A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes. (Ref: Para. A1–A4)
- (b) Direct assistance – The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

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<sup>6</sup> ISA 200, paragraph 14

## Requirements

### Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

#### *Evaluating the Internal Audit Function*

15. The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:
  - (a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (Ref: Para. A5–A9)
  - (b) The level of competence of the internal audit function; and (Ref: Para. A5–A9)
  - (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control. (Ref: Para. A10–A11)
16. The external auditor shall not use the work of the internal audit function if the external auditor determines that:
  - (a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
  - (b) The function lacks sufficient competence; or
  - (c) The function does not apply a systematic and disciplined approach, including quality control. (Ref: Para. A12–A14)

#### *Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used*

17. As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan. (Ref: Para. A15–A17)
18. The external auditor shall make all significant judgments in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly: (Ref: Para. A15–A17)
  - (a) The more judgment is involved in:
    - (i) Planning and performing relevant audit procedures; and
    - (ii) Evaluating the audit evidence gathered; (Ref: Para. A18–A19)

- (b) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant; (Ref: Para. A20–A22)
  - (c) The less the internal audit function’s organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and
  - (d) The lower the level of competence of the internal audit function.
19. The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor’s sole responsibility for the audit opinion expressed. (Ref: Para. A15–A22)
20. The external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with ISA 260 (Revised),<sup>7</sup> communicate how the external auditor has planned to use the work of the internal audit function. (Ref: Para. A23)

### Using the Work of the Internal Audit Function

21. If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities. (Ref: Para. A24–A26)
22. The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.
23. The external auditor shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether:
- (a) The work of the function had been properly planned, performed, supervised, reviewed and documented;
  - (b) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and
  - (c) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed. (Ref: Para. A27–A30)

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<sup>7</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 15

24. The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:
- (a) The amount of judgment involved;
  - (b) The assessed risk of material misstatement;
  - (c) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; and
  - (d) The level of competence of the function;<sup>8</sup> (Ref: Para. A27–A29)
- and shall include reperformance of some of the work. (Ref: Para. A30)
25. The external auditor shall also evaluate whether the external auditor's conclusions regarding the internal audit function in paragraph 15 of this ISA and the determination of the nature and extent of use of the work of the function for purposes of the audit in paragraphs 18–19 of this ISA remain appropriate.

### **Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance**

#### *Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit*

26. The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. If so, paragraphs 27–35 and 37 do not apply. (Ref: Para. A31)
27. If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity. (Ref: Para. A32–A34)
28. The external auditor shall not use an internal auditor to provide direct assistance if:
- (a) There are significant threats to the objectivity of the internal auditor; or
  - (b) The internal auditor lacks sufficient competence to perform the proposed work. (Ref: Para. A32–A34)

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<sup>8</sup> See paragraph 18.

*Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance*

29. In determining the nature and extent of work that may be assigned to internal auditors and the nature, timing and extent of direction, supervision and review that is appropriate in the circumstances, the external auditor shall consider:
- (a) The amount of judgment involved in:
    - (i) Planning and performing relevant audit procedures; and
    - (ii) Evaluating the audit evidence gathered;
  - (b) The assessed risk of material misstatement; and
  - (c) The external auditor's evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance. (Ref: Para. A35–A39)
30. The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:
- (a) Involve making significant judgments in the audit; (Ref: Para. A19)
  - (b) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited; (Ref: Para. A38)
  - (c) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
  - (d) Relate to decisions the external auditor makes in accordance with this ISA regarding the internal audit function and the use of its work or direct assistance. (Ref: Para. A35–A39)
31. Having appropriately evaluated whether and, if so, to what extent internal auditors can be used to provide direct assistance on the audit, the external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with ISA 260 (Revised),<sup>9</sup> communicate the nature and extent of the planned use of internal auditors to provide direct assistance so as to reach a mutual understanding that such use is not excessive in the circumstances of the engagement. (Ref: Para. A39)
32. The external auditor shall evaluate whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

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<sup>9</sup> ISA 260 (Revised), paragraph 15

**Using Internal Auditors to Provide Direct Assistance**

33. Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:
- (a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
  - (b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.
34. The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with ISA 220.<sup>10</sup> In so doing:
- (a) The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the factors in paragraph 29 of this ISA; and
  - (b) The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.
- The direction, supervision and review by the external auditor of the work performed by the internal auditors shall be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work. (Ref: Para. A40–A41)
35. In directing, supervising and reviewing the work performed by internal auditors, the external auditor shall remain alert for indications that the external auditor's evaluations in paragraph 27 are no longer appropriate.

**Documentation**

36. If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:
- (a) The evaluation of:
    - (i) Whether the function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors;
    - (ii) The level of competence of the function; and

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<sup>10</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

- (iii) Whether the function applies a systematic and disciplined approach, including quality control;
- (b) The nature and extent of the work used and the basis for that decision; and
- (c) The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

37. If the external auditor uses internal auditors to provide direct assistance on the audit, the external auditor shall include in the audit documentation:

- (a) The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;
- (b) The basis for the decision regarding the nature and extent of the work performed by the internal auditors;
- (c) Who reviewed the work performed and the date and extent of that review in accordance with ISA 230;<sup>11</sup>
- (d) The written agreements obtained from an authorized representative of the entity and the internal auditors under paragraph 33 of this ISA; and
- (e) The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

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## Application and Other Explanatory Material

### Definition of Internal Audit Function (Ref: Para. 2, 14(a))

A1. The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

#### *Activities Relating to Governance*

- The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

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<sup>11</sup> ISA 230, *Audit Documentation*

*Activities Relating to Risk Management*

- The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).
- The internal audit function may perform procedures to assist the entity in the detection of fraud.

*Activities Relating to Internal Control*

- Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.
  - Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
  - Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.
  - Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.
- A2. Activities similar to those performed by an internal audit function may be conducted by functions with other titles within an entity. Some or all of the activities of an internal audit function may also be outsourced to a third-party service provider. Neither the title of the function, nor whether it is performed by the entity or a third-party service provider, are sole determinants of whether or not the external auditor can use the work of the function. Rather, it is the nature of the activities; the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; competence; and systematic and disciplined approach of the function that are relevant. References in this ISA to the work of the internal audit function include relevant activities of other functions or third-party providers that have these characteristics.

- A3. In addition, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this ISA, although they may perform control activities that can be tested in accordance with ISA 330.<sup>12</sup> For this reason, monitoring controls performed by an owner-manager would not be considered equivalent to an internal audit function.
- A4. While the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:
- To obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud. In this regard, ISA 315 (Revised)<sup>13</sup> requires the external auditor to obtain an understanding of the nature of the internal audit function's responsibilities, its status within the organization, and the activities performed, or to be performed, and make inquiries of appropriate individuals within the internal audit function (if the entity has such a function); or
  - Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor.<sup>14</sup>

In addition, unless prohibited, or restricted to some extent, by law or regulation, the external auditor may use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (referred to as "direct assistance" in this ISA).<sup>15</sup>

## **Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used**

### *Evaluating the Internal Audit Function*

Objectivity and Competence (Ref: Para. 15(a)–(b))

- A5. The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for purposes of the audit,

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<sup>12</sup> See paragraph 10.

<sup>13</sup> ISA 315 (Revised), paragraph 6(a)

<sup>14</sup> See paragraphs 15–25.

<sup>15</sup> See paragraphs 26–35.

and the nature and extent to which the work of the internal audit function can be used in the circumstances.

- A6. The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important in determining whether to use and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.
- A7. Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments. Factors that may affect the external auditor's evaluation include the following:
- Whether the organizational status of the internal audit function, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgments. For example, whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.
  - Whether the internal audit function is free of any conflicting responsibilities, for example, having managerial or operational duties or responsibilities that are outside of the internal audit function.
  - Whether those charged with governance oversee employment decisions related to the internal audit function, for example, determining the appropriate remuneration policy.
  - Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance, for example, in communicating the internal audit function's findings to the external auditor.
  - Whether the internal auditors are members of relevant professional bodies and their memberships obligate their compliance with relevant professional standards relating to objectivity, or whether their internal policies achieve the same objectives.
- A8. Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards. Factors that may affect the external auditor's determination include the following:
- Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.

- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
- Whether the internal auditors have adequate technical training and proficiency in auditing. Relevant criteria that may be considered by the external auditor in making the assessment may include, for example, the internal auditors' possession of a relevant professional designation and experience.
- Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework and whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's financial statements.
- Whether the internal auditors are members of relevant professional bodies that oblige them to comply with the relevant professional standards including continuing professional development requirements.

A9. Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.

Application of a Systematic and Disciplined Approach (Ref: Para. 15(c))

A10. The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.

A11. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

- The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
- Whether the internal audit function has appropriate quality control policies and procedures, for example, such as those policies and

procedures in ISQC 1<sup>16</sup> that would be applicable to an internal audit function (such as those relating to leadership, human resources and engagement performance) or quality control requirements in standards set by the relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements such as conducting periodic external quality assessments.

Circumstances When Work of the Internal Audit Function Cannot Be Used (Ref: Para. 16)

- A12. The external auditor's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a systematic and disciplined approach may indicate that the risks to the quality of the work of the function are too significant and therefore it is not appropriate to use any of the work of the function as audit evidence.
- A13. Consideration of the factors in paragraphs A7, A8 and A11 of this ISA individually and in aggregate is important because an individual factor is often not sufficient to conclude that the work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function's organizational status is particularly important in evaluating threats to the objectivity of the internal auditors. If the internal audit function reports to management, this would be considered a significant threat to the function's objectivity unless other factors such as those described in paragraph A7 of this ISA collectively provide sufficient safeguards to reduce the threat to an acceptable level.
- A14. In addition, the IESBA Code<sup>17</sup> states that a self-review threat is created when the external auditor accepts an engagement to provide internal audit services to an audit client, and the results of those services will be used in conducting the audit. This is because of the possibility that the engagement team will use the results of the internal audit service without properly evaluating those results or without exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm. The IESBA Code<sup>18</sup> discusses the prohibitions that apply in certain circumstances and the safeguards that can be applied to reduce the threats to an acceptable level in other circumstances.

<sup>16</sup> International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

<sup>17</sup> The International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code), paragraphs 605.4 A2–605.4 A3

<sup>18</sup> IESBA Code, paragraphs 605.1–R605.5

*Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used*

Factors Affecting the Determination of the Nature and Extent of the Work of the Internal Audit Function that Can Be Used (Ref: Para. 17–19)

A15. Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established in accordance with ISA 300.<sup>19</sup>

A16. Examples of work of the internal audit function that can be used by the external auditor include the following:

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.
- Tracing transactions through the information system relevant to financial reporting.
- Testing of compliance with regulatory requirements.
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of ISA 600).<sup>20</sup>

A17. The external auditor’s determination of the planned nature and extent of use of the work of the internal audit function will be influenced by the external auditor’s evaluation of the extent to which the internal audit function’s organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the level of competence of the internal audit function in paragraph 18 of this ISA. In addition, the amount of judgment needed in planning, performing and evaluating such work and the assessed risk of material misstatement at the assertion level are inputs to the external auditor’s determination. Further, there are circumstances in which the external auditor cannot use the work of the internal audit function for purpose of the audit as described in paragraph 16 of this ISA.

Judgments in planning and performing audit procedures and evaluating results (Ref: Para. 18(a), 30(a))

A18. The greater the judgment needed to be exercised in planning and performing the audit procedures and evaluating the audit evidence, the external auditor will

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<sup>19</sup> ISA 300, *Planning an Audit of Financial Statements*

<sup>20</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

need to perform more procedures directly in accordance with paragraph 18 of this ISA, because using the work of the internal audit function alone will not provide the external auditor with sufficient appropriate audit evidence.

- A19. Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement in accordance with paragraph 18. Significant judgments include the following:
- Assessing the risks of material misstatement;
  - Evaluating the sufficiency of tests performed;
  - Evaluating the appropriateness of management's use of the going concern assumption;
  - Evaluating significant accounting estimates; and
  - Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

Assessed risk of material misstatement (Ref: Para. 18(b))

- A20. For a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly in accordance with paragraph 18 of this ISA, and accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in ISA 200,<sup>21</sup> the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly.
- A21. As explained in ISA 315 (Revised),<sup>22</sup> significant risks require special audit consideration and therefore the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, where the risks of material misstatement is other than low, the use of the work of the internal audit function alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.
- A22. Carrying out procedures in accordance with this ISA may cause the external auditor to reevaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of whether to use the work of the internal audit function and whether further application of this ISA is necessary.

<sup>21</sup> ISA 200, paragraph A31

<sup>22</sup> ISA 315 (Revised), paragraph 4(e)

Communication with Those Charged with Governance (Ref: Para. 20)

A23. In accordance with ISA 260 (Revised),<sup>23</sup> the external auditor is required to communicate with those charged with governance an overview of the planned scope and timing of the audit. The planned use of the work of the internal audit function is an integral part of the external auditor's overall audit strategy and is therefore relevant to those charged with governance for their understanding of the proposed audit approach.

### Using the Work of the Internal Audit Function

*Discussion and Coordination with the Internal Audit Function* (Ref: Para. 21)

A24. In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

- The timing of such work.
- The nature of the work performed.
- The extent of audit coverage.
- Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
- Proposed methods of item selection and sample sizes.
- Documentation of the work performed.
- Review and reporting procedures.

A25. Coordination between the external auditor and the internal audit function is effective when, for example:

- Discussions take place at appropriate intervals throughout the period.
- The external auditor informs the internal audit function of significant matters that may affect the function.
- The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

A26. ISA 200<sup>24</sup> discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to

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<sup>23</sup> ISA 260 (Revised), paragraph 15

<sup>24</sup> ISA 200, paragraphs 15 and A20

be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters that may affect the work of the external auditor to the external auditor's attention.<sup>25</sup> The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. In addition, if such information may be indicative of a heightened risk of a material misstatement of the financial statements or may be regarding any actual, suspected or alleged fraud, the external auditor can take this into account in the external auditor's identification of risk of material misstatement due to fraud in accordance with ISA 240.<sup>26</sup>

*Procedures to Determine the Adequacy of Work of the Internal Audit Function*  
(Ref: Para. 23–24)

- A27. The external auditor's audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use provide a basis for evaluating the overall quality of the function's work and the objectivity with which it has been performed.
- A28. The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function, in addition to reperformance in accordance with paragraph 24, include the following:
- Making inquiries of appropriate individuals within the internal audit function.
  - Observing procedures performed by the internal audit function.
  - Reviewing the internal audit function's work program and working papers.
- A29. The more judgment involved, the higher the assessed risk of material misstatement, the less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, or the lower the level of competence of the internal audit function, the more audit procedures are needed to be performed by the external auditor on the overall body of work of the function to support the decision to use the work of the function in obtaining sufficient appropriate audit evidence on which to base the audit opinion.

Reperformance (Ref: Para. 24)

- A30. For purposes of this ISA, reperformance involves the external auditor's independent execution of procedures to validate the conclusions reached by the internal audit function. This objective may be accomplished by examining items already examined by the internal audit function or, where it is not possible

<sup>25</sup> ISA 315 (Revised), paragraph A120

<sup>26</sup> ISA 315 (Revised), paragraph A11 in relation to ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

to do so, the same objective may also be accomplished by examining sufficient other similar items not actually examined by the internal audit function. Reperformance provides more persuasive evidence regarding the adequacy of the work of the internal audit function compared to other procedures the external auditor may perform in paragraph A28. While it is not necessary for the external auditor to do reperformance in each area of work of the internal audit function that is being used, some reperformance is required on the body of work of the internal audit function as a whole that the external auditor plans to use in accordance with paragraph 24. The external auditor is more likely to focus reperformance in those areas where more judgment was exercised by the internal audit function in planning, performing and evaluating the results of the audit procedures and in areas of higher risk of material misstatement.

### **Determining Whether, in Which Areas and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance**

*Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit* (Ref: Para. 5, 26–28)

- A31. In jurisdictions where the external auditor is prohibited by law or regulation from using internal auditors to provide direct assistance, it is relevant for the group auditors to consider whether the prohibition also extends to component auditors and, if so, to address this in the communication to the component auditors.<sup>27</sup>
- A32. As stated in paragraph A7 of this ISA, objectivity refers to the ability to perform the proposed work without allowing bias, conflict of interest or undue influence of others to override professional judgments. In evaluating the existence and significance of threats to the objectivity of an internal auditor, the following factors may be relevant:
- The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors.<sup>28</sup>
  - Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates.
  - Association with the division or department in the entity to which the work relates.
  - Significant financial interests in the entity other than remuneration on terms consistent with those applicable to other employees at a similar level of seniority.

Material issued by relevant professional bodies for internal auditors may provide additional useful guidance.

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<sup>27</sup> ISA 600, paragraph 40(b)

<sup>28</sup> See paragraph A7.

- A33. There may also be some circumstances in which the significance of the threats to the objectivity of an internal auditor is such that there are no safeguards that could reduce them to an acceptable level. For example, because the adequacy of safeguards is influenced by the significance of the work in the context of the audit, paragraph 30 (a) and (b) prohibits the use of internal auditors to provide direct assistance in relation to performing procedures that involve making significant judgments in the audit or that relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited. This would also be the case where the work involved creates a self-review threat, which is why internal auditors are prohibited from performing procedures in the circumstances described in paragraph 30 (c) and (d).
- A34. In evaluating the level of competence of an internal auditor, many of the factors in paragraph A8 of this ISA may also be relevant, applied in the context of individual internal auditors and the work to which they may be assigned.

*Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance* (Ref: Para. 29–31)

- A35. Paragraphs A15–A22 of this ISA provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors.
- A36. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned. Examples of activities and tasks that would not be appropriate to use internal auditors to provide direct assistance include the following:
- Discussion of fraud risks. However, the external auditors may make inquiries of internal auditors about fraud risks in the organization in accordance with ISA 315 (Revised).<sup>29</sup>
  - Determination of unannounced audit procedures as addressed in ISA 240.
- A37. Similarly, since in accordance with ISA 505<sup>30</sup> the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors. However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.
- A38. The amount of judgment involved and the risk of material misstatement are also relevant in determining the work that may be assigned to internal auditors providing direct assistance. For example, in circumstances where the valuation

<sup>29</sup> ISA 315 (Revised), paragraph 6(a)

<sup>30</sup> ISA 505, *External Confirmations*, paragraphs 7 and 16

of accounts receivable is assessed as an area of higher risk, the external auditor could assign the checking of the accuracy of the aging to an internal auditor providing direct assistance. However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to an internal auditor providing direct assistance.

- A39. Notwithstanding the direction, supervision and review by the external auditor, excessive use of internal auditors to provide direct assistance may affect perceptions regarding the independence of the external audit engagement.

**Using Internal Auditors to Provide Direct Assistance (Ref: Para. 34)**

- A40. As individuals in the internal audit function are not independent of the entity as is required of the external auditor when expressing an opinion on financial statements, the external auditor's direction, supervision and review of the work performed by internal auditors providing direct assistance will generally be of a different nature and more extensive than if members of the engagement team perform the work.
- A41. In directing the internal auditors, the external auditor may, for example, remind the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditor. In reviewing the work performed by the internal auditors, the external auditor's considerations include whether the evidence obtained is sufficient and appropriate in the circumstances, and that it supports the conclusions reached.

# INTERNATIONAL STANDARD ON AUDITING 620 USING THE WORK OF AN AUDITOR'S EXPERT

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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Appendix: Considerations for Agreement between the Auditor and  
an Auditor's External Expert

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International Standard on Auditing (ISA) 620, *Using the Work of an Auditor's Expert*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to the work of an individual or organization in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.
2. This ISA does not deal with:
  - (a) Situations where the engagement team includes a member, or consults an individual or organization, with expertise in a specialized area of accounting or auditing, which are dealt with in ISA 220;<sup>1</sup> or
  - (b) The auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (a management's expert), which is dealt with in ISA 500.<sup>2</sup>

### The Auditor's Responsibility for the Audit Opinion

3. The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert. Nonetheless, if the auditor using the work of an auditor's expert, having followed this ISA, concludes that the work of that expert is adequate for the auditor's purposes, the auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence.

### Effective Date

4. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objectives

5. The objectives of the auditor are:
  - (a) To determine whether to use the work of an auditor's expert; and
  - (b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.

### Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:

<sup>1</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraphs A11, A21–A23

<sup>2</sup> ISA 500, *Audit Evidence*, paragraphs A45–A59

- (a) Auditor's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner<sup>3</sup> or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert. (Ref: Para. A1–A3)
- (b) Expertise – Skills, knowledge and experience in a particular field.
- (c) Management's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

## Requirements

### Determining the Need for an Auditor's Expert

- 7. If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert. (Ref: Para. A4–A9)

### Nature, Timing and Extent of Audit Procedures

- 8. The nature, timing and extent of the auditor's procedures with respect to the requirements in paragraphs 9–13 of this ISA will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including: (Ref: Para. A10)
  - (a) The nature of the matter to which that expert's work relates;
  - (b) The risks of material misstatement in the matter to which that expert's work relates;
  - (c) The significance of that expert's work in the context of the audit;
  - (d) The auditor's knowledge of and experience with previous work performed by that expert; and
  - (e) Whether that expert is subject to the auditor's firm's quality control policies and procedures. (Ref: Para. A11–A13)

### The Competence, Capabilities and Objectivity of the Auditor's Expert

- 9. The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity. (Ref: Para. A14–A20)

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<sup>3</sup> "Partner" and "firm" should be read as referring to their public sector equivalents where relevant.

**Obtaining an Understanding of the Field of Expertise of the Auditor's Expert**

10. The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to: (Ref: Para. A21–A22)
  - (a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and
  - (b) Evaluate the adequacy of that work for the auditor's purposes.

**Agreement with the Auditor's Expert**

11. The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert: (Ref: Para. A23–A26)
  - (a) The nature, scope and objectives of that expert's work; (Ref: Para. A27)
  - (b) The respective roles and responsibilities of the auditor and that expert; (Ref: Para. A28–A29)
  - (c) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and (Ref: Para. A30)
  - (d) The need for the auditor's expert to observe confidentiality requirements. (Ref: Para. A31)

**Evaluating the Adequacy of the Auditor's Expert's Work**

12. The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including: (Ref: Para. A32)
  - (a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; (Ref: Para. A33–A34)
  - (b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and (Ref: Para. A35–A37)
  - (c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data. (Ref: Para. A38–A39)
13. If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall: (Ref: Para. A40)
  - (a) Agree with that expert on the nature and extent of further work to be performed by that expert; or
  - (b) Perform additional audit procedures appropriate to the circumstances.

### Reference to the Auditor's Expert in the Auditor's Report

14. The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the auditor's opinion. (Ref: Para. A41)
15. If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion. (Ref: Para. A42)

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### Application and Other Explanatory Material

#### Definition of an Auditor's Expert (Ref: Para. 6(a))

- A1. Expertise in a field other than accounting or auditing may include expertise in relation to such matters as:
  - The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
  - The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
  - The estimation of oil and gas reserves.
  - The valuation of environmental liabilities, and site clean-up costs.
  - The interpretation of contracts, laws and regulations.
  - The analysis of complex or unusual tax compliance issues.
- A2. In many cases, distinguishing between expertise in accounting or auditing, and expertise in another field, will be straightforward, even where this involves a specialized area of accounting or auditing. For example, an individual with expertise in applying methods of accounting for deferred income tax can often be easily distinguished from an expert in taxation law. The former is not an expert for the purposes of this ISA as this constitutes accounting expertise; the latter is an expert for the purposes of this ISA as this constitutes legal expertise. Similar distinctions may also be able to be made in other areas, for example, between expertise in methods of accounting for financial instruments, and expertise in complex modeling for the purpose of valuing financial instruments. In some cases, however, particularly those involving an emerging area of accounting

or auditing expertise, distinguishing between specialized areas of accounting or auditing, and expertise in another field, will be a matter of professional judgment. Applicable professional rules and standards regarding education and competency requirements for accountants and auditors may assist the auditor in exercising that judgment.<sup>4</sup>

- A3. It is necessary to apply judgment when considering how the requirements of this ISA are affected by the fact that an auditor's expert may be either an individual or an organization. For example, when evaluating the competence, capabilities and objectivity of an auditor's expert, it may be that the expert is an organization the auditor has previously used, but the auditor has no prior experience of the individual expert assigned by the organization for the particular engagement; or it may be the reverse, that is, the auditor may be familiar with the work of an individual expert but not with the organization that expert has joined. In either case, both the personal attributes of the individual and the managerial attributes of the organization (such as systems of quality control the organization implements) may be relevant to the auditor's evaluation.

#### **Determining the Need for an Auditor's Expert (Ref: Para. 7)**

- A4. An auditor's expert may be needed to assist the auditor in one or more of the following:
- Obtaining an understanding of the entity and its environment, including its internal control.
  - Identifying and assessing the risks of material misstatement.
  - Determining and implementing overall responses to assessed risks at the financial statement level.
  - Designing and performing further audit procedures to respond to assessed risks at the assertion level, comprising tests of controls or substantive procedures.
  - Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements.
- A5. The risks of material misstatement may increase when expertise in a field other than accounting is needed for management to prepare the financial statements, for example, because this may indicate some complexity, or because management may not possess knowledge of the field of expertise. If in preparing the financial statements management does not possess the necessary expertise, a management's expert may be used in addressing those risks. Relevant controls, including controls that relate to the work of a management's expert, if any, may also reduce the risks of material misstatement.

<sup>4</sup> For example, International Education Standard 8, *Competence Requirements for Audit Professionals*, may be of assistance.

- A6. If the preparation of the financial statements involves the use of expertise in a field other than accounting, the auditor, who is skilled in accounting and auditing, may not possess the necessary expertise to audit those financial statements. The engagement partner is required to be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement.<sup>5</sup> Further, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the engagement.<sup>6</sup> The auditor's determination of whether to use the work of an auditor's expert, and if so when and to what extent, assists the auditor in meeting these requirements. As the audit progresses, or as circumstances change, the auditor may need to revise earlier decisions about using the work of an auditor's expert.
- A7. An auditor who is not an expert in a relevant field other than accounting or auditing may nevertheless be able to obtain a sufficient understanding of that field to perform the audit without an auditor's expert. This understanding may be obtained through, for example:
- Experience in auditing entities that require such expertise in the preparation of their financial statements.
  - Education or professional development in the particular field. This may include formal courses, or discussion with individuals possessing expertise in the relevant field for the purpose of enhancing the auditor's own capacity to deal with matters in that field. Such discussion differs from consultation with an auditor's expert regarding a specific set of circumstances encountered on the engagement where that expert is given all the relevant facts that will enable the expert to provide informed advice about the particular matter.<sup>7</sup>
  - Discussion with auditors who have performed similar engagements.
- A8. In other cases, however, the auditor may determine that it is necessary, or may choose, to use an auditor's expert to assist in obtaining sufficient appropriate audit evidence. Considerations when deciding whether to use an auditor's expert may include:
- Whether management has used a management's expert in preparing the financial statements (see paragraph A9).
  - The nature and significance of the matter, including its complexity.
  - The risks of material misstatement in the matter.
  - The expected nature of procedures to respond to identified risks, including: the auditor's knowledge of and experience with the work of

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<sup>5</sup> ISA 220, paragraph 14

<sup>6</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraph 8(e)

<sup>7</sup> ISA 220, paragraph A22

experts in relation to such matters; and the availability of alternative sources of audit evidence.

A9. When management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- The management's expert's competence and capabilities.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements
- Any controls within the entity over the management's expert's work.

ISA 500<sup>8</sup> includes requirements and guidance regarding the effect of the competence, capabilities and objectivity of management's experts on the reliability of audit evidence.

#### **Nature, Timing and Extent of Audit Procedures** (Ref: Para. 8)

A10. The nature, timing and extent of audit procedures with respect to the requirements in paragraphs 9–13 of this ISA will vary depending on the circumstances. For example, the following factors may suggest the need for different or more extensive procedures than would otherwise be the case:

- The work of the auditor's expert relates to a significant matter that involves subjective and complex judgments.
- The auditor has not previously used the work of the auditor's expert, and has no prior knowledge of that expert's competence, capabilities and objectivity.
- The auditor's expert is performing procedures that are integral to the audit, rather than being consulted to provide advice on an individual matter.
- The expert is an auditor's external expert and is not, therefore, subject to the firm's quality control policies and procedures.

#### *The Auditor's Firm's Quality Control Policies and Procedures* (Ref: Para. 8(e))

A11. An auditor's internal expert may be a partner or staff, including temporary staff, of the auditor's firm, and therefore subject to the quality control policies and

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<sup>8</sup> ISA 500, paragraph 8

procedures of that firm in accordance with ISQC 1<sup>9</sup> or national requirements that are at least as demanding.<sup>10</sup> Alternatively, an auditor's internal expert may be a partner or staff, including temporary staff, of a network firm, which may share common quality control policies and procedures with the auditor's firm.

A12. An auditor's external expert is not a member of the engagement team and is not subject to quality control policies and procedures in accordance with ISQC 1.<sup>11</sup> In some jurisdictions, however, law or regulation may require that an auditor's external expert be treated as a member of the engagement team, and may therefore be subject to relevant ethical requirements, including those pertaining to independence, and other professional requirements, as determined by that law or regulation.

A13. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise.<sup>12</sup> The extent of that reliance will vary with the circumstances, and may affect the nature, timing and extent of the auditor's procedures with respect to such matters as:

- Competence and capabilities, through recruitment and training programs.
- Objectivity. Auditor's internal experts are subject to relevant ethical requirements, including those pertaining to independence.
- The auditor's evaluation of the adequacy of the auditor's expert's work. For example, the firm's training programs may provide auditor's internal experts with an appropriate understanding of the interrelationship of their expertise with the audit process. Reliance on such training and other firm processes, such as protocols for scoping the work of auditor's internal experts, may affect the nature, timing and extent of the auditor's procedures to evaluate the adequacy of the auditor's expert's work.
- Adherence to regulatory and legal requirements, through monitoring processes.
- Agreement with the auditor's expert.

Such reliance does not reduce the auditor's responsibility to meet the requirements of this ISA.

### **The Competence, Capabilities and Objectivity of the Auditor's Expert** (Ref: Para. 9)

A14. The competence, capabilities and objectivity of an auditor's expert are factors that significantly affect whether the work of the auditor's expert will be adequate

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<sup>9</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraph 12(f)

<sup>10</sup> ISA 220, paragraph 2

<sup>11</sup> ISQC 1, paragraph 12(f)

<sup>12</sup> ISA 220, paragraph 4

for the auditor's purposes. Competence relates to the nature and level of expertise of the auditor's expert. Capability relates to the ability of the auditor's expert to exercise that competence in the circumstances of the engagement. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest, or the influence of others may have on the professional or business judgment of the auditor's expert.

A15. Information regarding the competence, capabilities and objectivity of an auditor's expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with other auditors or others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.
- The auditor's firm's quality control policies and procedures (see paragraphs A11–A13).

A16. Matters relevant to evaluating the competence, capabilities and objectivity of the auditor's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

A17. Other matters that may be relevant include:

- The relevance of the auditor's expert's competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field. For example, a particular actuary may specialize in property and casualty insurance, but have limited expertise regarding pension calculations.
- The auditor's expert's competence with respect to relevant accounting and auditing requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.
- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the auditor's expert as the audit progresses.

- A18. A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats, and intimidation threats. Such threats may be addressed by eliminating the circumstances that create the threats, or applying safeguards to reduce threats to an acceptable level. There may also be safeguards specific to the audit engagement.
- A19. The evaluation of whether the threats to objectivity are at an acceptable level may depend upon the role of the auditor's expert and the significance of the expert's work in the context of the audit. In some cases, it may not be possible to eliminate circumstances that create threats or apply safeguards to reduce threats to an acceptable level, for example, if a proposed auditor's expert is an individual who has played a significant role in preparing the information that is being audited, that is, if the auditor's expert is a management's expert.
- A20. When evaluating the objectivity of an auditor's external expert, it may be relevant to:
- (a) Inquire of the entity about any known interests or relationships that the entity has with the auditor's external expert that may affect that expert's objectivity.
  - (b) Discuss with that expert any applicable safeguards, including any professional requirements that apply to that expert; and evaluate whether the safeguards are adequate to reduce threats to an acceptable level. Interests and relationships that it may be relevant to discuss with the auditor's expert include:
    - Financial interests.
    - Business and personal relationships.
    - Provision of other services by the expert, including by the organization in the case of an external expert that is an organization.

In some cases, it may also be appropriate for the auditor to obtain a written representation from the auditor's external expert about any interests or relationships with the entity of which that expert is aware.

**Obtaining an Understanding of the Field of Expertise of the Auditor's Expert**  
(Ref: Para. 10)

- A21. The auditor may obtain an understanding of the auditor's expert's field of expertise through the means described in paragraph A7, or through discussion with that expert.
- A22. Aspects of the auditor's expert's field relevant to the auditor's understanding may include:
- Whether that expert's field has areas of specialty within it that are relevant to the audit (see paragraph A17).

- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods, including models where applicable, are used by the auditor's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
- The nature of internal and external data or information the auditor's expert uses.

**Agreement with the Auditor's Expert** (Ref: Para. 11)

- A23. The nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed between the auditor and the auditor's expert regardless of whether the expert is an auditor's external expert or an auditor's internal expert.
- A24. The matters noted in paragraph 8 may affect the level of detail and formality of the agreement between the auditor and the auditor's expert, including whether it is appropriate that the agreement be in writing. For example, the following factors may suggest the need for more a detailed agreement than would otherwise be the case, or for the agreement to be set out in writing:
- The auditor's expert will have access to sensitive or confidential entity information.
  - The respective roles or responsibilities of the auditor and the auditor's expert are different from those normally expected.
  - Multi-jurisdictional legal or regulatory requirements apply.
  - The matter to which the auditor's expert's work relates is highly complex.
  - The auditor has not previously used work performed by that expert.
  - The greater the extent of the auditor's expert's work, and its significance in the context of the audit.
- A25. The agreement between the auditor and an auditor's external expert is often in the form of an engagement letter. The Appendix lists matters that the auditor may consider for inclusion in such an engagement letter, or in any other form of agreement with an auditor's external expert.
- A26. When there is no written agreement between the auditor and the auditor's expert, evidence of the agreement may be included in, for example:
- Planning memoranda, or related working papers such as the audit program.

- The policies and procedures of the auditor's firm. In the case of an auditor's internal expert, the established policies and procedures to which that expert is subject may include particular policies and procedures in relation to that expert's work. The extent of documentation in the auditor's working papers depends on the nature of such policies and procedures. For example, no documentation may be required in the auditor's working papers if the auditor's firm has detailed protocols covering the circumstances in which the work of such an expert is used.

*Nature, Scope and Objectives of Work* (Ref: Para. 11(a))

A27. It may often be relevant when agreeing on the nature, scope and objectives of the auditor's expert's work to include discussion of any relevant technical performance standards or other professional or industry requirements that the expert will follow.

*Respective Roles and Responsibilities* (Ref: Para. 11(b))

A28. Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may include:

- Whether the auditor or the auditor's expert will perform detailed testing of source data.
- Consent for the auditor to discuss the auditor's expert's findings or conclusions with the entity and others, and to include details of that expert's findings or conclusions in the basis for a modified opinion in the auditor's report, if necessary (see paragraph A42).
- Any agreement to inform the auditor's expert of the auditor's conclusions concerning that expert's work.

*Working Papers*

A29. Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may also include agreement about access to, and retention of, each other's working papers. When the auditor's expert is a member of the engagement team, that expert's working papers form part of the audit documentation. Subject to any agreement to the contrary, auditor's external experts' working papers are their own and do not form part of the audit documentation.

*Communication* (Ref: Para. 11(c))

A30. Effective two-way communication facilitates the proper integration of the nature, timing and extent of the auditor's expert's procedures with other work on the audit, and appropriate modification of the auditor's expert's objectives during the course of the audit. For example, when the work of the auditor's expert relates to the auditor's conclusions regarding a significant risk, both a formal written report at the conclusion of that expert's work, and oral reports as

the work progresses, may be appropriate. Identification of specific partners or staff who will liaise with the auditor's expert, and procedures for communication between that expert and the entity, assists timely and effective communication, particularly on larger engagements.

*Confidentiality* (Ref: Para. 11(d))

A31. It is necessary for the confidentiality provisions of relevant ethical requirements that apply to the auditor also to apply to the auditor's expert. Additional requirements may be imposed by law or regulation. The entity may also have requested that specific confidentiality provisions be agreed with auditor's external experts.

**Evaluating the Adequacy of the Auditor's Expert's Work** (Ref: Para. 12)

A32. The auditor's evaluation of the auditor's expert's competence, capabilities and objectivity, the auditor's familiarity with the auditor's expert's field of expertise, and the nature of the work performed by the auditor's expert affect the nature, timing and extent of audit procedures to evaluate the adequacy of that expert's work for the auditor's purposes.

*The Findings and Conclusions of the Auditor's Expert* (Ref: Para. 12(a))

A33. Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:

- Inquiries of the auditor's expert.
- Reviewing the auditor's expert's working papers and reports.
- Corroborative procedures, such as:
  - Observing the auditor's expert's work;
  - Examining published data, such as statistical reports from reputable, authoritative sources;
  - Confirming relevant matters with third parties;
  - Performing detailed analytical procedures; and
  - Reperforming calculations.
- Discussion with another expert with relevant expertise when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.
- Discussing the auditor's expert's report with management.

A34. Relevant factors when evaluating the relevance and reasonableness of the findings or conclusions of the auditor's expert, whether in a report or other form, may include whether they are:

- Presented in a manner that is consistent with any standards of the auditor's expert's profession or industry;
- Clearly expressed, including reference to the objectives agreed with the auditor, the scope of the work performed and standards applied;
- Based on an appropriate period and take into account subsequent events, where relevant;
- Subject to any reservation, limitation or restriction on use, and if so, whether this has implications for the auditor; and
- Based on appropriate consideration of errors or deviations encountered by the auditor's expert.

*Assumptions, Methods and Source Data*

Assumptions and Methods (Ref: Para. 12(b))

A35. When the auditor's expert's work is to evaluate underlying assumptions and methods, including models where applicable, used by management in developing an accounting estimate, the auditor's procedures are likely to be primarily directed to evaluating whether the auditor's expert has adequately reviewed those assumptions and methods. When the auditor's expert's work is to develop an auditor's point estimate or an auditor's range for comparison with management's point estimate, the auditor's procedures may be primarily directed to evaluating the assumptions and methods, including models where appropriate, used by the auditor's expert.

A36. ISA 540 (Revised)<sup>13</sup> discusses the assumptions and methods used by management in making accounting estimates, including the use in some cases of highly specialized, entity-developed models. Although that discussion is written in the context of the auditor obtaining sufficient appropriate audit evidence regarding management's assumptions and methods, it may also assist the auditor when evaluating an auditor's expert's assumptions and methods.

A37. When an auditor's expert's work involves the use of significant assumptions and methods, factors relevant to the auditor's evaluation of those assumptions and methods include whether they are:

- Generally accepted within the auditor's expert's field;
- Consistent with the requirements of the applicable financial reporting framework;
- Dependent on the use of specialized models; and
- Consistent with those of management, and if not, the reason for, and effects of, the differences.

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<sup>13</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, paragraphs 8, 13 and 15

## Source Data Used by the Auditor's Expert (Ref: Para. 12(c))

- A38. When an auditor's expert's work involves the use of source data that is significant to that expert's work, procedures such as the following may be used to test that data:
- Verifying the origin of the data, including obtaining an understanding of, and where applicable testing, the internal controls over the data and, where relevant, its transmission to the expert.
  - Reviewing the data for completeness and internal consistency.
- A39. In many cases, the auditor may test source data. However, in other cases, when the nature of the source data used by an auditor's expert is highly technical in relation to the expert's field, that expert may test the source data. If the auditor's expert has tested the source data, inquiry of that expert by the auditor, or supervision or review of that expert's tests may be an appropriate way for the auditor to evaluate that data's relevance, completeness, and accuracy.

*Inadequate Work* (Ref: Para. 13)

- A40. If the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures required by paragraph 13, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with ISA 705 (Revised) because the auditor has not obtained sufficient appropriate audit evidence.<sup>14</sup>

**Reference to the Auditor's Expert in the Auditor's Report** (Ref: Para. 14–15)

- A41. In some cases, law or regulation may require a reference to the work of an auditor's expert, for example, for the purposes of transparency in the public sector.
- A42. It may be appropriate in some circumstances to refer to the auditor's expert in an auditor's report containing a modified opinion, to explain the nature of the modification. In such circumstances, the auditor may need the permission of the auditor's expert before making such a reference.

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<sup>14</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, paragraph 6(b)

## Appendix

(Ref: Para. A25)

### **Considerations for Agreement between the Auditor and an Auditor's External Expert**

This Appendix lists matters that the auditor may consider for inclusion in any agreement with an auditor's external expert. The following list is illustrative and is not exhaustive; it is intended only to be a guide that may be used in conjunction with the considerations outlined in this ISA. Whether to include particular matters in the agreement depends on the circumstances of the engagement. The list may also be of assistance in considering the matters to be included in an agreement with an auditor's internal expert.

#### **Nature, Scope and Objectives of the Auditor's External Expert's Work**

- The nature and scope of the procedures to be performed by the auditor's external expert.
- The objectives of the auditor's external expert's work in the context of materiality and risk considerations concerning the matter to which the auditor's external expert's work relates, and, when relevant, the applicable financial reporting framework.
- Any relevant technical performance standards or other professional or industry requirements the auditor's external expert will follow.
- The assumptions and methods, including models where applicable, the auditor's external expert will use, and their authority.
- The effective date of, or when applicable the testing period for, the subject matter of the auditor's external expert's work, and requirements regarding subsequent events.

#### **The Respective Roles and Responsibilities of the Auditor and the Auditor's External Expert**

- Relevant auditing and accounting standards, and relevant regulatory or legal requirements.
- The auditor's external expert's consent to the auditor's intended use of that expert's report, including any reference to it, or disclosure of it, to others, for example, reference to it in the basis for a modified opinion in the auditor's report, if necessary, or disclosure of it to management or an audit committee.
- The nature and extent of the auditor's review of the auditor's external expert's work.
- Whether the auditor or the auditor's external expert will test source data.
- The auditor's external expert's access to the entity's records, files, personnel and to experts engaged by the entity.

- Procedures for communication between the auditor's external expert and the entity.
- The auditor's and the auditor's external expert's access to each other's working papers.
- Ownership and control of working papers during and after the engagement, including any file retention requirements.
- The auditor's external expert's responsibility to perform work with due skill and care.
- The auditor's external expert's competence and capability to perform the work.
- The expectation that the auditor's external expert will use all knowledge that expert has that is relevant to the audit or, if not, will inform the auditor.
- Any restriction on the auditor's external expert's association with the auditor's report.
- Any agreement to inform the auditor's external expert of the auditor's conclusions concerning that expert's work.

### **Communications and Reporting**

- Methods and frequency of communications, including:
  - How the auditor's external expert's findings or conclusions will be reported (for example, written report, oral report, ongoing input to the engagement team).
  - Identification of specific persons within the engagement team who will liaise with the auditor's external expert.
- When the auditor's external expert will complete the work and report findings or conclusions to the auditor.
- The auditor's external expert's responsibility to communicate promptly any potential delay in completing the work, and any potential reservation or limitation on that expert's findings or conclusions.
- The auditor's external expert's responsibility to communicate promptly instances in which the entity restricts that expert's access to records, files, personnel or experts engaged by the entity.
- The auditor's external expert's responsibility to communicate to the auditor all information that expert believes may be relevant to the audit, including any changes in circumstances previously communicated.
- The auditor's external expert's responsibility to communicate circumstances that may create threats to that expert's objectivity, and any relevant safeguards that may eliminate or reduce such threats to an acceptable level.

## **Confidentiality**

- The need for the auditor's expert to observe confidentiality requirements, including:
  - The confidentiality provisions of relevant ethical requirements that apply to the auditor.
  - Additional requirements that may be imposed by law or regulation, if any.
  - Specific confidentiality provisions requested by the entity, if any.

**INTERNATIONAL STANDARD ON AUDITING 700  
(REVISED)**

**FORMING AN OPINION AND REPORTING ON  
FINANCIAL STATEMENTS**

(Effective for audits of financial statements for periods  
ending on or after December 15, 2016)

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International Standard on Auditing (ISA) 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.
2. ISA 701<sup>1</sup> deals with the auditor's responsibility to communicate key audit matters in the auditor's report. ISA 705<sup>2</sup> (Revised) and ISA 706 (Revised)<sup>3</sup> deal with how the form and content of the auditor's report are affected when the auditor expresses a modified opinion or includes an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor's report. Other ISAs also contain reporting requirements that are applicable when issuing an auditor's report.
3. This ISA applies to an audit of a complete set of general purpose financial statements and is written in that context. ISA 800 (Revised)<sup>4</sup> deals with special considerations when financial statements are prepared in accordance with a special purpose framework. ISA 805 (Revised)<sup>5</sup> deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement. This ISA also applies to audits for which ISA 800 (Revised) or ISA 805 (Revised) apply.
4. The requirements of this ISA are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This ISA promotes consistency in the auditor's report, but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with ISAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

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<sup>1</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

<sup>2</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

<sup>3</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

<sup>4</sup> ISA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*

<sup>5</sup> ISA 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*

## Effective Date

5. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2016.

## Objectives

6. The objectives of the auditor are:
- (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
  - (b) To express clearly that opinion through a written report.

## Definitions

7. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) General purpose financial statements – Financial statements prepared in accordance with a general purpose framework.
  - (b) General purpose framework – A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.<sup>6</sup>

- (c) Unmodified opinion – The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all

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<sup>6</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(a)

material respects, in accordance with the applicable financial reporting framework.<sup>7</sup>

8. Reference to “financial statements” in this ISA means “a complete set of general purpose financial statements.”<sup>8</sup> The requirements of the applicable financial reporting framework determine the presentation, structure and content of the financial statements, and what constitutes a complete set of financial statements.
9. Reference to “International Financial Reporting Standards” in this ISA means the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board, and reference to “International Public Sector Accounting Standards” means the International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board.

## Requirements

### Forming an Opinion on the Financial Statements

10. The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.<sup>9,10</sup>
11. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:
  - (a) The auditor’s conclusion, in accordance with ISA 330, whether sufficient appropriate audit evidence has been obtained;<sup>11</sup>
  - (b) The auditor’s conclusion, in accordance with ISA 450, whether uncorrected misstatements are material, individually or in aggregate;<sup>12</sup> and
  - (c) The evaluations required by paragraphs 12–15.
12. The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity’s accounting practices, including indicators of possible bias in management’s judgments. (Ref: Para. A1–A3)

<sup>7</sup> Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

<sup>8</sup> ISA 200, paragraph 13(f) sets out the content of financial statements.

<sup>9</sup> ISA 200, paragraph 11

<sup>10</sup> Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

<sup>11</sup> ISA 330, *The Auditor’s Responses to Assessed Risks*, paragraph 26

<sup>12</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

13. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:
- (a) The financial statements appropriately disclose the significant accounting policies selected and applied. In making this evaluation, the auditor shall consider the relevance of the accounting policies to the entity, and whether they have been presented in an understandable manner; (Ref: Para. A4)
  - (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
  - (c) The accounting estimates and related disclosures made by management are reasonable;
  - (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable. In making this evaluation, the auditor shall consider whether:
    - The information that should have been included has been included, and whether such information is appropriately classified, aggregated or disaggregated, and characterized.
    - The overall presentation of the financial statements has been undermined by including information that is not relevant or that obscures a proper understanding of the matters disclosed. (Ref: Para. A5)
  - (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A6)
  - (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.
14. When the financial statements are prepared in accordance with a fair presentation framework, the evaluation required by paragraphs 12–13 shall also include whether the financial statements achieve fair presentation. The auditor’s evaluation as to whether the financial statements achieve fair presentation shall include consideration of: (Ref: Para A7–A9)
- (a) The overall presentation, structure and content of the financial statements; and
  - (b) Whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
15. The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. (Ref: Para. A10–A15)

**Form of Opinion**

16. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
17. If the auditor:
  - (a) Concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
  - (b) Is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor’s report in accordance with ISA 705 (Revised).
18. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor’s report in accordance with ISA 705 (Revised). (Ref: Para. A16)
19. When the financial statements are prepared in accordance with a compliance framework, the auditor is not required to evaluate whether the financial statements achieve fair presentation. However, if in extremely rare circumstances the auditor concludes that such financial statements are misleading, the auditor shall discuss the matter with management and, depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor’s report. (Ref: Para. A17)

**Auditor’s Report**

20. The auditor’s report shall be in writing. (Ref: Para. A18–A19)

*Auditor’s Report for Audits Conducted in Accordance with International Standards on Auditing*

## Title

21. The auditor’s report shall have a title that clearly indicates that it is the report of an independent auditor. (Ref: Para. A20)

## Addressee

22. The auditor’s report shall be addressed, as appropriate, based on the circumstances of the engagement. (Ref: Para. A21)

## Auditor’s Opinion

23. The first section of the auditor’s report shall include the auditor’s opinion, and shall have the heading “Opinion.”

24. The Opinion section of the auditor's report shall also:
- (a) Identify the entity whose financial statements have been audited;
  - (b) State that the financial statements have been audited;
  - (c) Identify the title of each statement comprising the financial statements;
  - (d) Refer to the notes, including the summary of significant accounting policies; and
  - (e) Specify the date of, or period covered by, each financial statement comprising the financial statements. (Ref: Para. A22–A23)
25. When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:
- (a) In our opinion, the accompanying financial statements present fairly, in all material respects, [...] in accordance with [the applicable financial reporting framework]; or
  - (b) In our opinion, the accompanying financial statements give a true and fair view of [...] in accordance with [the applicable financial reporting framework]. (Ref: Para. A24–A31)
26. When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the accompanying financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework]. (Ref: Para. A26–A31)
27. If the reference to the applicable financial reporting framework in the auditor's opinion is not to IFRSs issued by the International Accounting Standards Board or IPSASs issued by the International Public Sector Accounting Standards Board, the auditor's opinion shall identify the jurisdiction of origin of the framework.

#### Basis for Opinion

28. The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that: (Ref: Para. A32)
- (a) States that the audit was conducted in accordance with International Standards on Auditing; (Ref: Para. A33)
  - (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the ISAs;
  - (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit,

and has fulfilled the auditor’s other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code); and (Ref: Para. A34–A39)

- (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor’s opinion.

### Going Concern

- 29. Where applicable, the auditor shall report in accordance with ISA 570 (Revised).<sup>13</sup>

### Key Audit Matters

- 30. For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor’s report in accordance with ISA 701.
- 31. When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor’s report, the auditor shall do so in accordance with ISA 701. (Ref: Para. A40–A42)

### Other Information

- 32. Where applicable, the auditor shall report in accordance with ISA 720 (Revised).<sup>14</sup>

### Responsibilities for the Financial Statements

- 33. The auditor’s report shall include a section with a heading “Responsibilities of Management for the Financial Statements.” The auditor’s report shall use the term that is appropriate in the context of the legal framework in the particular jurisdiction and need not refer specifically to “management”. In some jurisdictions, the appropriate reference may be to those charged with governance. (Ref: Para. A44)
- 34. This section of the auditor’s report shall describe management’s responsibility for: (Ref: Para. A45–A48)
  - (a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of

<sup>13</sup> ISA 570 (Revised), *Going Concern*, paragraphs 21–23

<sup>14</sup> ISA 720 (Revised), *The Auditor’s Responsibilities Relating to Other Information*

financial statements that are free from material misstatement, whether due to fraud or error; and

- (b) Assessing the entity's ability to continue as a going concern<sup>15</sup> and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate. (Ref: Para. A48)
35. This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfill the responsibilities described in paragraph 34 above. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework in the particular jurisdiction. (Ref: Para. A49)
36. When the financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

#### Auditor's Responsibilities for the Audit of the Financial Statements

37. The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."
38. This section of the auditor's report shall: (Ref: Para. A50)
- (a) State that the objectives of the auditor are to:
    - (i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
    - (ii) Issue an auditor's report that includes the auditor's opinion. (Ref: Para. A51)
  - (b) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists; and
  - (c) State that misstatements can arise from fraud or error, and either:
    - (i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the

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<sup>15</sup> ISA 570 (Revised), paragraph 2

economic decisions of users taken on the basis of these financial statements;<sup>16</sup> or

- (ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework. (Ref: Para. A53)
39. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further: (Ref: Para. A50)
- (a) State that, as part of an audit in accordance with ISAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and
  - (b) Describe an audit by stating that the auditor's responsibilities are:
    - (i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
    - (ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.
    - (iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
    - (iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the

<sup>16</sup> ISA 320, *Materiality in Planning and Performing an Audit*, paragraph 2

financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.

- (v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- (c) When ISA 600<sup>17</sup> applies, further describe the auditor's responsibilities in a group audit engagement by stating that:
- (i) The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the group financial statements;
  - (ii) The auditor is responsible for the direction, supervision and performance of the group audit; and
  - (iii) The auditor remains solely responsible for the auditor's opinion.
40. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall: (Ref: Para. A50)
- (a) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;
  - (b) For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicates with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, actions taken to eliminate threats or safeguards applied; and
  - (c) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with ISA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these

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<sup>17</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

matters in the auditor’s report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor’s report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. (Ref: Para. A53)

Location of the description of the auditor’s responsibilities for the audit of the financial statements

41. The description of the auditor’s responsibilities for the audit of the financial statements required by paragraphs 39–40 shall be included: (Ref: Para. A54)
  - (a) Within the body of the auditor’s report;
  - (b) Within an appendix to the auditor’s report, in which case the auditor’s report shall include a reference to the location of the appendix; or (Ref: Para. A55–A57)
  - (c) By a specific reference within the auditor’s report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so. (Ref: Para. A54, A56–A57)
42. When the auditor refers to a description of the auditor’s responsibilities on a website of an appropriate authority, the auditor shall determine that such description addresses, and is not inconsistent with, the requirements in paragraphs 39–40 of this ISA. (Ref: Para. A56)

#### Other Reporting Responsibilities

43. If the auditor addresses other reporting responsibilities in the auditor’s report on the financial statements that are in addition to the auditor’s responsibilities under the ISAs, these other reporting responsibilities shall be addressed in a separate section in the auditor’s report with a heading titled “Report on Other Legal and Regulatory Requirements” or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the ISAs. (Ref: Para. A58–A60)
44. If other reporting responsibilities are presented in the same section as the related report elements required by the ISAs, the auditor’s report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the ISAs. (Ref: Para. A60)
45. If the auditor’s report contains a separate section that addresses other reporting responsibilities, the requirements of paragraphs 21–40 of this ISA shall be included under a section with a heading “Report on the Audit of the Financial

Statements.” The “Report on Other Legal and Regulatory Requirements” shall follow the “Report on the Audit of the Financial Statements.” (Ref: Para. A60)

#### Name of the Engagement Partner

46. The name of the engagement partner shall be included in the auditor’s report on financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat. In the rare circumstances that the auditor intends not to include the name of the engagement partner in the auditor’s report, the auditor shall discuss this intention with those charged with governance to inform the auditor’s assessment of the likelihood and severity of a significant personal security threat. (Ref: Para. A61–A63)

#### Signature of the Auditor

47. The auditor’s report shall be signed. (Ref: Para. A64–A65)

#### Auditor’s Address

48. The auditor’s report shall name the location in the jurisdiction where the auditor practices.

#### Date of the Auditor’s Report

49. The auditor’s report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements, including evidence that: (Ref: Para. A66–A69)
- (a) All the statements and disclosures that comprise the financial statements have been prepared; and
  - (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

#### *Auditor’s Report Prescribed by Law or Regulation*

50. If the auditor is required by law or regulation of a specific jurisdiction to use a specific layout, or wording of the auditor’s report, the auditor’s report shall refer to International Standards on Auditing only if the auditor’s report includes, at a minimum, each of the following elements: (Ref: Para. A70–A71)
- (a) A title.
  - (b) An addressee, as required by the circumstances of the engagement.
  - (c) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the jurisdiction of origin of the financial reporting framework that is

not International Financial Reporting Standards or International Public Sector Accounting Standards, see paragraph 27).

- (d) An identification of the entity's financial statements that have been audited.
- (e) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the IESBA Code.
- (f) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements in paragraph 22 of ISA 570 (Revised).
- (g) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements in paragraph 23 of ISA 570 (Revised).
- (h) Where applicable, a section that includes the information required by ISA 701, or additional information about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that ISA.<sup>18</sup> (Ref: Para. A72–A75)
- (i) Where applicable, a section that addresses the reporting requirements in paragraph 24 of ISA 720 (Revised).
- (j) A description of management's responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements in paragraphs 33–36.
- (k) A reference to International Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements in paragraphs 37–40. (Ref: Para. A50–A53)
- (l) For audits of complete sets of general purpose financial statements of listed entities, the name of the engagement partner unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat.
- (m) The auditor's signature.
- (n) The auditor's address.
- (o) The date of the auditor's report.

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<sup>18</sup> ISA 701, paragraphs 11–16

*Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards of a Specific Jurisdiction and International Standards on Auditing*

51. An auditor may be required to conduct an audit in accordance with the auditing standards of a specific jurisdiction (the “national auditing standards”), and has additionally complied with the ISAs in the conduct of the audit. If this is the case, the auditor’s report may refer to International Standards on Auditing in addition to the national auditing standards, but the auditor shall do so only if: (Ref: Para. A76–A77)
- (a) There is no conflict between the requirements in the national auditing standards and those in ISAs that would lead the auditor (i) to form a different opinion, or (ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by ISAs; and
  - (b) The auditor’s report includes, at a minimum, each of the elements set out in paragraphs 50(a)–(o) when the auditor uses the layout or wording specified by the national auditing standards. However, reference to “law or regulation” in paragraph 50(k) shall be read as reference to the national auditing standards. The auditor’s report shall thereby identify such national auditing standards.
52. When the auditor’s report refers to both the national auditing standards and International Standards on Auditing, the auditor’s report shall identify the jurisdiction of origin of the national auditing standards.

**Supplementary Information Presented with the Financial Statements** (Ref: Para. A78–A84)

53. If supplementary information that is not required by the applicable financial reporting framework is presented with the audited financial statements, the auditor shall evaluate whether, in the auditor’s professional judgment, supplementary information is nevertheless an integral part of the financial statements due to its nature or how it is presented. When it is an integral part of the financial statements, the supplementary information shall be covered by the auditor’s opinion.
54. If supplementary information that is not required by the applicable financial reporting framework is not considered an integral part of the audited financial statements, the auditor shall evaluate whether such supplementary information is presented in a way that sufficiently and clearly differentiates it from the audited financial statements. If this is not the case, then the auditor shall ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall identify the unaudited supplementary information and explain in the auditor’s report that such supplementary information has not been audited.

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## Application and Other Explanatory Material

### Qualitative Aspects of the Entity's Accounting Practices (Ref: Para. 12)

- A1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
- A2. ISA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.<sup>19</sup> In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor's evaluation of whether the financial statements as a whole are materially misstated include the following:
- The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings).
  - Possible management bias in the making of accounting estimates.
- A3. ISA 540 (Revised) addresses possible management bias in making accounting estimates.<sup>20</sup> Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

### Accounting Policies Appropriately Disclosed in the Financial Statements (Ref: Para. 13(a))

- A4. In evaluating whether the financial statements appropriately disclose the significant accounting policies selected and applied, the auditor's consideration includes matters such as:
- Whether all disclosures related to the significant accounting policies that are required to be included by the applicable financial reporting framework have been disclosed;
  - Whether the information about the significant accounting policies that has been disclosed is relevant and therefore reflects how the recognition, measurement and presentation criteria in the applicable financial reporting framework have been applied to classes of transactions, account balances and disclosures in the financial

<sup>19</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, Appendix 2

<sup>20</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, paragraph 21

statements in the particular circumstances of the entity's operations and its environment; and

- The clarity with which the significant accounting policies have been presented.

**Information Presented in the Financial Statements Is Relevant, Reliable, Comparable and Understandable** (Ref: Para. 13(d))

A5. Evaluating the understandability of the financial statements includes consideration of such matters as whether:

- The information in the financial statements is presented in a clear and concise manner.
- The placement of significant disclosures gives appropriate prominence to them (e.g., when there is perceived value of entity-specific information to users), and whether the disclosures are appropriately cross-referenced in a manner that would not give rise to significant challenges for users in identifying necessary information.

**Disclosures of the Effect of Material Transactions and Events on the Information Conveyed in the Financial Statements** (Ref: Para. 13(e))

A6. It is common for financial statements prepared in accordance with a general purpose framework to present an entity's financial position, financial performance and cash flows. Evaluating whether, in view of the applicable financial reporting framework, the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the entity's financial position, financial performance and cash flows includes consideration of such matters as:

- The extent to which the information in the financial statements is relevant and specific to the circumstances of the entity; and
- Whether the disclosures are adequate to assist the intended users to understand:
  - The nature and extent of the entity's potential assets and liabilities arising from transactions or events that do not meet the criteria for recognition (or the criteria for derecognition) established by the applicable financial reporting framework.
  - The nature and extent of risks of material misstatement arising from transactions and events.
  - The methods used and the assumptions and judgments made, and changes to them, that affect amounts presented or otherwise disclosed, including relevant sensitivity analyses.

**Evaluating Whether the Financial Statements Achieve Fair Presentation**

(Ref: Para. 14)

- A7. Some financial reporting frameworks acknowledge explicitly or implicitly the concept of fair presentation.<sup>21</sup> As noted in paragraph 7(b) of this ISA, a fair presentation<sup>22</sup> financial reporting framework not only requires compliance with the requirements of the framework, but also acknowledges explicitly or implicitly that it may be necessary for management to provide disclosures beyond those specifically required by the framework.<sup>23</sup>
- A8. The auditor's evaluation about whether the financial statements achieve fair presentation, both in respect of presentation and disclosure, is a matter of professional judgment. This evaluation takes into account such matters as the facts and circumstances of the entity, including changes thereto, based on the auditor's understanding of the entity and the audit evidence obtained during the audit. The evaluation also includes consideration, for example, of the disclosures needed to achieve a fair presentation arising from matters that could be material (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of the users taken on the basis of the financial statements as a whole), such as the effect of evolving financial reporting requirements or the changing economic environment.
- A9. Evaluating whether the financial statements achieve fair presentation may include, for example, discussions with management and those charged with governance about their views on why a particular presentation was chosen, as well as alternatives that may have been considered. The discussions may include, for example:
- The degree to which the amounts in the financial statements are aggregated or disaggregated, and whether the presentation of amounts or disclosures obscures useful information, or results in misleading information.
  - Consistency with appropriate industry practice, or whether any departures are relevant to the entity's circumstances and therefore warranted.

**Description of the Applicable Financial Reporting Framework (Ref: Para. 15)**

- A10. As explained in ISA 200, the preparation of the financial statements by management and, where appropriate, those charged with governance requires the inclusion of an adequate description of the applicable financial reporting

<sup>21</sup> For example, International Financial Reporting Standards (IFRSs) note that fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses.

<sup>22</sup> See ISA 200, paragraph 13(a)

<sup>23</sup> For example, IFRSs require an entity to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (International Accounting Standard 1, *Presentation of Financial Statements*, paragraph 17(c)).

framework in the financial statements.<sup>24</sup> That description advises users of the financial statements of the framework on which the financial statements are based.

- A11. A description that the financial statements are prepared in accordance with a particular applicable financial reporting framework is appropriate only if the financial statements comply with all the requirements of that framework that are effective during the period covered by the financial statements.
- A12. A description of the applicable financial reporting framework that contains imprecise qualifying or limiting language (e.g., “the financial statements are in substantial compliance with International Financial Reporting Standards”) is not an adequate description of that framework as it may mislead users of the financial statements.

#### *Reference to More than One Financial Reporting Framework*

- A13. In some cases, the financial statements may represent that they are prepared in accordance with two financial reporting frameworks (e.g., the national framework and IFRSs). This may be because management is required, or has chosen, to prepare the financial statements in accordance with both frameworks, in which case both are applicable financial reporting frameworks. Such description is appropriate only if the financial statements comply with each of the frameworks individually. To be regarded as being prepared in accordance with both frameworks, the financial statements need to comply with both frameworks simultaneously and without any need for reconciling statements. In practice, simultaneous compliance is unlikely unless the jurisdiction has adopted the other framework (e.g., IFRSs) as its own national framework, or has eliminated all barriers to compliance with it.
- A14. Financial statements that are prepared in accordance with one financial reporting framework and that contain a note or supplementary statement reconciling the results to those that would be shown under another framework are not prepared in accordance with that other framework. This is because the financial statements do not include all the information in the manner required by that other framework.
- A15. The financial statements may, however, be prepared in accordance with one applicable financial reporting framework and, in addition, describe in the notes to the financial statements the extent to which the financial statements comply with another framework (e.g., financial statements prepared in accordance with the national framework that also describe the extent to which they comply with IFRSs). Such description may constitute supplementary financial information as discussed in paragraph 54 and is covered by the auditor’s opinion if it cannot be clearly differentiated from the financial statements.

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<sup>24</sup> ISA 200, paragraphs A4–A5

**Form of Opinion**

- A16. There may be cases where the financial statements, although prepared in accordance with the requirements of a fair presentation framework, do not achieve fair presentation. Where this is the case, it may be possible for management to include additional disclosures in the financial statements beyond those specifically required by the framework or, in extremely rare circumstances, to depart from a requirement in the framework in order to achieve fair presentation of the financial statements. (Ref: Para. 18)
- A17. It will be extremely rare for the auditor to consider financial statements that are prepared in accordance with a compliance framework to be misleading if, in accordance with ISA 210, the auditor determined that the framework is acceptable.<sup>25</sup> (Ref: Para. 19)

**Auditor's Report (Ref: Para. 20)**

- A18. A written report encompasses reports issued in hard copy and those using an electronic medium.
- A19. The Appendix to this ISA contains illustrations of auditor's reports on financial statements, incorporating the elements set out in paragraphs 21–49. With the exception of the Opinion and Basis for Opinion sections, this ISA does not establish requirements for ordering the elements of the auditor's report. However, this ISA requires the use of specific headings, which are intended to assist in making auditor's reports that refer to audits that have been conducted in accordance with ISAs more recognizable, particularly in situations where the elements of the auditor's report are presented in an order that differs from the illustrative auditor's reports in the Appendix to this ISA.

*Auditor's Report for Audits Conducted in Accordance with International Standards on Auditing*

## Title (Ref: Para. 21)

- A20. A title indicating the report is the report of an independent auditor, for example, "Independent Auditor's Report," distinguishes the independent auditor's report from reports issued by others.

## Addressee (Ref: Para. 22)

- A21. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed in that particular jurisdiction. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

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<sup>25</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

## Auditor's Opinion (Ref. Para. 24–26)

## Reference to the financial statements that have been audited

- A22. The auditor's report states, for example, that the auditor has audited the financial statements of the entity, which comprise [state the title of each financial statement comprising the complete set of financial statements required by the applicable financial reporting framework, specifying the date or period covered by each financial statement] and notes to the financial statements, including a summary of significant accounting policies.
- A23. When the auditor is aware that the audited financial statements will be included in a document that contains other information, such as an annual report, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the audited financial statements are presented. This helps users to identify the financial statements to which the auditor's report relates.

## “Present fairly, in all material respects” or “give a true and fair view”

- A24. The phrases “present fairly, in all material respects,” and “give a true and fair view” are regarded as being equivalent. Whether the phrase “present fairly, in all material respects,” or the phrase “give a true and fair view” is used in any particular jurisdiction is determined by the law or regulation governing the audit of financial statements in that jurisdiction, or by generally accepted practice in that jurisdiction. Where law or regulation requires the use of different wording, this does not affect the requirement in paragraph 14 of this ISA for the auditor to evaluate the fair presentation of financial statements prepared in accordance with a fair presentation framework.
- A25. When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as “with the foregoing explanation” or “subject to” in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

## Description of the financial statements and the matters they present

- A26. The auditor's opinion covers the complete set of financial statements as defined by the applicable financial reporting framework. For example, in the case of many general purpose frameworks, the financial statements may include: a statement of financial position, a statement of comprehensive income, a statement of changes in equity, a statement of cash flows, and related notes, which ordinarily comprise a summary of significant accounting policies and other explanatory information. In some jurisdictions, additional information may also be considered to be an integral part of the financial statements.
- A27. In the case of financial statements prepared in accordance with a fair presentation framework, the auditor's opinion states that the financial statements present fairly, in all material respects, or give a true and fair view of, the matters that the financial statements are designed to present. For example, in the case of

financial statements prepared in accordance with IFRSs, these matters are *the financial position of the entity as at the end of the period and the entity's financial performance and cash flows for the period then ended*. Consequently, the [...] in paragraph 25 and elsewhere in this ISA is intended to be replaced by the words in italics in the preceding sentence when the applicable financial reporting framework is IFRSs or, in the case of other applicable financial reporting frameworks, be replaced with words that describe the matters that the financial statements are designed to present.

Description of the applicable financial reporting framework and how it may affect the auditor's opinion

A28. The identification of the applicable financial reporting framework in the auditor's opinion is intended to advise users of the auditor's report of the context in which the auditor's opinion is expressed; it is not intended to limit the evaluation required in paragraph 14. The applicable financial reporting framework is identified in such terms as:

“... in accordance with International Financial Reporting Standards” or

“... in accordance with accounting principles generally accepted in Jurisdiction X ...”

A29. When the applicable financial reporting framework encompasses financial reporting standards and legal or regulatory requirements, the framework is identified in such terms as “... in accordance with International Financial Reporting Standards and the requirements of Jurisdiction X Corporations Act.” ISA 210 deals with circumstances where there are conflicts between the financial reporting standards and the legislative or regulatory requirements.<sup>26</sup>

A30. As indicated in paragraph A13, the financial statements may be prepared in accordance with two financial reporting frameworks, which are therefore both applicable financial reporting frameworks. Accordingly, each framework is considered separately when forming the auditor's opinion on the financial statements, and the auditor's opinion in accordance with paragraphs 25–27 refers to both frameworks as follows:

- (a) If the financial statements comply with each of the frameworks individually, two opinions are expressed: that is, that the financial statements are prepared in accordance with one of the applicable financial reporting frameworks (e.g., the national framework) and an opinion that the financial statements are prepared in accordance with the other applicable financial reporting framework (e.g., IFRSs). These opinions may be expressed separately or in a single sentence (e.g., the financial statements are presented fairly, in all material respects [...], in accordance with accounting principles generally accepted in Jurisdiction X and with IFRSs).

<sup>26</sup> ISA 210, paragraph 18

- (b) If the financial statements comply with one of the frameworks but fail to comply with the other framework, an unmodified opinion can be given that the financial statements are prepared in accordance with the one framework (e.g., the national framework) but a modified opinion given with regard to the other framework (e.g., IFRSs) in accordance with ISA 705 (Revised).
- A31. As indicated in paragraph A15, the financial statements may represent compliance with the applicable financial reporting framework and, in addition, disclose the extent of compliance with another financial reporting framework. Such supplementary information is covered by the auditor's opinion if it cannot be clearly differentiated from the financial statements (see paragraphs 53–54 and related application material in paragraphs A78–A84). Accordingly,
- (a) If the disclosure as to the compliance with the other framework is misleading, a modified opinion is expressed in accordance with ISA 705 (Revised).
- (b) If the disclosure is not misleading, but the auditor judges it to be of such importance that it is fundamental to the users' understanding of the financial statements, an Emphasis of Matter paragraph is added in accordance with ISA 706 (Revised), drawing attention to the disclosure.

#### Basis for Opinion (Ref: Para. 28)

- A32. The Basis for Opinion section provides important context about the auditor's opinion. Accordingly, this ISA requires the Basis for Opinion section to directly follow the Opinion section in the auditor's report.
- A33. The reference to the standards used conveys to the users of the auditor's report that the audit has been conducted in accordance with established standards.

#### Relevant ethical requirements (Ref: Para. 28(c))

- A34. The identification of the jurisdiction of origin of relevant ethical requirements increases transparency about those requirements relating to the particular audit engagement. ISA 200 explains that relevant ethical requirements ordinarily comprise the provisions of the IESBA Code related to an audit of financial statements, together with national requirements that are more restrictive.<sup>27</sup> When the relevant ethical requirements include those of the IESBA Code, the statement may also make reference to the IESBA Code. If the IESBA Code constitutes all of the ethical requirements relevant to the audit, the statement need not identify a jurisdiction of origin.
- A35. In some jurisdictions, relevant ethical requirements may exist in several different sources, such as the ethical code(s) and additional rules and requirements within law and regulation. When the independence and other

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<sup>27</sup> ISA 200, paragraph A16

relevant ethical requirements are contained in a limited number of sources, the auditor may choose to name the relevant source(s) (e.g., the name of the code, rule or regulation applicable in the jurisdiction), or may refer to a term that is commonly understood and that appropriately summarizes those sources (e.g., independence requirements for audits of private entities in Jurisdiction X).

- A36. Law or regulation, national auditing standards or the terms of an audit engagement may require the auditor to provide in the auditor's report more specific information about the sources of the relevant ethical requirements, including those pertaining to independence, that applied to the audit of the financial statements.
- A37. In determining the appropriate amount of information to include in the auditor's report when there are multiple sources of relevant ethical requirements relating to the audit of the financial statements, an important consideration is balancing transparency against the risk of obscuring other useful information in the auditor's report.

#### Considerations specific to group audits

- A38. In group audits when there are multiple sources of relevant ethical requirements, including those pertaining to independence, the reference in the auditor's report to the jurisdiction ordinarily relates to the relevant ethical requirements that are applicable to the group engagement team. This is because, in a group audit, component auditors are also subject to ethical requirements that are relevant to the group audit.<sup>28</sup>
- A39. The ISAs do not establish specific independence or ethical requirements for auditors, including component auditors, and thus do not extend, or otherwise override, the independence requirements of the IESBA Code or other ethical requirements to which the group engagement team is subject, nor do the ISAs require that the component auditor in all cases to be subject to the same specific independence requirements that are applicable to the group engagement team. As a result, relevant ethical requirements, including those pertaining to independence, in a group audit situation may be complex. ISA 600<sup>29</sup> provides guidance for auditors in performing work on the financial information of a component for a group audit, including those situations where the component auditor does not meet the independence requirements that are relevant to the group audit.

#### Key Audit Matters (Ref: Para. 31)

- A40. Law or regulation may require communication of key audit matters for audits of entities other than listed entities, for example, entities characterized in such law or regulation as public interest entities.

<sup>28</sup> ISA 600, paragraph A37

<sup>29</sup> ISA 600, paragraphs 19–20

- A41. The auditor may also decide to communicate key audit matters for other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities.
- A42. ISA 210 requires the auditor to agree the terms of the audit engagement with management and those charged with governance, as appropriate, and explains that the roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance arrangements of the entity and relevant law or regulation.<sup>30</sup> ISA 210 also requires the audit engagement letter or other suitable form of written agreement to include reference to the expected form and content of any reports to be issued by the auditor.<sup>31</sup> When the auditor is not otherwise required to communicate key audit matters, ISA 210<sup>32</sup> explains that it may be helpful for the auditor to make reference in the terms of the audit engagement to the possibility of communicating key audit matters in the auditor's report and, in certain jurisdictions, it may be necessary for the auditor to include a reference to such possibility in order to retain the ability to do so.

#### Considerations specific to public sector entities

- A43. Listed entities are not common in the public sector. However, public sector entities may be significant due to size, complexity or public interest aspects. In such cases, an auditor of a public sector entity may be required by law or regulation or may otherwise decide to communicate key audit matters in the auditor's report.

#### Responsibilities for the Financial Statements (Ref: Para. 33–34)

- A44. ISA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with ISAs is conducted.<sup>33</sup> Management and, where appropriate, those charged with governance, accept responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted. ISA 260 (Revised) uses the term those charged with governance to describe

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<sup>30</sup> ISA 210, paragraphs 9 and A22

<sup>31</sup> ISA 210, paragraph 10

<sup>32</sup> ISA 210, paragraph A25

<sup>33</sup> ISA 200, paragraph 13(j)

the person(s) or organization(s) with responsibility for overseeing the entity, and provides a discussion about the diversity of governance structures across jurisdictions and by entity.

- A45. There may be circumstances when it is appropriate for the auditor to add to the descriptions of the responsibilities of management and those charged with governance in paragraphs 34–35 to reflect additional responsibilities that are relevant to the preparation of the financial statements in the context of the particular jurisdiction or the nature of the entity.
- A46. ISA 210 requires the auditor to agree management’s responsibilities in an engagement letter or other suitable form of written agreement.<sup>34</sup> ISA 210 provides some flexibility in doing so, by explaining that, if law or regulation prescribes the responsibilities of management and, where appropriate, those charged with governance, in relation to financial reporting, the auditor may determine that the law or regulation includes responsibilities that, in the auditor’s judgment, are equivalent in effect to those set out in ISA 210. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the engagement letter or other suitable form of written agreement. In such cases, this wording may also be used in the auditor’s report to describe the responsibilities as required by paragraph 34(a) of this ISA. In other circumstances, including where the auditor decides not to use the wording of law or regulation as incorporated in the engagement letter, the wording in paragraph 34(a) of this ISA is used. In addition to including the description of management’s responsibilities in the auditor’s report as required by paragraph 34, the auditor may refer to a more detailed description of these responsibilities by including a reference to where such information may be obtained (e.g., in the annual report of the entity or a website of an appropriate authority).
- A47. In some jurisdictions, law or regulation prescribing management’s responsibilities may specifically refer to a responsibility for the adequacy of accounting books and records, or accounting system. As books, records and systems are an integral part of internal control (as defined in ISA 315 (Revised)<sup>35</sup>), the descriptions in ISA 210 and in paragraph 34 do not make specific reference to them.
- A48. The Appendix to this ISA provides illustrations of how the requirement in paragraph 34(b) would be applied when IFRSs is the applicable financial reporting framework. If an applicable financial reporting framework other than IFRSs is used, the illustrative statements featured in the Appendix to this ISA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

<sup>34</sup> ISA 210, paragraph 6(b)(i)–(ii)

<sup>35</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 4(c)

## Oversight of the financial reporting process (Ref: Para. 35)

A49. When some, but not all, of the individuals involved in the oversight of the financial reporting process are also involved in preparing the financial statements, the description as required by paragraph 35 of this ISA may need to be modified to appropriately reflect the particular circumstances of the entity. When individuals responsible for the oversight of the financial reporting process are the same as those responsible for the preparation of the financial statements, no reference to oversight responsibilities is required.

Auditor's Responsibilities for the Audit of the Financial Statements  
(Ref: Para. 37–40)

A50. The description of the auditor's responsibilities as required by paragraphs 37–40 of this ISA may be tailored to reflect the specific nature of the entity, for example, when the auditor's report addresses consolidated financial statements. Illustration 2 in the Appendix to this ISA includes an example of how this may be done.

## Objectives of the auditor (Ref: Para. 38(a))

A51. The auditor's report explains that the objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes the auditor's opinion. These are in contrast to management's responsibilities for the preparation for the financial statements.

## Description of materiality (Ref: Para. 38(c))

A52. The Appendix to this ISA provides illustrations of how the requirement in paragraph 38(c), to provide a description of materiality, would be applied when IFRSs is the applicable financial reporting framework. If an applicable financial reporting framework other than IFRSs is used, the illustrative statements presented in the Appendix to this ISA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

## Auditor's responsibilities relating to ISA 701 (Ref: Para. 40(c))

A53. The auditor may also consider it useful to provide additional information in the description of the auditor's responsibilities beyond what is required by paragraph 40(c). For example, the auditor may make reference to the requirement in paragraph 9 of ISA 701 to determine the matters that required significant auditor attention in performing the audit, taking into account areas of higher assessed risk of material misstatement or significant risks identified in accordance with ISA 315 (Revised); significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and the effects on the audit of significant events or transactions that occurred during the period.

Location of the description of the auditor’s responsibilities for the audit of the financial statements (Ref: Para. 41, 50(j))

A54. Including the information required by paragraphs 39–40 of this ISA in an appendix to the auditor’s report or, when law, regulation or national auditing standards expressly permit, referring to a website of an appropriate authority containing such information may be a useful way of streamlining the content of the auditor’s report. However, because the description of the auditor’s responsibilities contains information that is necessary to inform users’ expectations of an audit conducted in accordance with ISAs, a reference is required to be included in the auditor’s report indicating where such information can be accessed.

Location in an appendix (Ref: Para. 41(b), 50(j))

A55. Paragraph 41 permits the auditor to include the statements required by paragraphs 39–40 describing the auditor’s responsibilities for the audit of the financial statements in an appendix to the auditor’s report, provided that appropriate reference is made within the body of the auditor’s report to the location of the appendix. The following is an illustration of how such a reference to an appendix could be made in the auditor’s report:

### **Auditor’s Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor’s report. This description, which is located at [*indicate page number or other specific reference to the location of the description*], forms part of our auditor’s report.

Reference to a website of an appropriate authority (Ref: Para. 41(c), 42)

A56. Paragraph 41 explains that the auditor may refer to a description of the auditor’s responsibilities located on a website of an appropriate authority, only if expressly permitted by law, regulation or national auditing standards. The information on

the website that is incorporated in the auditor's report by way of a specific reference to the website location where such information can be found may describe the auditor's work, or the audit in accordance with ISAs more broadly, but it cannot be inconsistent with the description required in paragraphs 39–40 of this ISA. This means that the wording of the description of the auditor's responsibilities on the website may be more detailed, or may address other matters relating to an audit of financial statements, provided that such wording reflects and does not contradict the matters addressed in paragraphs 39–40.

- A57. An appropriate authority could be a national auditing standard setter, regulator, or an audit oversight body. Such organizations are well-placed to ensure the accuracy, completeness and continued availability of the standardized information. It would not be appropriate for the auditor to maintain such a website. The following is an illustration of how such a reference to a website could be made in the auditor's report:

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located at [*Organization's*] website at: [*website address*]. This description forms part of our auditor's report.

### **Other Reporting Responsibilities (Ref: Para. 43–45)**

- A58. In some jurisdictions, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibilities under the ISAs. For example, the auditor may be asked to report certain matters if they come to the auditor's attention during the course of the audit of the financial statements. Alternatively, the auditor may be asked to perform and report on additional specified procedures, or to express an opinion on specific matters, such as the adequacy of accounting books and records, internal control over financial reporting or other information. Auditing standards in the specific jurisdiction often provide guidance on the auditor's responsibilities with respect to specific additional reporting responsibilities in that jurisdiction.

- A59. In some cases, the relevant law or regulation may require or permit the auditor to report on these other responsibilities as part of their auditor’s report on the financial statements. In other cases, the auditor may be required or permitted to report on them in a separate report.
- A60. Paragraphs 43–45 of this ISA permit combined presentation of other reporting responsibilities and the auditor’s responsibilities under the ISAs only when they address the same topics and the wording of the auditor’s report clearly differentiates the other reporting responsibilities from those under the ISAs. Such clear differentiation may make it necessary for the auditor’s report to refer to the source of the other reporting responsibilities and to state that such responsibilities are beyond those required under the ISAs. Otherwise, other reporting responsibilities are required to be addressed in a separate section in the auditor’s report with a heading “Report on Other Legal and Regulatory Requirements,” or otherwise as appropriate to the content of the section. In such cases, paragraph 44 requires the auditor to include reporting responsibilities under the ISAs under a heading titled “Report on the Audit of the Financial Statements.”

Name of the Engagement Partner (Ref: Para. 46)

- A61. ISQC 1<sup>36</sup> requires that the firm establish policies and procedures to provide reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements. Notwithstanding these ISQC 1 requirements, naming the engagement partner in the auditor’s report is intended to provide further transparency to the users of the auditor’s report on financial statements of a listed entity.
- A62. Law, regulation or national auditing standards may require that the auditor’s report include the name of the engagement partner responsible for audits other than those of financial statements of listed entities. The auditor may also be required by law, regulation or national auditing standards, or may decide to include additional information beyond the engagement partner’s name in the auditor’s report to further identify the engagement partner, for example, the engagement partner’s professional license number that is relevant to the jurisdiction where the auditor practices.
- A63. In rare circumstances, the auditor may identify information or be subject to experiences that indicate the likelihood of a personal security threat that, if the identity of the engagement partner is made public, may result in physical harm to the engagement partner, other engagement team members or other closely related individuals. However, such a threat does not include, for example, threats of legal liability or legal, regulatory or professional sanctions. Discussions with those charged with governance about circumstances that may result in physical harm may provide additional information about the likelihood or severity of

<sup>36</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraph 32

the significant personal security threat. Law, regulation or national auditing standards may establish further requirements that are relevant to determining whether the disclosure of the name of the engagement partner may be omitted.

#### Signature of the Auditor (Ref: Para. 47)

- A64. The auditor's signature is either in the name of the audit firm, the personal name of the auditor or both, as appropriate for the particular jurisdiction. In addition to the auditor's signature, in certain jurisdictions, the auditor may be required to declare in the auditor's report the auditor's professional accountancy designation or the fact that the auditor or firm, as appropriate, has been recognized by the appropriate licensing authority in that jurisdiction.
- A65. In some cases, law or regulation may allow for the use of electronic signatures in the auditor's report.

#### Date of the Auditor's Report (Ref: Para. 49)

- A66. The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in ISA 560.<sup>37</sup>
- A67. Since the auditor's opinion is provided on the financial statements and the financial statements are the responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until evidence is obtained that all the statements and disclosures that comprise the financial statements have been prepared and management has accepted responsibility for them.
- A68. In some jurisdictions, law or regulation identifies the individuals or bodies (e.g., the directors) that are responsible for concluding that all the statements and disclosures that comprise the financial statements have been prepared, and specifies the necessary approval process. In such cases, evidence is obtained of that approval before dating the report on the financial statements. In other jurisdictions, however, the approval process is not prescribed in law or regulation. In such cases, the procedures the entity follows in preparing and finalizing its financial statements in view of its management and governance structures are considered in order to identify the individuals or body with the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared. In some cases, law or regulation identifies the point in the financial statement reporting process at which the audit is expected to be complete.
- A69. In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these

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<sup>37</sup> ISA 560, *Subsequent Events*, paragraphs 10–17

jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of ISAs is the earlier date on which those with the recognized authority determine that all the statements and disclosures that comprise the financial statements have been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

*Auditor's Report Prescribed by Law or Regulation (Ref: Para. 50)*

A70. ISA 200 explains that the auditor may be required to comply with legal or regulatory requirements in addition to ISAs.<sup>38</sup> When the differences between the legal or regulatory requirements and ISAs relate only to the layout and wording of the auditor's report, the requirements in paragraph 50(a)–(o) set out the minimum elements to be included in the auditor's report to enable a reference to the International Standards on Auditing. In those circumstances, the requirements in paragraphs 21–49 that are not included in paragraph 50(a)–(o) do not need to be applied including, for example, the required ordering of the Opinion and Basis for Opinion sections.

A71. Where specific requirements in a particular jurisdiction do not conflict with ISAs, the layout and wording required by paragraphs 21–49 of this ISA assist users of the auditor's report in more readily recognizing the auditor's report as a report of an audit conducted in accordance with ISAs.

*Information Required by ISA 701 (Ref: Para. 50(h))*

A72. Law or regulation may require the auditor to provide additional information about the audit that was performed, which may include information that is consistent with the objectives of ISA 701, or may prescribe the nature and extent of communication about such matters.

A73. The ISAs do not override law or regulation that governs an audit of financial statements. When ISA 701 is applicable, reference can only be made to ISAs in the auditor's report if, in applying the law or regulation, the section required by paragraph 50(h) of this ISA is not inconsistent with the reporting requirements in ISA 701. In such circumstances, the auditor may need to tailor certain aspects of the communication of key audit matters in the auditor's report required by ISA 701, for example by:

- Modifying the heading “Key Audit Matters”, if law or regulation prescribes a specific heading;
- Explaining why the information required by law or regulation is being provided in the auditor's report, for example by making a reference to the relevant law or regulation and describing how that information relates to the key audit matters;

<sup>38</sup> ISA 200, paragraph A57

- Where law or regulation prescribes the nature and extent of the description, supplementing the prescribed information to achieve an overall description of each key audit matter that is consistent with the requirement in paragraph 13 of ISA 701.

A74. ISA 210 deals with circumstances where law or regulation of the relevant jurisdiction prescribes the layout or wording of the auditor's report in terms that are significantly different from the requirements of ISAs, which in particular includes the auditor's opinion. In these circumstances, ISA 210 requires the auditor to evaluate:

- (a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,
- (b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding.

If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, ISA 210 requires the auditor not to accept the audit engagement, unless required by law or regulation to do so. In accordance with ISA 210, an audit conducted in accordance with such law or regulation does not comply with ISAs. Accordingly, the auditor does not include any reference in the auditor's report to the audit having been conducted in accordance with International Standards on Auditing.<sup>39</sup>

#### Considerations specific to public sector entities

A75. Auditors of public sector entities may also have the ability pursuant to law or regulation to report publicly on certain matters, either in the auditor's report or in a supplementary report, which may include information that is consistent with the objectives of ISA 701. In such circumstances, the auditor may need to tailor certain aspects of the communication of key audit matters in the auditor's report required by ISA 701 or include a reference in the auditor's report to a description of the matter in the supplementary report.

#### *Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards of a Specific Jurisdiction and International Standards on Auditing (Ref: Para. 51)*

A76. The auditor may refer in the auditor's report to the audit having been conducted in accordance with both International Standards on Auditing as well as the national auditing standards when, in addition to complying with the relevant national auditing standards, the auditor complies with each of the ISAs relevant to the audit.<sup>40</sup>

A77. A reference to both International Standards on Auditing and the national auditing standards is not appropriate if there is a conflict between the requirements in

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<sup>39</sup> ISA 210, paragraph 21

<sup>40</sup> ISA 200, paragraph A58

ISAs and those in the national auditing standards that would lead the auditor to form a different opinion or not to include an Emphasis of Matter or Other Matter paragraph that, in the particular circumstances, is required by ISAs. In such a case, the auditor's report refers only to the auditing standards (either International Standards on Auditing or the national auditing standards) in accordance with which the auditor's report has been prepared.

**Supplementary Information Presented with the Financial Statements** (Ref: Para. 53–54)

- A78. In some circumstances, the entity may be required by law, regulation or standards, or may voluntarily choose, to present together with the financial statements supplementary information that is not required by the applicable financial reporting framework. For example, supplementary information might be presented to enhance a user's understanding of the applicable financial reporting framework or to provide further explanation of specific financial statement items. Such information is normally presented in either supplementary schedules or as additional notes.
- A79. Paragraph 53 of this ISA explains that the auditor's opinion covers supplementary information that is an integral part of the financial statements because of its nature or how it is presented. This evaluation is a matter of professional judgment. To illustrate:
- When the notes to the financial statements include an explanation or the reconciliation of the extent to which the financial statements comply with another financial reporting framework, the auditor may consider this to be supplementary information that cannot be clearly differentiated from the financial statements. The auditor's opinion would also cover notes or supplementary schedules that are cross-referenced from the financial statements.
  - When an additional profit and loss account that discloses specific items of expenditure is disclosed as a separate schedule included as an Appendix to the financial statements, the auditor may consider this to be supplementary information that can be clearly differentiated from the financial statements.
- A80. Supplementary information that is covered by the auditor's opinion does not need to be specifically referred to in the auditor's report when the reference to the notes in the description of the statements that comprise the financial statements in the auditor's report is sufficient.
- A81. Law or regulation may not require that the supplementary information be audited, and management may decide to ask the auditor not to include the supplementary information within the scope of the audit of the financial statements.

- A82. The auditor’s evaluation whether unaudited supplementary information is presented in a manner that could be construed as being covered by the auditor’s opinion includes, for example, where that information is presented in relation to the financial statements and any audited supplementary information, and whether it is clearly labeled as “unaudited.”
- A83. Management could change the presentation of unaudited supplementary information that could be construed as being covered by the auditor’s opinion, for example, by:
- Removing any cross-references from the financial statements to unaudited supplementary schedules or unaudited notes so that the demarcation between the audited and unaudited information is sufficiently clear.
  - Placing the unaudited supplementary information outside of the financial statements or, if that is not possible in the circumstances, at a minimum placing the unaudited notes together at the end of the required notes to the financial statements and clearly labeling them as unaudited. Unaudited notes that are intermingled with the audited notes can be misinterpreted as being audited.
- A84. The fact that supplementary information is unaudited does not relieve the auditor of the responsibilities described in ISA 720 (Revised).

**Appendix**

(Ref: Para. A19)

**Illustrations of Independent Auditor's Reports on Financial Statements**

- Illustration 1: An auditor's report on financial statements of a listed entity prepared in accordance with a fair presentation framework
- Illustration 2: An auditor's report on consolidated financial statements of a listed entity prepared in accordance with a fair presentation framework
- Illustration 3: An auditor's report on financial statements of an entity other than a listed entity prepared in accordance with a fair presentation framework (where reference is made to material that is located on a website of an appropriate authority)
- Illustration 4: An auditor's report on financial statements of an entity other than a listed entity prepared in accordance with a general purpose compliance framework

**Illustration 1 – Auditor’s Report on Financial Statements of a Listed Entity Prepared in Accordance with a Fair Presentation Framework**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit comprise the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code), together with the ethical requirements relating to the audit in the jurisdiction, and the auditor refers to both.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- Key audit matters have been communicated in accordance with ISA 701.
- The auditor has obtained all of the other information prior to the date of the auditor’s report and has not yet identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

## INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>1</sup>

#### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards) (IESBA Code)*, together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

#### Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

#### Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]

[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 1 in Appendix 2 of ISA 720 (Revised).]

<sup>1</sup> The sub-title “Report on the Audit of the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.

## **Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>2</sup>**

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs,<sup>3</sup> and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

## **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of this ISA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting

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<sup>2</sup> Throughout these illustrative auditor's reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

<sup>3</sup> Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.<sup>4</sup>
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, actions taken to eliminate threats or safeguards applied.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

<sup>4</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

## Report on Other Legal and Regulatory Requirements

*[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the ISAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the ISAs where such a difference exists.]*

The engagement partner on the audit resulting in this independent auditor's report is [name].

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

**Illustration 2 – Auditor’s Report on Consolidated Financial Statements of a Listed Entity Prepared in Accordance with a Fair Presentation Framework**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- **Audit of a complete set of consolidated financial statements of a listed entity using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., ISA 600 applies).**
- **The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management’s responsibility for the consolidated financial statements in ISA 210.**
- **The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.**
- **The International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code), comprises all of the relevant ethical requirements that apply to the audit.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **Key audit matters have been communicated in accordance with ISA 701.**
- **The auditor has obtained all of the other information prior to the date of the auditor’s report and has not identified a material misstatement of the other information.**
- **Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.**
- **In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Consolidated Financial Statements<sup>5</sup>

#### Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, (or *give a true and fair view of*) the consolidated financial position of the Group as at December 31, 20X1, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code), and we have fulfilled our other ethical responsibilities in accordance with the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

#### Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

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<sup>5</sup> The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

## **Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

*[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 1 in Appendix 2 of ISA 720 (Revised).]*

## **Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements<sup>6</sup>**

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with IFRSs,<sup>7</sup> and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is responsible for assessing the Group’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group’s financial reporting process.

## **Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements**

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

Paragraph 41(b) of this ISA explains that the shaded material below can be located in an Appendix to the auditor’s report. Paragraph 41(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor’s responsibilities, rather than including this material in the auditor’s report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor’s responsibilities below.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

<sup>6</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>7</sup> Where management’s responsibility is to prepare financial statements that give a true and fair view, this may read: “Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ...”

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.<sup>8</sup>
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably

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<sup>8</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements.

be thought to bear on our independence, and where applicable, actions taken to eliminate threats or safeguards applied.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

## Report on Other Legal and Regulatory Requirements

*[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs as part of the Report on the Audit of the Consolidated Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the ISAs may be combined (i.e., included in the Report on the Audit of the Consolidated Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the ISAs where such a difference exists.]*

The engagement partner on the audit resulting in this independent auditor's report is [name].

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

**Illustration 3 – Auditor’s Report on Financial Statements of an Entity Other than a Listed Entity Prepared in Accordance with a Fair Presentation Framework**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- **Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).**
- **The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.**
- **The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.**
- **The auditor has obtained all of the other information prior to the date of the auditor’s report and has not identified a material misstatement of the other information.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **The auditor has no other reporting responsibilities required under local law.**
- **The auditor elects to refer to the description of the auditor’s responsibility included on a website of an appropriate authority.**

## INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]

[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 1 in Appendix 2 of ISA 720 (Revised).]

### Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>9</sup>

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs,<sup>10</sup> and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless

<sup>9</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>10</sup> Where management’s responsibility is to prepare financial statements that give a true and fair view, this may read: “Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ...”

management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of the auditor's responsibilities for the audit of the financial statements is located at [Organization's] website at: [website link]. This description forms part of our auditor's report.

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

**Illustration 4 – Auditor’s Report on Financial Statements of an Entity Other than a Listed Entity Prepared in Accordance with a General Purpose Compliance Framework**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity required by law or regulation. The audit is not a group audit (i.e., ISA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the Financial Reporting Framework (XYZ Law) of Jurisdiction X (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.
- The auditor has obtained all of the other information prior to the date of the auditor’s report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- The auditor has no other reporting responsibilities required under local law.

## INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements of the Company are prepared, in all material respects, in accordance with XYZ Law of Jurisdiction X.

### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 1 in Appendix 2 of ISA 720 (Revised).]

### Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>11</sup>

Management is responsible for the preparation of the financial statements in accordance with XYZ Law of Jurisdiction X,<sup>12</sup> and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

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<sup>11</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>12</sup> Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

Those charged with governance are responsible for overseeing the Company's financial reporting process.

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of this ISA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.<sup>13</sup>
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention

<sup>13</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

**INTERNATIONAL STANDARD ON AUDITING 701**  
**COMMUNICATING KEY AUDIT MATTERS IN**  
**THE INDEPENDENT AUDITOR’S REPORT**

(Effective for audits of financial statements for periods  
ending on or after December 15, 2016)

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International Standard on Auditing (ISA) 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

ISA

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.
2. The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements ("intended users") to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements. (Ref: Para. A1–A4)
3. The communication of key audit matters in the auditor's report may also provide intended users a basis to further engage with management and those charged with governance about certain matters relating to the entity, the audited financial statements, or the audit that was performed.
4. Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:
  - (a) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
  - (b) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with ISA 705 (Revised);<sup>1</sup>
  - (c) A substitute for reporting in accordance with ISA 570 (Revised)<sup>2</sup> when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
  - (d) A separate opinion on individual matters. (Ref: Para. A5–A8)
5. This ISA applies to audits of complete sets of general purpose financial statements of listed entities and circumstances when the auditor otherwise decides to communicate key audit matters in the auditor's report. This ISA also applies when the auditor is required by law or regulation to communicate key

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<sup>1</sup> ISA 705 (Revised), Modifications to the Opinion in the Independent Auditor's Report

<sup>2</sup> ISA 570 (Revised), Going Concern, paragraphs 22–23

audit matters in the auditor's report.<sup>3</sup> However, ISA 705 (Revised) prohibits the auditor from communicating key audit matters when the auditor disclaims an opinion on the financial statements, unless such reporting is required by law or regulation.<sup>4</sup>

### Effective Date

6. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2016.

### Objectives

7. The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

### Definition

8. For purposes of the ISAs, the following term has the meaning attributed below:  
Key audit matters—Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

### Requirements

#### Determining Key Audit Matters

9. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following: (Ref: Para. A9–A18)
  - (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised).<sup>5</sup> (Ref: Para. A19–A22)
  - (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that are subject to a high degree of estimation uncertainty. (Ref: Para. A23–A24)
  - (c) The effect on the audit of significant events or transactions that occurred during the period. (Ref: Para. A25–A26)

<sup>3</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 30–31

<sup>4</sup> ISA 705 (Revised), paragraph 29

<sup>5</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

10. The auditor shall determine which of the matters determined in accordance with paragraph 9 were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters. (Ref: Para. A9–A11, A27–A30)

### **Communicating Key Audit Matters**

11. The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters," unless the circumstances in paragraphs 14 or 15 apply. The introductory language in this section of the auditor's report shall state that:
- (a) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and
  - (b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters. (Ref: Para. A31–A33)

#### *Key Audit Matters Not a Substitute for Expressing a Modified Opinion*

12. The auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion in accordance with ISA 705 (Revised) as a result of the matter. (Ref: Para. A5)

#### *Descriptions of Individual Key Audit Matters*

13. The description of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address: (Ref: Para. A34–A41)
- (a) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and (Ref: Para. A42–A45)
  - (b) How the matter was addressed in the audit. (Ref: Para. A46–A51)

#### *Circumstances in Which a Matter Determined to Be a Key Audit Matter Is Not Communicated in the Auditor's Report*

14. The auditor shall describe each key audit matter in the auditor's report unless: (Ref: Para. A53–A56)
- (a) Law or regulation precludes public disclosure about the matter; or (Ref: Para. A52)
  - (b) In extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the

public interest benefits of such communication. This shall not apply if the entity has publicly disclosed information about the matter.

*Interaction between Descriptions of Key Audit Matters and Other Elements Required to Be Included in the Auditor's Report*

15. A matter giving rise to a modified opinion in accordance with ISA 705 (Revised), or a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised), are by their nature key audit matters. However, in such circumstances, these matters shall not be described in the Key Audit Matters section of the auditor's report and the requirements in paragraphs 13–14 do not apply. Rather, the auditor shall:
- (a) Report on these matter(s) in accordance with the applicable ISA(s); and
  - (b) Include a reference to the Basis for Qualified (Adverse) Opinion or the Material Uncertainty Related to Going Concern section(s) in the Key Audit Matters section. (Ref: Para. A6–A7)

*Form and Content of the Key Audit Matters Section in Other Circumstances*

16. If the auditor determines, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate or that the only key audit matters communicated are those matters addressed by paragraph 15, the auditor shall include a statement to this effect in a separate section of the auditor's report under the heading "Key Audit Matters." (Ref: Para. A57–A59)

**Communication with Those Charged with Governance**

17. The auditor shall communicate with those charged with governance:
- (a) Those matters the auditor has determined to be the key audit matters; or
  - (b) If applicable, depending on the facts and circumstances of the entity and the audit, the auditor's determination that there are no key audit matters to communicate in the auditor's report. (Ref: Para. A60–A63)

**Documentation**

18. The auditor shall include in the audit documentation:<sup>6</sup> (Ref: Para. A64)
- (a) The matters that required significant auditor attention as determined in accordance with paragraph 9, and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter in accordance with paragraph 10;
  - (b) Where applicable, the rationale for the auditor's determination that there are no key audit matters to communicate in the auditor's report or that

<sup>6</sup> ISA 230, *Audit Documentation*, paragraphs 8–11 and A6

the only key audit matters to communicate are those matters addressed by paragraph 15; and

- (c) Where applicable, the rationale for the auditor's determination not to communicate in the auditor's report a matter determined to be a key audit matter.

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## Application and Other Explanatory Material

### Scope of this ISA (Ref: Para. 2)

- A1. Significance can be described as the relative importance of a matter, taken in context. The significance of a matter is judged by the auditor in the context in which it is being considered. Significance can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and effect on the subject matter and the expressed interests of intended users or recipients. This involves an objective analysis of the facts and circumstances, including the nature and extent of communication with those charged with governance.
- A2. Users of financial statements have expressed an interest in those matters about which the auditor had the most robust dialogue with those charged with governance as part of the two-way communication required by ISA 260 (Revised)<sup>7</sup> and have called for additional transparency about those communications. For example, users have expressed particular interest in understanding significant judgments made by the auditor in forming the opinion on the financial statements as a whole, because they are often related to the areas of significant management judgment in preparing the financial statements.
- A3. Requiring auditors to communicate key audit matters in the auditor's report may also enhance communications between the auditor and those charged with governance about those matters, and may increase attention by management and those charged with governance to the disclosures in the financial statements to which reference is made in the auditor's report.
- A4. ISA 320<sup>8</sup> explains that it is reasonable for the auditor to assume that users of the financial statements:
  - (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
  - (b) Understand that the financial statements are prepared, presented and audited to levels of materiality;

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<sup>7</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

<sup>8</sup> ISA 320, *Materiality in Planning and Performing the Audit*, paragraph 4

- (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- (d) Make reasonable economic decisions on the basis of the information in the financial statements.

Because the auditor's report accompanies the audited financial statements, the users of the auditor's report are considered to be the same as the intended users of the financial statements.

*Relationship between Key Audit Matters, the Auditor's Opinion and Other Elements of the Auditor's Report* (Ref: Para. 4, 12, 15)

- A5. ISA 700 (Revised) establishes requirements and provides guidance on forming an opinion on the financial statements.<sup>9</sup> Communicating key audit matters is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation. ISA 705 (Revised) addresses circumstances in which the auditor concludes that there is a material misstatement relating to the appropriateness or adequacy of disclosures in the financial statements.<sup>10</sup>
- A6. When the auditor expresses a qualified or adverse opinion in accordance with ISA 705 (Revised), presenting the description of a matter giving rise to a modified opinion in the Basis for Qualified (Adverse) Opinion section helps to promote intended users' understanding and to identify such circumstances when they occur. Separating the communication of this matter from other key audit matters described in the Key Audit Matters section therefore gives it the appropriate prominence in the auditor's report (see paragraph 15). The Appendix in ISA 705 (Revised) includes illustrative examples of how the introductory language in the Key Audit Matters section is affected when the auditor expresses a qualified or adverse opinion and other key audit matters are communicated in the auditor's report. Paragraph A58 of this ISA illustrates how the Key Audit Matters section is presented when the auditor has determined that there are no other key audit matters to be communicated in the auditor's report beyond matters addressed in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section of the auditor's report.
- A7. When the auditor expresses a qualified or adverse opinion, communicating other key audit matters would still be relevant to enhancing intended users' understanding of the audit, and therefore the requirements to determine key audit matters apply. However, as an adverse opinion is expressed in

<sup>9</sup> ISA 700 (Revised), paragraphs 10–15 and A1–A15

<sup>10</sup> See paragraph A7 of ISA 705 (Revised).

circumstances when the auditor has concluded that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements:<sup>11</sup>

- (a) Depending on the significance of the matter(s) giving rise to an adverse opinion, the auditor may determine that no other matters are key audit matters. In such circumstances, the requirement in paragraph 15 applies (see paragraph A58).
- (b) If one or more matters other than the matter(s) giving rise to an adverse opinion are determined to be key audit matters, it is particularly important that the descriptions of such other key audit matters do not imply that the financial statements as a whole are more credible in relation to those matters than would be appropriate in the circumstances, in view of the adverse opinion (see paragraph A47).

A8. ISA 706 (Revised)<sup>12</sup> establishes mechanisms for auditors of financial statements of all entities to include additional communication in the auditor's report through the use of Emphasis of Matter paragraphs and Other Matter paragraphs when the auditor considers it necessary to do so. In such cases, these paragraphs are presented separately from the Key Audit Matters section in the auditor's report. When a matter has been determined to be a key audit matter, the use of such paragraphs is not a substitute for the description of the individual key audit matter in accordance with paragraph 13.<sup>13</sup> ISA 706 (Revised) provides further guidance on the relationship between key audit matters and Emphasis of Matter paragraphs in accordance with that ISA.<sup>14</sup>

### **Determining Key Audit Matters** (Ref: Para. 9–10)

A9. The auditor's decision-making process in determining key audit matters is designed to select a smaller number of matters from the matters communicated with those charged with governance, based on the auditor's judgment about which matters were of most significance in the audit of the financial statements of the current period.

A10. The auditor's determination of key audit matters is limited to those matters of most significance in the audit of the financial statements of the current period, even when comparative financial statements are presented (i.e., even when the auditor's opinion refers to each period for which financial statements are presented).<sup>15</sup>

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<sup>11</sup> ISA 705 (Revised), paragraph 8

<sup>12</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

<sup>13</sup> See paragraphs 8(b) and 10(b) of ISA 706 (Revised).

<sup>14</sup> ISA 706 (Revised), paragraphs A1–A3

<sup>15</sup> See ISA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*.

- A11. Notwithstanding that the auditor's determination of key audit matters is for the audit of the financial statements of the current period and this ISA does not require the auditor to update key audit matters included in the prior period's auditor's report, it may nevertheless be useful for the auditor to consider whether a matter that was a key audit matter in the audit of the financial statements of the prior period continues to be a key audit matter in the audit of the financial statements of the current period.

*Matters that Required Significant Auditor Attention* (Ref: Para. 9)

- A12. The concept of significant auditor attention recognizes that an audit is risk-based and focuses on identifying and assessing the risks of material misstatement of the financial statements, designing and performing audit procedures responsive to those risks, and obtaining audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. For a particular account balance, class of transactions or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In designing further audit procedures, the auditor is required to obtain more persuasive audit evidence the higher the auditor's assessment of risk.<sup>16</sup> When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.<sup>17</sup>
- A13. Accordingly, matters that pose challenges to the auditor in obtaining sufficient appropriate audit evidence or pose challenges to the auditor in forming an opinion on the financial statements may be particularly relevant in the auditor's determination of key audit matters.
- A14. Areas of significant auditor attention often relate to areas of complexity and significant management judgment in the financial statements, and therefore often involve difficult or complex auditor judgments. In turn, this often affects the auditor's overall audit strategy, the allocation of resources and extent of audit effort in relation to such matters. These effects may include, for example, the extent of involvement of senior personnel on the audit engagement or the involvement of an auditor's expert or individuals with expertise in a specialized area of accounting or auditing, whether engaged or employed by the firm to address these areas.
- A15. Various ISAs require specific communications with those charged with governance and others that may relate to areas of significant auditor attention. For example:

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<sup>16</sup> ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 7(b)

<sup>17</sup> ISA 330, paragraph A19

- ISA 260 (Revised) requires the auditor to communicate significant difficulties, if any, encountered during the audit with those charged with governance.<sup>18</sup> The ISAs acknowledge potential difficulties in relation to, for example:
  - Related party transactions,<sup>19</sup> in particular limitations on the auditor's ability to obtain audit evidence that all other aspects of a related party transaction (other than price) are equivalent to those of a similar arm's length transaction.
  - Limitations on the group audit, for example, where the group engagement team's access to information may have been restricted.<sup>20</sup>
- ISA 220 establishes requirements for the engagement partner in relation to undertaking appropriate consultation on difficult or contentious matters.<sup>21</sup> For example, the auditor may have consulted with others within the firm or outside the firm on a significant technical matter, which may be an indicator that it is a key audit matter. The engagement partner is also required to discuss, among other things, significant matters arising during the audit engagement with the engagement quality control reviewer.<sup>22</sup>

*Considerations in Determining Those Matters that Required Significant Auditor Attention (Ref: Para. 9)*

- A16. The auditor may develop a preliminary view at the planning stage about matters that are likely to be areas of significant auditor attention in the audit and therefore may be key audit matters. The auditor may communicate this with those charged with governance when discussing the planned scope and timing of the audit in accordance with ISA 260 (Revised). However, the auditor's determination of key audit matters is based on the results of the audit or evidence obtained throughout the audit.
- A17. Paragraph 9 includes specific required considerations in the auditor's determination of those matters that required significant auditor attention. These considerations focus on the nature of matters communicated with those charged with governance that are often linked to matters disclosed in the financial statements, and are intended to reflect areas of the audit of the financial statements that may be of particular interest to intended users. The fact that these considerations are required is not intended to imply that matters related to them are always key audit matters; rather, matters related to such specific

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<sup>18</sup> ISA 260 (Revised), paragraphs 16(b) and A21

<sup>19</sup> ISA 550, *Related Parties*, paragraph A42

<sup>20</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph 49(d)

<sup>21</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 18

<sup>22</sup> ISA 220, paragraph 19

considerations are key audit matters only if they are determined to be of most significance in the audit in accordance with paragraph 10. As the considerations may be interrelated (e.g., matters relating to the circumstances described in paragraphs 9(b)-(c) may also be identified as significant risks), the applicability of more than one of the considerations to a particular matter communicated with those charged with governance may increase the likelihood of the auditor identifying that matter as a key audit matter.

- A18. In addition to matters that relate to the specific required considerations in paragraph 9, there may be other matters communicated with those charged with governance that required significant auditor attention and that therefore may be determined to be key audit matters in accordance with paragraph 10. Such matters may include, for example, matters relevant to the audit that was performed that may not be required to be disclosed in the financial statements. For example, the implementation of a new IT system (or significant changes to an existing IT system) during the period may be an area of significant auditor attention, in particular if such a change had a significant effect on the auditor's overall audit strategy or related to a significant risk (e.g., changes to a system affecting revenue recognition).

#### Areas of Higher Assessed Risk of Material Misstatement, or Significant Risks Identified in Accordance with ISA 315 (Revised) (Ref: Para. 9(a))

- A19. ISA 260 (Revised) requires the auditor to communicate with those charged with governance about the significant risks identified by the auditor.<sup>23</sup> Paragraph A13 of ISA 260 (Revised) explains that the auditor may also communicate with those charged with governance about how the auditor plans to address areas of higher assessed risks of material misstatement.
- A20. ISA 315 (Revised) defines a significant risk as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration. Areas of significant management judgment and significant unusual transactions may often be identified as significant risks. Significant risks are therefore often areas that require significant auditor attention.
- A21. However, this may not be the case for all significant risks. For example, ISA 240 presumes that there are risks of fraud in revenue recognition and requires the auditor to treat those assessed risks of material misstatement due to fraud as significant risks.<sup>24</sup> In addition, ISA 240 indicates that, due to the unpredictable way in which management override of controls could occur, it is a risk of material misstatement due to fraud and thus a significant risk.<sup>25</sup> Depending on their nature, these risks may not require significant auditor attention, and

<sup>23</sup> ISA 260 (Revised), paragraph 15

<sup>24</sup> ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, paragraphs 27–28

<sup>25</sup> ISA 240, paragraph 32

therefore would not be considered in the auditor's determination of key audit matters in accordance with paragraph 10.

- A22. ISA 315 (Revised) explains that the auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained.<sup>26</sup> Revision to the auditor's risk assessment and reevaluation of the planned audit procedures with respect to a particular area of the financial statements (i.e., a significant change in the audit approach, for example, if the auditor's risk assessment was based on an expectation that certain controls were operating effectively and the auditor has obtained audit evidence that they were not operating effectively throughout the audit period, particularly in an area with higher assessed risk of material misstatement) may result in an area being determined as one requiring significant auditor attention.

Significant Auditor Judgments Relating to Areas in the Financial Statements that Involved Significant Management Judgment, Including Accounting Estimates that Are Subject to a High Degree of Estimation Uncertainty (Ref: Para. 9(b))

- A23. ISA 260 (Revised) requires the auditor to communicate with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.<sup>27</sup> In many cases, this relates to critical accounting estimates and related disclosures, which are likely to be areas of significant auditor attention, and also may be identified as significant risks.
- A24. However, users of the financial statements have highlighted their interest in accounting estimates that are subject to a high degree of estimation uncertainty (see ISA 540 (Revised)<sup>28</sup>) that may have not been determined to be significant risks. Among other things, such estimates are highly dependent on management judgment and are often the most complex areas of the financial statements, and may require the involvement of both a management's expert and an auditor's expert. Users have also highlighted that accounting policies that have a significant effect on the financial statements (and significant changes to those policies) are relevant to their understanding of the financial statements, especially in circumstances where an entity's practices are not consistent with others in its industry.

The Effect on the Audit of Significant Events or Transactions that Occurred during the Period (Ref: Para. 9(c))

- A25. Events or transactions that had a significant effect on the financial statements or the audit may be areas of significant auditor attention and may be identified as significant risks. For example, the auditor may have had extensive discussions

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<sup>26</sup> ISA 315 (Revised), paragraph 31

<sup>27</sup> ISA 260 (Revised), paragraph 16(a)

<sup>28</sup> See paragraphs 16–17 of ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*.

with management and those charged with governance at various stages throughout the audit about the effect on the financial statements of significant transactions with related parties or significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.<sup>29</sup> Management may have made difficult or complex judgments in relation to recognition, measurement, presentation or disclosure of such transactions, which may have had a significant effect on the auditor's overall strategy.

- A26. Significant economic, accounting, regulatory, industry, or other developments that affected management's assumptions or judgments may also affect the auditor's overall approach to the audit and result in a matter requiring significant auditor attention.

*Matters of Most Significance (Ref: Para. 10)*

- A27. Matters that required significant auditor attention also may have resulted in significant interaction with those charged with governance. The nature and extent of communication about such matters with those charged with governance often provides an indication of which matters are of most significance in the audit. For example, the auditor may have had more in-depth, frequent or robust interactions with those charged with governance on more difficult and complex matters, such as the application of significant accounting policies that were the subject of significant auditor or management judgment.
- A28. The concept of matters of most significance is applicable in the context of the entity and the audit that was performed. As such, the auditor's determination and communication of key audit matters is intended to identify matters specific to the audit and to involve making a judgment about their importance relative to other matters in the audit.
- A29. Other considerations that may be relevant to determining the relative significance of a matter communicated with those charged with governance and whether such a matter is a key audit matter include:
- The importance of the matter to intended users' understanding of the financial statements as a whole, in particular, its materiality to the financial statements.
  - The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved in management's selection of an appropriate policy compared to other entities within its industry.
  - The nature and materiality, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements due to fraud or error related to the matter, if any.

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<sup>29</sup> See paragraphs 16(a), 16(c) and A22, and Appendix 2, of ISA 260 (Revised).

- The nature and extent of audit effort needed to address the matter, including:
  - The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any.
  - The nature of consultations outside the engagement team regarding the matter.
- The nature and severity of difficulties in applying audit procedures, evaluating the results of those procedures, and obtaining relevant and reliable evidence on which to base the auditor's opinion, in particular as the auditor's judgments become more subjective.
- The severity of any control deficiencies identified relevant to the matter.
- Whether the matter involved a number of separate, but related, auditing considerations. For example, long-term contracts may involve significant auditor attention with respect to revenue recognition, litigation or other contingencies, and may have an effect on other accounting estimates.

A30. Determining which, and how many, of those matters that required significant auditor attention were of most significance in the audit of the financial statements of the current period is a matter of professional judgment. The number of key audit matters to be included in the auditor's report may be affected by the size and complexity of the entity, the nature of its business and environment, and the facts and circumstances of the audit engagement. In general, the greater the number of matters initially determined to be key audit matters, the more the auditor may need to reconsider whether each of these matters meets the definition of a key audit matter. Lengthy lists of key audit matters may be contrary to the notion of such matters being those of most significance in the audit.

### **Communicating Key Audit Matters**

*Separate Key Audit Matters Section in the Auditor's Report* (Ref: Para. 11)

- A31. Placing the separate Key Audit Matters section in close proximity to the auditor's opinion may give prominence to such information and acknowledge the perceived value of engagement-specific information to intended users.
- A32. The order of presentation of individual matters within the Key Audit Matters section is a matter of professional judgment. For example, such information may be organized in order of relative importance, based on the auditor's judgment, or may correspond to the manner in which matters are disclosed in the financial statements. The requirement in paragraph 11 to include subheadings is intended to further differentiate the matters.

- A33. When comparative financial information is presented, the introductory language of the Key Audit Matters section is tailored to draw attention to the fact that the key audit matters described relate to only the audit of the financial statements of the current period, and may include reference to the specific period covered by those financial statements (e.g., “for the year ended December 31, 20X1”).

Descriptions of Individual Key Audit Matters (Ref: Para. 13)

- A34. The adequacy of the description of a key audit matter is a matter of professional judgment. The description of a key audit matter is intended to provide a succinct and balanced explanation to enable intended users to understand why the matter was one of most significance in the audit and how the matter was addressed in the audit. Limiting the use of highly technical auditing terms also helps to enable intended users who do not have a reasonable knowledge of auditing to understand the basis for the auditor's focus on particular matters during the audit. The nature and extent of information provided by the auditor is intended to be balanced in the context of the responsibilities of the respective parties (i.e., for the auditor to provide useful information in a concise and understandable form, while not inappropriately being the provider of original information about the entity).
- A35. Original information is any information about the entity that has not otherwise been made publicly available by the entity (e.g., has not been included in the financial statements or other information available at the date of the auditor's report, or addressed in other oral or written communications by management or those charged with governance, such as a preliminary announcement of financial information or investor briefings). Such information is the responsibility of the entity's management and those charged with governance.
- A36. It is appropriate for the auditor to seek to avoid the description of a key audit matter inappropriately providing original information about the entity. The description of a key audit matter is not usually of itself original information about the entity, as it describes the matter in the context of the audit. However, the auditor may consider it necessary to include additional information to explain why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter, and how the matter was addressed in the audit, provided that disclosure of such information is not precluded by law or regulation. When such information is determined to be necessary by the auditor, the auditor may encourage management or those charged with governance to disclose additional information, rather than the auditor providing original information in the auditor's report.
- A37. Management or those charged with governance may decide to include new or enhanced disclosures in the financial statements or elsewhere in the annual report relating to a key audit matter in light of the fact that the matter will be communicated in the auditor's report. Such new or enhanced disclosures, for example, may be included to provide more robust information about the

sensitivity of key assumptions used in accounting estimates or the entity's rationale for a particular accounting practice or policy when acceptable alternatives exist under the applicable financial reporting framework.

- A38. ISA 720 (Revised) defines the term annual report and explains that documents such as a management report, management commentary, or operating and financial review or similar reports by those charged with governance (e.g., a directors' report), a Chairman's statement, corporate governance statement, or internal control and risk assessment reports may form part of the annual report.<sup>30</sup> ISA 720 (Revised) addresses the auditor's responsibilities relating to other information included in the annual report. Although the auditor's opinion on the financial statements does not cover the other information, the auditor may consider this information, as well as other publicly available communications by the entity or other credible sources, in formulating the description of a key audit matter.
- A39. Audit documentation prepared during the audit can also be useful to the auditor in formulating the description of a key audit matter. For example, written communications, or the auditor's documentation of oral communications, with those charged with governance and other audit documentation provides a useful basis for the auditor's communication in the auditor's report. This is because audit documentation in accordance with ISA 230 is intended to address the significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions, and serves as a record of the nature, timing and extent of the audit procedures performed, the results of those procedures, and the audit evidence obtained. Such documentation may assist the auditor in developing a description of key audit matters that explains the significance of the matter and also in applying the requirement in paragraph 18.

#### Reference to Where the Matter Is Disclosed in the Financial Statements (Ref: Para. 13)

- A40. Paragraphs 13(a)-(b) requires the description of each key audit matter to address why the auditor considered the matter to be one of most significance in the audit and how the matter was addressed in the audit. Accordingly, the description of key audit matters is not a mere reiteration of what is disclosed in the financial statements. However, a reference to any related disclosures enables intended users to further understand how management has addressed the matter in preparing the financial statements.
- A41. In addition to referring to related disclosure(s), the auditor may draw attention to key aspects of them. The extent of disclosure by management about specific aspects or factors in relation to how a particular matter is affecting the financial statements of the current period may help the auditor in pinpointing particular

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<sup>30</sup> ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, paragraphs 12(a) and A1–A3

aspects of how the matter was addressed in the audit such that intended users can understand why the matter is a key audit matter. For example:

- When an entity includes robust disclosure about accounting estimates, the auditor may draw attention to the disclosure of key assumptions, the disclosure of the range of possible outcomes, and other qualitative and quantitative disclosures relating to key sources of estimation uncertainty or critical accounting estimates, as part of addressing why the matter was one of most significance in the audit and how the matter was addressed in the audit.
- When the auditor concludes in accordance with ISA 570 (Revised) that no material uncertainty exists relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor may nevertheless determine that one or more matters relating to this conclusion arising from the auditor's work effort under ISA 570 (Revised) are key audit matters. In such circumstances, the auditor's description of such key audit matters in the auditor's report could include aspects of the identified events or conditions disclosed in the financial statements, such as substantial operating losses, available borrowing facilities and possible debt refinancing, or non-compliance with loan agreements, and related mitigating factors.<sup>31</sup>

#### Why the Auditor Considered the Matter to Be One of Most Significance in the Audit (Ref: Para. 13(a))

- A42. The description of a key audit matter in the auditor's report is intended to provide insight as to why the matter was determined to be a key audit matter. Accordingly, the requirements in paragraphs 9–10 and the application material in paragraphs A12–A29 related to determining key audit matters may also be helpful for the auditor in considering how such matters are to be communicated in the auditor's report. For example, explaining the factors that led the auditor to conclude that a particular matter required significant auditor attention and was of most significance in the audit is likely to be of interest to intended users.
- A43. The relevance of the information for intended users is a consideration for the auditor in determining what to include in the description of a key audit matter. This may include whether the description would enable a better understanding of the audit and the auditor's judgments.
- A44. Relating a matter directly to the specific circumstances of the entity may also help to minimize the potential that such descriptions become overly standardized and less useful over time. For example, certain matters may be determined as key audit matters in a particular industry across a number of entities due to the circumstances of the industry or the underlying complexity in financial reporting. In describing why the auditor considered the matter to be

<sup>31</sup> See paragraph A3 of ISA 570 (Revised).

one of most significance, it may be useful for the auditor to highlight aspects specific to the entity (e.g., circumstances that affected the underlying judgments made in the financial statements of the current period) in order to make the description more relevant for intended users. This also may be important in describing a key audit matter that recurs over periods.

A45. The description may also make reference to the principal considerations that led the auditor, in the circumstances of the audit, to determine the matter to be one of most significance, for example:

- Economic conditions that affected the auditor's ability to obtain audit evidence, for example illiquid markets for certain financial instruments.
- New or emerging accounting policies, for example entity-specific or industry-specific matters on which the engagement team consulted within the firm.
- Changes in the entity's strategy or business model that had a material effect on the financial statements.

How the Matter Was Addressed in the Audit (Ref: Para. 13(b))

A46. The amount of detail to be provided in the auditor's report to describe how a key audit matter was addressed in the audit is a matter of professional judgment. In accordance with paragraph 13(b), the auditor may describe:

- Aspects of the auditor's response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement;
- A brief overview of procedures performed;
- An indication of the outcome of the auditor's procedures; or
- Key observations with respect to the matter,

or some combination of these elements.

Law or regulation or national auditing standards may prescribe a specific form or content for the description of a key audit matter, or may specify the inclusion of one or more of these elements.

A47. In order for intended users to understand the significance of a key audit matter in the context of the audit of the financial statements as a whole, as well as the relationship between key audit matters and other elements of the auditor's report, including the auditor's opinion, care may be necessary so that language used in the description of a key audit matter:

- Does not imply that the matter has not been appropriately resolved by the auditor in forming the opinion on the financial statements.
- Relates the matter directly to the specific circumstances of the entity, while avoiding generic or standardized language.

- Takes into account how the matter is addressed in the related disclosure(s) in the financial statements, if any.
  - Does not contain or imply discrete opinions on separate elements of the financial statements.
- A48. Describing aspects of the auditor's response or approach to a matter, in particular when the audit approach required significant tailoring to the facts and circumstances of the entity, may assist intended users in understanding unusual circumstances and significant auditor judgments required to address the risk of material misstatement. In addition, the audit approach in a particular period may have been influenced by entity-specific circumstances, economic conditions, or industry developments. It may also be useful for the auditor to make reference to the nature and extent of communications with those charged with governance about the matter.
- A49. For example, in describing the auditor's approach to an accounting estimate that has been identified as having high estimation uncertainty, such as the valuation of complex financial instruments, the auditor may wish to highlight that the auditor employed or engaged an auditor's expert. Such a reference to the use of an auditor's expert does not reduce the auditor's responsibility for the opinion on the financial statements and is therefore not inconsistent with paragraphs 14–15 of ISA 620.<sup>32</sup>
- A50. There may be challenges in describing the auditor's procedures, particularly in complex, judgmental areas of the audit. In particular, it may be difficult to summarize the procedures performed in a succinct way that adequately communicates the nature and extent of the auditor's response to the assessed risk of material misstatement, and the significant auditor judgments involved. Nonetheless, the auditor may consider it necessary to describe certain procedures performed to communicate how the matter was addressed in the audit. Such description may typically be at a high level, rather than include a detailed description of procedures.
- A51. As noted in paragraph A46, the auditor may also provide an indication of the outcome of the auditor's response in the description of the key audit matter in the auditor's report. However, if this is done, care is needed to avoid the auditor giving the impression that the description is conveying a separate opinion on an individual key audit matter or that in any way may call into question the auditor's opinion on the financial statements as a whole.

*Circumstances in Which a Matter Determined to Be a Key Audit Matter Is Not Communicated in the Auditor's Report (Ref: Para. 14)*

- A52. Law or regulation may preclude public disclosure by either management or the auditor about a specific matter determined to be a key audit matter. For

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<sup>32</sup> ISA 620, *Using the Work of an Auditor's Expert*

example, law or regulation may specifically prohibit any public communication that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act (e.g., matters that are or appear to be related to money laundering).

- A53. As indicated by paragraph 14(b), it will be extremely rare for a matter determined to be a key audit matter not to be communicated in the auditor's report. This is because there is presumed to be a public interest benefit in providing greater transparency about the audit for intended users. Accordingly, the judgment not to communicate a key audit matter is appropriate only in cases when the adverse consequences to the entity or the public as a result of such communication are viewed as so significant that they would reasonably be expected to outweigh the public interest benefits of communicating about the matter.
- A54. The determination not to communicate a key audit matter takes into account the facts and circumstances related to the matter. Communication with management and those charged with governance helps the auditor understand management's views about the significance of the adverse consequences that may arise as a result of communicating about a matter. In particular, communication with management and those charged with governance helps to inform the auditor's judgment in determining whether to communicate the matter by:
- Assisting the auditor in understanding why the matter has not been publicly disclosed by the entity (e.g., if law, regulation or certain financial reporting frameworks permit delayed disclosure or non-disclosure of the matter) and management's views as to the adverse consequences, if any, of disclosure. Management may draw attention to certain aspects in law or regulation or other authoritative sources that may be relevant to the consideration of adverse consequences (e.g., such aspects may include harm to the entity's commercial negotiations or competitive position). However, management's views about the adverse consequences alone do not alleviate the need for the auditor to determine whether the adverse consequences would reasonably be expected to outweigh the public interest benefits of communication in accordance with paragraph 14(b).
  - Highlighting whether there have been any communications with applicable regulatory, enforcement or supervisory authorities in relation to the matter, in particular whether such discussions would appear to support management's assertion as to why public disclosure about the matter is not appropriate.
  - Enabling the auditor, where appropriate, to encourage management and those charged with governance to make public disclosure of relevant information about the matter. In particular, this may be possible if the concerns of management and those charged with governance about communicating are limited to specific aspects relating to the matter, such

that certain information about the matter may be less sensitive and could be communicated.

The auditor also may consider it necessary to obtain a written representation from management as to why public disclosure about the matter is not appropriate, including management's view about the significance of the adverse consequences that may arise as a result of such communication.

- A55. It may also be necessary for the auditor to consider the implications of communicating about a matter determined to be a key audit matter in light of relevant ethical requirements. In addition, the auditor may be required by law or regulation to communicate with applicable regulatory, enforcement or supervisory authorities in relation to the matter, regardless of whether the matter is communicated in the auditor's report. Such communication may also be useful to inform the auditor's consideration of the adverse consequences that may arise from communicating about the matter.
- A56. The issues considered by the auditor regarding a decision to not communicate a matter are complex and involve significant auditor judgment. Accordingly, the auditor may consider it appropriate to obtain legal advice.

*Form and Content of the Key Audit Matters Section in Other Circumstances*  
(Ref: Para. 16)

- A57. The requirement in paragraph 16 applies in three circumstances:
- (a) The auditor determines in accordance with paragraph 10 that there are no key audit matters (see paragraph A59).
  - (b) The auditor determines in accordance with paragraph 14 that a key audit matter will not be communicated in the auditor's report and no other matters have been determined to be key audit matters.
  - (c) The only matters determined to be key audit matters are those communicated in accordance with paragraph 15.
- A58. The following illustrates the presentation in the auditor's report if the auditor has determined there are no key audit matters to communicate:

**Key Audit Matters**

[Except for the matter described in the *Basis for Qualified (Adverse) Opinion* section or *Material Uncertainty Related to Going Concern* section,] We have determined that there are no [other] key audit matters to communicate in our report.

- A59. The determination of key audit matters involves making a judgment about the relative importance of matters that required significant auditor attention. Therefore, it may be rare that the auditor of a complete set of general purpose financial statements of a listed entity would not determine at least one key audit matter from the matters communicated with those charged with governance

to be communicated in the auditor's report. However, in certain limited circumstances (e.g., for a listed entity that has very limited operations), the auditor may determine that there are no key audit matters in accordance with paragraph 10 because there are no matters that required significant auditor attention.

### **Communication with Those Charged with Governance (Ref: Para. 17)**

- A60. ISA 260 (Revised) requires the auditor to communicate with those charged with governance on a timely basis.<sup>33</sup> The appropriate timing for communications about key audit matters will vary with the circumstances of the engagement. However, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit, and may further discuss such matters when communicating about audit findings. Doing so may help to alleviate the practical challenges of attempting to have a robust two-way dialogue about key audit matters at the time the financial statements are being finalized for issuance.
- A61. Communication with those charged with governance enables them to be made aware of the key audit matters that the auditor intends to communicate in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary. The auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate this discussion. Communication with those charged with governance recognizes their important role in overseeing the financial reporting process, and provides the opportunity for those charged with governance to understand the basis for the auditor's decisions in relation to key audit matters and how these matters will be described in the auditor's report. It also enables those charged with governance to consider whether new or enhanced disclosures may be useful in light of the fact that these matters will be communicated in the auditor's report.
- A62. The communication with those charged with governance required by paragraph 17(a) also addresses the extremely rare circumstances in which a matter determined to be a key audit matter is not communicated in the auditor's report (see paragraphs 14 and A54).
- A63. The requirement in paragraph 17(b) to communicate with those charged with governance when the auditor has determined there are no key audit matters to communicate in the auditor's report may provide an opportunity for the auditor to have further discussion with others who are familiar with the audit and the significant matters that may have arisen (including the engagement quality control reviewer, where one has been appointed). These discussions may cause the auditor to re-evaluate the auditor's determination that there are no key audit matters.

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<sup>33</sup> ISA 260 (Revised), paragraph 21

**Documentation** (Ref: Para. 18)

- A64. Paragraph 8 of ISA 230 requires the auditor to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand, among other things, significant professional judgments. In the context of key audit matters, these professional judgments include the determination, from the matters communicated with those charged with governance, of the matters that required significant auditor attention, as well as whether or not each of those matters is a key audit matter. The auditor's judgments in this regard are likely to be supported by the documentation of the auditor's communications with those charged with governance and the audit documentation relating to each individual matter (see paragraph A39), as well as certain other audit documentation of the significant matters arising during the audit (e.g., a completion memorandum). However, this ISA does not require the auditor to document why other matters communicated with those charged with governance were not matters that required significant auditor attention.

**INTERNATIONAL STANDARD ON AUDITING 705  
(REVISED)**

**MODIFICATIONS TO THE OPINION IN THE  
INDEPENDENT AUDITOR’S REPORT**

(Effective for audits of financial statements for periods  
ending on or after December 15, 2016)

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International Standard on Auditing (ISA) 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with ISA 700 (Revised),<sup>3</sup> the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. This ISA also deals with how the form and content of the auditor's report is affected when the auditor expresses a modified opinion. In all cases, the reporting requirements in ISA 700 (Revised) apply, and are not repeated in this ISA unless they are explicitly addressed or amended by the requirements of this ISA.

### Types of Modified Opinions

2. This ISA establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon:
  - (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
  - (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements. (Ref: Para. A1)

### Effective Date

3. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2016.

## Objective

4. The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:
  - (a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
  - (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

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<sup>3</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

## Definitions

5. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Pervasive – A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:
    - (i) Are not confined to specific elements, accounts or items of the financial statements;
    - (ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
    - (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.
  - (b) Modified opinion – A qualified opinion, an adverse opinion or a disclaimer of opinion on the financial statements.

## Requirements

### Circumstances When a Modification to the Auditor's Opinion Is Required

6. The auditor shall modify the opinion in the auditor's report when:
  - (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or (Ref: Para. A2–A7)
  - (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement. (Ref: Para. A8–A12)

### Determining the Type of Modification to the Auditor's Opinion

#### *Qualified Opinion*

7. The auditor shall express a qualified opinion when:
  - (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
  - (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

*Adverse Opinion*

8. The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

*Disclaimer of Opinion*

9. The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.
10. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

*Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement*

11. If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.
12. If management refuses to remove the limitation referred to in paragraph 11 of this ISA, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity,<sup>4</sup> and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.
13. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:
  - (a) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
  - (b) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:

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<sup>4</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

- (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or (Ref: Para. A13)
  - (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements. (Ref. Para. A14)
14. If the auditor withdraws as contemplated by paragraph 13(b)(i), before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion. (Ref: Para. A15)

*Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion*

15. When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement. To include such an unmodified opinion in the same report<sup>5</sup> in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole. (Ref: Para. A16)

**Form and Content of the Auditor's Report When the Opinion Is Modified**

*Auditor's Opinion*

16. When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section. (Ref: Para. A17–A19)

**Qualified Opinion**

17. When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section:
- (a) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
  - (b) When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material

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<sup>5</sup> ISA 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, deals with circumstances where the auditor is engaged to express a separate opinion on one or more specific elements, accounts or items of a financial statement.

respects, in accordance with [the applicable financial reporting framework].

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase “except for the possible effects of the matter(s) ...” for the modified opinion. (Ref: Para. A20)

#### Adverse Opinion

18. When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section:
  - (a) When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
  - (b) When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

#### Disclaimer of Opinion

19. When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:
  - (a) State that the auditor does not express an opinion on the accompanying financial statements;
  - (b) State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
  - (c) Amend the statement required by paragraph 24(b) of ISA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

#### Basis for Opinion

20. When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by ISA 700 (Revised): (Ref: Para. A21)
  - (a) Amend the heading “Basis for Opinion” required by paragraph 28 of ISA 700 (Revised) to “Basis for Qualified Opinion,” “Basis for Adverse Opinion,” or “Basis for Disclaimer of Opinion,” as appropriate; and
  - (b) Within this section, include a description of the matter giving rise to the modification.

21. If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures), the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in this section. (Ref: Para. A22)
22. If there is a material misstatement of the financial statements that relates to qualitative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.
23. If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:
  - (a) Discuss the non-disclosure with those charged with governance;
  - (b) Describe in the Basis for Opinion section the nature of the omitted information; and
  - (c) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information. (Ref: Para. A23)
24. If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.
25. When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion required by paragraph 28(d) of ISA 700 (Revised) to include the word "qualified" or "adverse", as appropriate.
26. When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the elements required by paragraphs 28(b) and 28(d) of ISA 700 (Revised). Those elements are:
  - (a) A reference to the section of the auditor's report where the auditor's responsibilities are described; and
  - (b) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
27. Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof. (Ref: Para. A24)

*Description of Auditor's Responsibilities for the Audit of the Financial Statements  
When the Auditor Disclaims an Opinion on the Financial Statements*

28. When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by paragraphs 39–41 of ISA 700 (Revised) to include only the following: (Ref: Para. A25)
- (a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with International Standards on Auditing and to issue an auditor's report;
  - (b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
  - (c) The statement about auditor independence and other ethical responsibilities required by paragraph 28(c) of ISA 700 (Revised).

*Considerations When the Auditor Disclaims an Opinion on the Financial Statements*

29. Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with ISA 701 or an Other Information section in accordance with ISA 720 (Revised).<sup>6,7</sup> (Ref: Para. A26)

**Communication with Those Charged with Governance**

30. When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification. (Ref: Para. A27)

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**Application and Other Explanatory Material**

**Types of Modified Opinions (Ref: Para. 2)**

- A1. The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

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<sup>6</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraphs 11–13

<sup>7</sup> ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, paragraph A54

<i>Nature of Matter Giving Rise to the Modification</i>	<i>Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements</i>	
	<i>Material but Not Pervasive</i>	<i>Material and Pervasive</i>
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

### **Circumstances When a Modification to the Auditor's Opinion Is Required**

#### *Nature of Material Misstatements (Ref: Para. 6(a))*

- A2. ISA 700 (Revised) requires the auditor, in order to form an opinion on the financial statements, to conclude as to whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement.<sup>8</sup> This conclusion takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements in accordance with ISA 450.<sup>9</sup>
- A3. ISA 450 defines a misstatement as a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Accordingly, a material misstatement of the financial statements may arise in relation to:
- The appropriateness of the selected accounting policies;
  - The application of the selected accounting policies; or
  - The appropriateness or adequacy of disclosures in the financial statements.

#### *Appropriateness of the Selected Accounting Policies*

- A4. In relation to the appropriateness of the accounting policies management has selected, material misstatements of the financial statements may arise for example when:
- The selected accounting policies are not consistent with the applicable financial reporting framework;

<sup>8</sup> ISA 700 (Revised), paragraph 11

<sup>9</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

- (b) The financial statements do not correctly describe an accounting policy relating to a significant item in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows; or
  - (c) The financial statements do not represent or disclose the underlying transactions and events in a manner that achieves fair presentation.
- A5. Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has changed its selection of significant accounting policies, a material misstatement of the financial statements may arise when the entity has not complied with these requirements.

#### Application of the Selected Accounting Policies

- A6. In relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:
- (a) When management has not applied the selected accounting policies consistently with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or
  - (b) Due to the method of application of the selected accounting policies (such as an unintentional error in application).

#### Appropriateness or Adequacy of Disclosures in the Financial Statements

- A7. In relation to the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when:
- (a) The financial statements do not include all of the disclosures required by the applicable financial reporting framework;
  - (b) The disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework; or
  - (c) The financial statements do not provide the additional disclosures necessary to achieve fair presentation beyond disclosures specifically required by the applicable financial reporting framework.

Paragraph A17 of ISA 450 provides further examples of material misstatements in qualitative disclosures that may arise.

#### *Nature of an Inability to Obtain Sufficient Appropriate Audit Evidence* (Ref: Para. 6(b))

- A8. The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

- (a) Circumstances beyond the control of the entity;
  - (b) Circumstances relating to the nature or timing of the auditor's work; or
  - (c) Limitations imposed by management.
- A9. An inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. If this is not possible, the requirements of paragraphs 7(b) and 9–10 apply as appropriate. Limitations imposed by management may have other implications for the audit, such as for the auditor's assessment of fraud risks and consideration of engagement continuance.
- A10. Examples of circumstances beyond the control of the entity include when:
- The entity's accounting records have been destroyed.
  - The accounting records of a significant component have been seized indefinitely by governmental authorities.
- A11. Examples of circumstances relating to the nature or timing of the auditor's work include when:
- The entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to evaluate whether the equity method has been appropriately applied.
  - The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.
  - The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.
- A12. Examples of an inability to obtain sufficient appropriate audit evidence arising from a limitation on the scope of the audit imposed by management include when:
- Management prevents the auditor from observing the counting of the physical inventory.
  - Management prevents the auditor from requesting external confirmation of specific account balances.

### **Determining the Type of Modification to the Auditor's Opinion**

*Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement*  
(Ref: Para. 13(b)(i)–14)

- A13. The practicality of withdrawing from the audit may depend on the stage of completion of the engagement at the time that management imposes the scope

limitation. If the auditor has substantially completed the audit, the auditor may decide to complete the audit to the extent possible, disclaim an opinion and explain the scope limitation within the Basis for Disclaimer of Opinion section prior to withdrawing.

- A14. In certain circumstances, withdrawal from the audit may not be possible if the auditor is required by law or regulation to continue the audit engagement. This may be the case for an auditor that is appointed to audit the financial statements of public sector entities. It may also be the case in jurisdictions where the auditor is appointed to audit the financial statements covering a specific period, or appointed for a specific period and is prohibited from withdrawing before the completion of the audit of those financial statements or before the end of that period, respectively. The auditor may also consider it necessary to include an Other Matter paragraph in the auditor's report.<sup>10</sup>
- A15. When the auditor concludes that withdrawal from the audit is necessary because of a scope limitation, there may be a professional, legal or regulatory requirement for the auditor to communicate matters relating to the withdrawal from the engagement to regulators or the entity's owners.

*Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion*  
(Ref: Para. 15)

- A16. The following are examples of reporting circumstances that would not contradict the auditor's adverse opinion or disclaimer of opinion:
- The expression of an unmodified opinion on financial statements prepared under a given financial reporting framework and, within the same report, the expression of an adverse opinion on the same financial statements under a different financial reporting framework.<sup>11</sup>
  - The expression of a disclaimer of opinion regarding the results of operations, and cash flows, where relevant, and an unmodified opinion regarding the financial position (see ISA 510<sup>12</sup>). In this case, the auditor has not expressed a disclaimer of opinion on the financial statements as a whole.

### **Form and Content of the Auditor's Report When the Opinion Is Modified**

*Illustrative Auditor's Reports* (Ref: Para. 16)

- A17. Illustrations 1 and 2 in the Appendix contain auditor's reports with qualified and adverse opinions, respectively, as the financial statements are materially misstated.

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<sup>10</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, paragraph A10

<sup>11</sup> See paragraph A31 of ISA 700 (Revised) for a description of this circumstance.

<sup>12</sup> ISA 510, *Initial Audit Engagements—Opening Balances*, paragraph 10

A18. Illustration 3 in the Appendix contains an auditor's report with a qualified opinion as the auditor is unable to obtain sufficient appropriate audit evidence. Illustration 4 contains a disclaimer of opinion due to an inability to obtain sufficient appropriate audit evidence about a single element of the financial statements. Illustration 5 contains a disclaimer of opinion due to an inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements. In each of the latter two cases, the possible effects on the financial statements of the inability are both material and pervasive. The Appendices to other ISAs that include reporting requirements, including ISA 570 (Revised),<sup>13</sup> also include illustrations of auditor's reports with modified opinions.

*Auditor's Opinion* (Ref: Para. 16)

A19. Amending this heading makes it clear to the user that the auditor's opinion is modified and indicates the type of modification.

*Qualified Opinion* (Ref: Para. 17)

A20. When the auditor expresses a qualified opinion, it would not be appropriate to use phrases such as "with the foregoing explanation" or "subject to" in the Opinion section as these are not sufficiently clear or forceful.

*Basis for Opinion* (Ref: Para. 20, 21, 23, 27)

A21. Consistency in the auditor's report helps to promote users' understanding and to identify unusual circumstances when they occur. Accordingly, although uniformity in the wording of a modified opinion and in the description of the reasons for the modification may not be possible, consistency in both the form and content of the auditor's report is desirable.

A22. An example of the financial effects of material misstatements that the auditor may describe within the Basis for Opinion section in the auditor's report is the quantification of the effects on income tax, income before taxes, net income and equity if inventory is overstated.

A23. Disclosing the omitted information within the Basis for Opinion section would not be practicable if:

- (a) The disclosures have not been prepared by management or the disclosures are otherwise not readily available to the auditor; or
- (b) In the auditor's judgment, the disclosures would be unduly voluminous in relation to the auditor's report.

A24. An adverse opinion or a disclaimer of opinion relating to a specific matter described within the Basis for Opinion section does not justify the omission of a description of other identified matters that would have otherwise required a

<sup>13</sup> ISA 570 (Revised), *Going Concern*

modification of the auditor's opinion. In such cases, the disclosure of such other matters of which the auditor is aware may be relevant to users of the financial statements.

*Description of Auditor's Responsibilities for the Audit of the Financial Statements  
When the Auditor Disclaims an Opinion on the Financial Statements (Ref: Para. 28)*

A25. When the auditor disclaims an opinion on the financial statements, the following statements are better positioned within the Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report, as illustrated in Illustrations 4–5 of the Appendix to this ISA:

- The statement required by paragraph 28(a) of ISA 700 (Revised), amended to state that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with ISAs; and
- The statement required by paragraph 28(c) of ISA 700 (Revised) about independence and other ethical responsibilities.

*Considerations When the Auditor Disclaims an Opinion on the Financial Statements  
(Ref: Para. 29)*

A26. Providing the reasons for the auditor's inability to obtain sufficient appropriate audit evidence within the Basis for Disclaimer of Opinion section of the auditor's report provides useful information to users in understanding why the auditor has disclaimed an opinion on the financial statements and may further guard against inappropriate reliance on them. However, communication of any key audit matters other than the matter(s) giving rise to the disclaimer of opinion may suggest that the financial statements as a whole are more credible in relation to those matters than would be appropriate in the circumstances, and would be inconsistent with the disclaimer of opinion on the financial statements as a whole. Similarly, it would not be appropriate to include an Other Information section in accordance with ISA 720 (Revised) addressing the auditor's consideration of the consistency of the other information with the financial statements. Accordingly, paragraph 29 of this ISA prohibits a Key Audit Matters section or an Other Information section from being included in the auditor's report when the auditor disclaims an opinion on the financial statements, unless the auditor is otherwise required by law or regulation to communicate key audit matters or to report on other information.

**Communication with Those Charged with Governance (Ref: Para. 30)**

A27. Communicating with those charged with governance the circumstances that lead to an expected modification to the auditor's opinion and the wording of the modification enables:

- (a) The auditor to give notice to those charged with governance of the intended modification(s) and the reasons (or circumstances) for the modification(s);

- (b) The auditor to seek the concurrence of those charged with governance regarding the facts of the matter(s) giving rise to the expected modification(s), or to confirm matters of disagreement with management as such; and
- (c) Those charged with governance to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s).

## Appendix

(Ref: Para. A17–A18, A25)

### **Illustrations of Independent Auditor's Reports with Modifications to the Opinion**

- Illustration 1: An auditor's report containing a qualified opinion due to a material misstatement of the financial statements.
- Illustration 2: An auditor's report containing an adverse opinion due to a material misstatement of the consolidated financial statements.
- Illustration 3: An auditor's report containing a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding a foreign associate.
- Illustration 4: An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements.
- Illustration 5: An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements.

**Illustration 1 – Qualified Opinion due to a Material Misstatement of the Financial Statements**

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- **Audit of a complete set of financial statements of a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600<sup>1</sup> does not apply).**
- **The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.<sup>2</sup>**
- **Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements (i.e., a qualified opinion is appropriate).**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **Key audit matters have been communicated in accordance with ISA 701.**
- **The auditor has obtained all of the other information prior to the date of the auditor's report and the matter giving rise to the qualified opinion on the consolidated financial statements also affects the other information.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.**

<sup>1</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

<sup>2</sup> ISA 210, *Agreeing the Terms of Audit Engagements*

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>3</sup>

#### Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Qualified Opinion

The Company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from IFRSs. The Company's records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

#### Other Information [or other title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[Reporting in accordance with the reporting requirements of ISA 720 (Revised) – see Illustration 6 in Appendix 2 of ISA 720 (Revised). The last paragraph of the other

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<sup>3</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

*information section in Illustration 6 would be customized to describe the specific matter giving rise to the qualified opinion that also affects the other information.]*

### **Key Audit Matters**

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section we have determined the matters described below to be the key audit matters to be communicated in our report.

*[Description of each key audit matter in accordance with ISA 701.]*

### **Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>4</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

### **Auditor's Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

### **Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

The engagement partner on the audit resulting in this independent auditor's report is [name].

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>4</sup> Throughout the illustrative auditor's reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

**Illustration 2 – Adverse Opinion due to a Material Misstatement of the Consolidated Financial Statements**

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- **Audit of a complete set of consolidated financial statements of a listed entity using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., ISA 600 applies).**
- **The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in ISA 210.**
- **The consolidated financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements have not been determined because it was not practicable to do so (i.e., an adverse opinion is appropriate).**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **ISA 701 applies; however, the auditor has determined that there are no key audit matters other than the matter described in the Basis for Adverse Opinion section.**
- **The auditor has obtained all of the other information prior to the date of the auditor's report and the matter giving rise to the adverse opinion on the consolidated financial statements also affects the other information.**
- **Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.**
- **In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Consolidated Financial Statements<sup>5</sup>

#### Adverse Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the *Basis for Adverse Opinion* section of our report, the accompanying consolidated financial statements do not present fairly (or *do not give a true and fair view of*) the consolidated financial position of the Group as at December 31, 20X1, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Adverse Opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRSs, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

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<sup>5</sup> The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

**Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see *Illustration 7 in Appendix 2 of ISA 720 (Revised)*. The last paragraph of the other information section in *Illustration 7* would be customized to describe the specific matter giving rise to the qualified opinion that also affects the other information.]

**Key Audit Matters**

Except for the matter described in the *Basis for Adverse Opinion* section, we have determined that there are no other key audit matters to communicate in our report.

**Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements<sup>6</sup>**

[Reporting in accordance with ISA 700 (Revised) – see *Illustration 2 in ISA 700 (Revised)*.]

**Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements**

[Reporting in accordance with ISA 700 (Revised) – see *Illustration 2 in ISA 700 (Revised)*.]

**Report on Other Legal and Regulatory Requirements**

[Reporting in accordance with ISA 700 (Revised) – see *Illustration 2 in ISA 700 (Revised)*.]

The engagement partner on the audit resulting in this independent auditor’s report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

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<sup>6</sup> Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

**Illustration 3 – Qualified Opinion due to the Auditor's Inability to Obtain Sufficient Audit Evidence Regarding a Foreign Associate**

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- **Audit of a complete set of consolidated financial statements of a listed entity using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., ISA 600 applies).**
- **The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in ISA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the consolidated financial statements (i.e., a qualified opinion is appropriate).**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **Key audit matters have been communicated in accordance with ISA 701.**
- **The auditor has obtained all of the other information prior to the date of the auditor's report and the matter giving rise to the qualified opinion on the consolidated financial statements also affects the other information.**
- **Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.**
- **In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Consolidated Financial Statements<sup>7</sup>

#### Qualified Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying consolidated financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Group as at December 31, 20X1, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Qualified Opinion

The Group's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the consolidated statement of financial position as at December 31, 20X1, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

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<sup>7</sup> The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

**Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

*[Reporting in accordance with the reporting requirements of ISA 720 (Revised) – see Illustration 6 in Appendix 2 of ISA 720 (Revised). The last paragraph of the other information section in Illustration 6 would be customized to describe the specific matter giving rise to the qualified opinion that also affects the other information.]*

**Key Audit Matters**

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

*[Description of each key audit matter in accordance with ISA 701.]*

**Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements<sup>8</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised).]*

**Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised).]*

**Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised).]*

The engagement partner on the audit resulting in this independent auditor’s report is [name].

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>8</sup> Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

**Illustration 4 – Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about a Single Element of the Consolidated Financial Statements**

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- **Audit of a complete set of consolidated financial statements of an entity other than a listed entity using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., ISA 600 applies).**
- **The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in ISA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the consolidated financial statements (i.e., a disclaimer of opinion is appropriate).**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.**
- **A more limited description of the auditor's responsibilities section is required.**
- **In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Consolidated Financial Statements<sup>9</sup>

#### Disclaimer of Opinion

We were engaged to audit the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying consolidated financial statements of the Group. Because of the significance of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

#### Basis for Disclaimer of Opinion

The Group's investment in its joint venture XYZ Company is carried at xxx on the Group's consolidated statement of financial position, which represents over 90% of the Group's net assets as at December 31, 20X1. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, and the elements making up the consolidated statement of changes in equity and the consolidated cash flow statement.

#### Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements<sup>10</sup>

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised).]*

#### Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our responsibility is to conduct an audit of the Group's consolidated financial statements in accordance with International Standards on Auditing and to issue an auditor's report. However, because of the matter described in the *Basis for Disclaimer*

<sup>9</sup> The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

<sup>10</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

*of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements.

## **Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

**Illustration 5 – Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about Multiple Elements of the Financial Statements**

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600, does not apply).
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements, that is, the auditor was also unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- A more limited description of the auditor's responsibilities section is required.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>11</sup>

#### Disclaimer of Opinion

We were engaged to audit the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the Company. Because of the significance of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

#### Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after December 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and 20X1, which are stated in the statements of financial position at xxx and xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of xxx as at December 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of comprehensive income, statement of changes in equity and statement of cash flows.

#### Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>12</sup>

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

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<sup>11</sup> The sub-title “Report on the Audit of the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.

<sup>12</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our responsibility is to conduct an audit of the Company's financial statements in accordance with International Standards on Auditing and to issue an auditor's report. However, because of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements.

### **Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

**INTERNATIONAL STANDARD ON AUDITING 706  
(REVISED)**

**EMPHASIS OF MATTER PARAGRAPHS AND  
OTHER MATTER PARAGRAPHS IN THE INDEPENDENT  
AUDITOR’S REPORT**

(Effective for audits of financial statements for periods  
ending on or after December 15, 2016)

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Framework and that Includes an Emphasis of Matter Paragraph

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International Standard on Auditing (ISA) 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with additional communication in the auditor's report when the auditor considers it necessary to:
  - (a) Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or
  - (b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
2. ISA 701<sup>1</sup> establishes requirements and provides guidance when the auditor determines key audit matters and communicates them in the auditor's report. When the auditor includes a Key Audit Matters section in the auditor's report, this ISA addresses the relationship between key audit matters and any additional communication in the auditor's report in accordance with this ISA. (Ref: Para. A1–A3)
3. ISA 570 (Revised)<sup>2</sup> and ISA 720 (Revised)<sup>3</sup> establishes requirements and provides guidance about communication in the auditor's report relating to going concern and other information respectively.
4. Appendices 1 and 2 identify ISAs that contain specific requirements for the auditor to include Emphasis of Matter paragraphs or Other Matter paragraphs in the auditor's report. In those circumstances, the requirements in this ISA regarding the form of such paragraphs apply. (Ref: Para. A4)

### Effective Date

5. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2016.

### Objective

6. The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

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<sup>1</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

<sup>2</sup> ISA 570 (Revised), *Going Concern*

<sup>3</sup> ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

- (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or
- (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

## Definitions

7. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) **Emphasis of Matter paragraph** – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.
  - (b) **Other Matter paragraph** – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

## Requirements

### Emphasis of Matter Paragraphs in the Auditor's Report

8. If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided: (Ref: Para. A5–A6)
- (a) The auditor would not be required to modify the opinion in accordance with ISA 705 (Revised)<sup>4</sup> as a result of the matter; and
  - (b) When ISA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report. (Ref: Para. A1–A3)
9. When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:
- (a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
  - (b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be

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<sup>4</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

- (c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized. (Ref: Para. A7–A8, A16–A17)

### **Other Matter Paragraphs in the Auditor's Report**

- 10. If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:
  - (a) This is not prohibited by law or regulation; and
  - (b) When ISA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report. (Ref: Para. A9–A14)
- 11. When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading. (Ref: Para. A15–A17)

### **Communication with Those Charged with Governance**

- 12. If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph. (Ref: Para. A18)

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## **Application and Other Explanatory Material**

### **The Relationship between Emphasis of Matter Paragraphs and Key Audit Matters in the Auditor's Report** (Ref: Para. 2, 8(b))

- A1. Key audit matters are defined in ISA 701 as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance, which include significant findings from the audit of the financial statements of the current period.<sup>5</sup> Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit and may also assist them in understanding the entity and areas of significant management judgment in the audited financial statements. When

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<sup>5</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 16

ISA 701 applies, the use of Emphasis of Matter paragraphs is not a substitute for a description of individual key audit matters.

- A2. Matters that are determined to be key audit matters in accordance with ISA 701 may also be, in the auditor's judgment, fundamental to users' understanding of the financial statements. In such cases, in communicating the matter as a key audit matter in accordance with ISA 701, the auditor may wish to highlight or draw further attention to its relative importance. The auditor may do so by presenting the matter more prominently than other matters in the Key Audit Matters section (e.g., as the first matter) or by including additional information in the description of the key audit matter to indicate the importance of the matter to users' understanding of the financial statements.
- A3. There may be a matter that is not determined to be a key audit matter in accordance with ISA 701 (i.e., because it did not require significant auditor attention), but which, in the auditor's judgment, is fundamental to users' understanding of the financial statements (e.g., a subsequent event). If the auditor considers it necessary to draw users' attention to such a matter, the matter is included in an Emphasis of Matter paragraph in the auditor's report in accordance with this ISA.

#### **Circumstances in Which an Emphasis of Matter Paragraph May Be Necessary (Ref: Para. 4, 8)**

- A4. Appendix 1 identifies ISAs that contain specific requirements for the auditor to include Emphasis of Matter paragraphs in the auditor's report in certain circumstances. These circumstances include:
- When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
  - To alert users that the financial statements are prepared in accordance with a special purpose framework.
  - When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).<sup>6</sup>
- A5. Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:
- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
  - A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.<sup>7</sup>

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<sup>6</sup> ISA 560, *Subsequent Events*, paragraphs 12(b) and 16

<sup>7</sup> ISA 560, paragraph 6

- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

A6. However, a widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters.

**Including an Emphasis of Matter Paragraph in the Auditor's Report** (Ref: Para. 9)

A7. The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. An Emphasis of Matter paragraph is not a substitute for:

- (a) A modified opinion in accordance with ISA 705 (Revised) when required by the circumstances of a specific audit engagement;
- (b) Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or
- (c) Reporting in accordance with ISA 570 (Revised)<sup>8</sup> when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

A8. Paragraphs A16–A17 provide further guidance on the placement of Emphasis of Matter paragraphs in particular circumstances.

**Other Matter Paragraphs in the Auditor's Report** (Ref: Para. 10–11)

*Circumstances in Which an Other Matter Paragraph May Be Necessary*

Relevant to Users' Understanding of the Audit

A9. ISA 260 (Revised) requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit, which includes communication about the significant risks identified by the auditor.<sup>9</sup> Although matters relating to significant risks may be determined to be key audit matters, other planning and scoping matters (e.g., the planned scope of the audit, or the application of materiality in the context of the audit) are unlikely to be key audit matters because of how key audit matters are defined in ISA 701. However, law or regulation may require the auditor to communicate about planning and scoping matters in the auditor's report, or the auditor may consider it necessary to communicate about such matters in an Other Matter paragraph.

A10. In the rare circumstance where the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient

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<sup>8</sup> ISA 570 (Revised), paragraphs 22–23

<sup>9</sup> ISA 260 (Revised), paragraph 15

appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive,<sup>10</sup> the auditor may consider it necessary to include an Other Matter paragraph in the auditor's report to explain why it is not possible for the auditor to withdraw from the engagement.

#### Relevant to Users' Understanding of the Auditor's Responsibilities or the Auditor's Report

- A11. Law, regulation or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon. When the Other Matter section includes more than one matter that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, it may be helpful to use different sub-headings for each matter.
- A12. An Other Matter paragraph does not deal with circumstances where the auditor has other reporting responsibilities that are in addition to the auditor's responsibility under the ISAs (see Other Reporting Responsibilities section in ISA 700 (Revised)<sup>11</sup>), or where the auditor has been asked to perform and report on additional specified procedures, or to express an opinion on specific matters.

#### Reporting on more than one set of financial statements

- A13. An entity may prepare one set of financial statements in accordance with a general purpose framework (e.g., the national framework) and another set of financial statements in accordance with another general purpose framework (e.g., International Financial Reporting Standards), and engage the auditor to report on both sets of financial statements. If the auditor has determined that the frameworks are acceptable in the respective circumstances, the auditor may include an Other Matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.

#### Restriction on distribution or use of the auditor's report

- A14. Financial statements prepared for a specific purpose may be prepared in accordance with a general purpose framework because the intended users have determined that such general purpose financial statements meet their financial information needs. Since the auditor's report is intended for specific users, the auditor may consider it necessary in the circumstances to include an Other Matter paragraph, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.

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<sup>10</sup> See paragraph 13(b)(ii) of ISA 705 (Revised) for a discussion of this circumstance.

<sup>11</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 43–44

*Including an Other Matter Paragraph in the Auditor's Report*

A15. The content of an Other Matter paragraph reflects clearly that such other matter is not required to be presented and disclosed in the financial statements. An Other Matter paragraph does not include information that the auditor is prohibited from providing by law, regulation or other professional standards, for example, ethical standards relating to confidentiality of information. An Other Matter paragraph also does not include information that is required to be provided by management.

**Placement of Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Auditor's Report (Ref: Para. 9, 11)**

A16. The placement of an Emphasis of Matter paragraph or Other Matter paragraph in the auditor's report depends on the nature of the information to be communicated, and the auditor's judgment as to the relative significance of such information to intended users compared to other elements required to be reported in accordance with ISA 700 (Revised). For example:

*Emphasis of Matter Paragraphs*

- When the Emphasis of Matter paragraph relates to the applicable financial reporting framework, including circumstances where the auditor determines that the financial reporting framework prescribed by law or regulation would otherwise be unacceptable,<sup>12</sup> the auditor may consider it necessary to place the paragraph immediately following the Basis for Opinion section to provide appropriate context to the auditor's opinion.
- When a Key Audit Matters section is presented in the auditor's report, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section, based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph. The auditor may also add further context to the heading "Emphasis of Matter", such as "Emphasis of Matter – Subsequent Event", to differentiate the Emphasis of Matter paragraph from the individual matters described in the Key Audit Matters section.

*Other Matter Paragraphs*

- When a Key Audit Matters section is presented in the auditor's report and an Other Matter paragraph is also considered necessary, the auditor may add further context to the heading "Other Matter", such as "Other Matter – Scope of the Audit", to differentiate the Other Matter paragraph from the individual matters described in the Key Audit Matters section.

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<sup>12</sup> For example, as required by ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph 19 and ISA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, paragraph 14

- When an Other Matter paragraph is included to draw users' attention to a matter relating to Other Reporting Responsibilities addressed in the auditor's report, the paragraph may be included in the Report on Other Legal and Regulatory Requirements section.
- When relevant to all the auditor's responsibilities or users' understanding of the auditor's report, the Other Matter paragraph may be included as a separate section following the Report on the Audit of the Financial Statements and the Report on Other Legal and Regulatory Requirements.

A17. Appendix 3 is an illustration of the interaction between the Key Audit Matters section, an Emphasis of Matter paragraph and an Other Matter paragraph when all are presented in the auditor's report. The illustrative report in Appendix 4 includes an Emphasis of Matter paragraph in an auditor's report for an entity other than a listed entity that contains a qualified opinion and for which key audit matters have not been communicated.

**Communication with Those Charged with Governance** (Ref. Para. 12)

A18. The communication required by paragraph 12 enables those charged with governance to be made aware of the nature of any specific matters that the auditor intends to highlight in the auditor's report, and provides them with an opportunity to obtain further clarification from the auditor where necessary. Where the inclusion of an Other Matter paragraph on a particular matter in the auditor's report recurs on each successive engagement, the auditor may determine that it is unnecessary to repeat the communication on each engagement, unless otherwise required to do so by law or regulation.

## Appendix 1

(Ref: Para. 4, A4)

### List of ISAs Containing Requirements for Emphasis of Matter Paragraphs

This appendix identifies paragraphs in other ISAs that require the auditor to include an Emphasis of Matter paragraph in the auditor's report in certain circumstances. The list is not a substitute for considering the requirements and related application and other explanatory material in ISAs.

- ISA 210, *Agreeing the Terms of Audit Engagements* – paragraph 19(b)
- ISA 560, *Subsequent Events* – paragraphs 12(b) and 16
- ISA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* – paragraph 14

## Appendix 2

(Ref. Para. 4)

### List of ISAs Containing Requirements for Other Matter Paragraphs

This appendix identifies paragraphs in other ISAs that require the auditor to include an Other Matter paragraph in the auditor's report in certain circumstances. The list is not a substitute for considering the requirements and related application and other explanatory material in ISAs.

- ISA 560, *Subsequent Events* – paragraphs 12(b) and 16
- ISA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* – paragraphs 13–14, 16–17 and 19

## Appendix 3

(Ref: Para. A17)

### Illustration of an Independent Auditor's Report that Includes a Key Audit Matters Section, an Emphasis of Matter Paragraph, and an Other Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- **Audit of a complete set of financial statements of a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600<sup>1</sup> does not apply).**
- **The financial statements are prepared by management of the entity in accordance with International Financial Reporting Standards (IFRSs) (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.**
- **The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.**
- **Key audit matters have been communicated in accordance with ISA 701.**

<sup>1</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

- **The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.**
- **Corresponding figures are presented, and the prior period's financial statements were audited by a predecessor auditor. The auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and has decided to do so.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>2</sup>

#### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

<sup>2</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

### **Emphasis of Matter<sup>3</sup>**

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

### **Key Audit Matters**

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

*[Description of each key audit matter in accordance with ISA 701.]*

### **Other Matter**

The financial statements of ABC Company for the year ended December 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

### **Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]**

*[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 1 in Appendix 2 of ISA 720 (Revised).]*

### **Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>4</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

### **Auditor's Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

### **Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

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<sup>3</sup> As noted in paragraph A16, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph.

<sup>4</sup> Throughout these illustrative auditor's reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN  
THE INDEPENDENT AUDITOR'S REPORT

The engagement partner on the audit resulting in this independent auditor's report is  
[*name*].

[*Signature in the name of the audit firm, the personal name of the auditor, or both, as  
appropriate for the particular jurisdiction*]

[*Auditor Address*]

[*Date*]

## Appendix 4

(Ref: Para. A8)

### **Illustration of an Independent Auditor's Report Containing a Qualified Opinion Due to a Departure from the Applicable Financial Reporting Framework and that Includes an Emphasis of Matter Paragraph**

**For purposes of this illustrative auditor's report, the following circumstances are assumed:**

- **Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600<sup>1</sup> does not apply).**
- **The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.**
- **A departure from the applicable financial reporting framework resulted in a qualified opinion.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.**
- **The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.**

- **The auditor has not obtained any other information prior to the date of the auditor's report.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>1</sup>

#### Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Qualified Opinion

The Company's short-term marketable securities are carried in the statement of financial position at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from IFRSs. The Company's records indicate that had management marked the marketable securities to market, the Company would have recognized an unrealized loss of xxx in the statement of comprehensive income for the year. The carrying amount of the securities in the statement of financial position would have been reduced by the same amount at December 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are

<sup>1</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

**Emphasis of Matter – Effects of a Fire**

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

**Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>2</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

**Auditor's Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

**Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>2</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

**INTERNATIONAL STANDARD ON AUDITING 710**  
**COMPARATIVE INFORMATION**  
**CORRESPONDING FIGURES AND COMPARATIVE**  
**FINANCIAL STATEMENTS**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.



## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to comparative information in an audit of financial statements. When the financial statements of the prior period have been audited by a predecessor auditor or were not audited, the requirements and guidance in ISA 510<sup>1</sup> regarding opening balances also apply.

### The Nature of Comparative Information

2. The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.
3. The essential audit reporting differences between the approaches are:
  - (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
  - (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

This ISA addresses separately the auditor's reporting requirements for each approach.

### Effective Date

4. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

## Objectives

5. The objectives of the auditor are:
  - (a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and
  - (b) To report in accordance with the auditor's reporting responsibilities.

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<sup>1</sup> ISA 510, *Initial Audit Engagements—Opening Balances*

## Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Comparative information – The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.
  - (b) Corresponding figures – Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.
  - (c) Comparative financial statements – Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor’s opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

For purposes of this ISA, references to “prior period” should be read as “prior periods” when the comparative information includes amounts and disclosures for more than one period.

## Requirements

### Audit Procedures

7. The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:
- (a) The comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated; and
  - (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.
8. If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine

whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of ISA 560.<sup>2</sup> If the prior period financial statements are amended, the auditor shall determine that the comparative information agrees with the amended financial statements.

9. As required by ISA 580,<sup>3</sup> the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information. (Ref: Para. A1)

## **Audit Reporting**

### *Corresponding Figures*

10. When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the circumstances described in paragraphs 11, 12, and 14. (Ref: Para. A2)
11. If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
  - (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
  - (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures. (Ref: Para. A3–A5)
12. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, and the corresponding figures have not been properly restated or appropriate disclosures have not been made, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein. (Ref: Para. A6)

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<sup>2</sup> ISA 560, *Subsequent Events*, paragraphs 14–17

<sup>3</sup> ISA 580, *Written Representations*, paragraph 14

### Prior Period Financial Statements Audited by a Predecessor Auditor

13. If the financial statements of the prior period were audited by a predecessor auditor and the auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report:
- (a) That the financial statements of the prior period were audited by the predecessor auditor;
  - (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
  - (c) The date of that report. (Ref: Para. A7)

### Prior Period Financial Statements Not Audited

14. If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements. (Ref: Para. A8)<sup>4</sup>

### *Comparative Financial Statements*

15. When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed. (Ref: Para. A9–A10)
16. When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with ISA 706 (Revised).<sup>5</sup> (Ref: Para. A11)

### Prior Period Financial Statements Audited by a Predecessor Auditor

17. If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:
- (a) that the financial statements of the prior period were audited by a predecessor auditor;

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<sup>4</sup> ISA 510, paragraph 6

<sup>5</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, paragraph 8

- (b) the type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- (c) the date of that report,

unless the predecessor auditor's report on the prior period's financial statements is reissued with the financial statements.

18. If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and, unless all of those charged with governance are involved in managing the entity,<sup>6</sup> those charged with governance and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period. (Ref: Para. A12)

#### Prior Period Financial Statements Not Audited

19. If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements. (Ref: Para. A13)<sup>7</sup>

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## Application and Other Explanatory Material

### Audit Procedures

#### *Written Representations* (Ref: Para. 9)

- A1. In the case of comparative financial statements, the written representations are requested for all periods referred to in the auditor's opinion because management needs to reaffirm that the written representations it previously made with respect to the prior period remain appropriate. In the case of corresponding figures, the written representations are requested for the financial statements of the current period only because the auditor's opinion is on those financial statements, which include the corresponding figures. However, the auditor requests a specific written representation regarding any restatement made to correct a material misstatement in the prior period financial statements that affect the comparative information.

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<sup>6</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

<sup>7</sup> ISA 510, paragraph 6

## **Audit Reporting**

### *Corresponding Figures*

#### No Reference in Auditor's Opinion (Ref: Para. 10)

- A2. The auditor's opinion does not refer to the corresponding figures because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.

#### Modification in Auditor's Report on the Prior Period Unresolved (Ref: Para. 11)

- A3. When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.
- A4. When the auditor's opinion on the prior period, as previously expressed, was modified, the unresolved matter that gave rise to the modification may not be relevant to the current period figures. Nevertheless, a qualified opinion, a disclaimer of opinion, or an adverse opinion (as applicable) may be required on the current period's financial statements because of the effects or possible effects of the unresolved matter on the comparability of the current and corresponding figures.
- A5. Illustrative examples of the auditor's report if the auditor's report on the prior period included a modified opinion and the matter giving rise to the modification is unresolved are contained in Illustrations 1 and 2 of the Appendix.

#### Misstatement in Prior Period Financial Statements (Ref: Para. 12)

- A6. When the prior period financial statements that are misstated have not been amended and an auditor's report has not been reissued, but the corresponding figures have been properly restated or appropriate disclosures have been made in the current period financial statements, the auditor's report may include an Emphasis of Matter paragraph describing the circumstances and referring to where relevant disclosures that fully describe the matter that can be found in the financial statements (see ISA 706 (Revised)).

#### Prior Period Financial Statements Audited by a Predecessor Auditor (Ref: Para. 13)

- A7. An illustrative example of the auditor's report if the prior period financial statements were audited by a predecessor auditor and the auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures is contained in Illustration 3 of the Appendix.

Prior Period Financial Statements Not Audited (Ref: Para. 14)

- A8. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor is required by ISA 705 (Revised)<sup>8</sup> to express a qualified opinion or disclaim an opinion on the financial statements, as appropriate, in accordance with ISA 705 (Revised). If the auditor encountered significant difficulty in obtaining sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements, the auditor may determine this to be a key audit matter in accordance with ISA 701.<sup>9</sup>

*Comparative Financial Statements*

Reference in Auditor's Opinion (Ref: Para. 15)

- A9. Because the auditor's report on comparative financial statements applies to the financial statements for each of the periods presented, the auditor may express a qualified opinion or an adverse opinion, disclaim an opinion, or include an Emphasis of Matter paragraph with respect to one or more periods, while expressing a different auditor's opinion on the financial statements of the other period.
- A10. An illustrative example of the auditor's report if the auditor is required to report on both the current and the prior period financial statements in connection with the current year's audit and the prior period included a modified opinion and the matter giving rise to the modification is unresolved, is contained in Illustration 4 of the Appendix.

Opinion on Prior Period Financial Statements Different from Previous Opinion (Ref: Para. 16)

- A11. When reporting on the prior period financial statements in connection with the current period's audit, the opinion expressed on the prior period financial statements may be different from the opinion previously expressed if the auditor becomes aware of circumstances or events that materially affect the financial statements of a prior period during the course of the audit of the current period. In some jurisdictions, the auditor may have additional reporting responsibilities designed to prevent future reliance on the auditor's previously issued report on the prior period financial statements.

Prior Period Financial Statements Audited by a Predecessor Auditor (Ref: Para. 18)

- A12. The predecessor auditor may be unable or unwilling to reissue the auditor's report on the prior period financial statements. An Other Matter paragraph of the auditor's report may indicate that the predecessor auditor reported on the financial statements of the prior period before amendment. In addition, if the auditor is engaged to audit and obtains sufficient appropriate audit evidence to

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<sup>8</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

<sup>9</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

be satisfied as to the appropriateness of the amendment, the auditor's report may also include the following paragraph:

As part of our audit of the 20X2 financial statements, we also audited the adjustments described in Note X that were applied to amend the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole.

Prior Period Financial Statements Not Audited (Ref: Para. 19)

- A13. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor is required by ISA 705 (Revised) to express a qualified opinion or disclaim an opinion on the financial statements, as appropriate, in accordance with ISA 705 (Revised). If the auditor encountered significant difficulty in obtaining sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements, the auditor may determine this to be a key audit matter in accordance with ISA 701.

## Appendix

(Ref: Para. A5, A7, A10)

### Illustrations of Independent Auditors' Reports

#### **Illustration 1 – Corresponding Figures**

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- **Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600<sup>1</sup> does not apply).**
- **The financial statements are prepared by management of the entity in accordance with International Financial Reporting Standards (IFRSs) (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.<sup>2</sup>**
- **The auditor's report on the prior period, as previously issued, included a qualified opinion.**
- **The matter giving rise to the modification is unresolved.**
- **The effects or possible effects of the matter on the current period's figures are material and require a modification to the auditor's opinion regarding the current period figures.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).<sup>3</sup>**
- **The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.**
- **The auditor has not obtained any other information prior to the date of the auditor's report.**

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<sup>1</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

<sup>2</sup> ISA 210, *Agreeing the Terms of Audit Engagements*

<sup>3</sup> ISA 570 (Revised), *Going Concern*

- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>1</sup>

#### Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements, which constitutes a departure from IFRSs. This is the result of a decision taken by management at the start of the preceding financial year and caused us to qualify our audit opinion on the financial statements relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by xxx in 20X1 and xxx in 20X0, property, plant and equipment should be reduced by accumulated depreciation of xxx in 20X1 and xxx in 20X0, and the accumulated loss should be increased by xxx in 20X1 and xxx in 20X0.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe

<sup>1</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

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

**Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements<sup>2</sup>**

*[Reporting in accordance with ISA 700 (Revised)<sup>3</sup> – see Illustration 1 in ISA 700 (Revised).]*

**Auditor’s Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

**Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see illustration 1 in ISA 700 (Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>2</sup> Throughout these illustrative auditor’s reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

<sup>3</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

**Illustration 2 – Corresponding Figures**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor’s report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period’s figures are immaterial but require a modification to the auditor’s opinion because of the effects or possible effects of the unresolved matter on the comparability of the current period’s figures and the corresponding figures.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- The auditor is not required, and has otherwise has not decided, to communicate key audit matters in accordance with ISA 701.
- The auditor has not obtained any other information prior to the date of the auditor’s report.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>4</sup>

#### Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects on the corresponding figures of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Qualified Opinion

Because we were appointed auditors of the Company during 20X0, we were not able to observe the counting of the physical inventories at the beginning of that period or satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories affect the determination of the results of operations, we were unable to determine whether adjustments to the results of operations and opening retained earnings might be necessary for 20X0. Our audit opinion on the financial statements for the period ended December 31, 20X0 was modified accordingly. Our opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures and the corresponding figures.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

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<sup>4</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

**Responsibilities of Management and Those Charged with Governance for the  
Financial Statements<sup>5</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700  
(Revised).]*

**Auditor’s Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700  
(Revised).]*

**Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700  
(Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as  
appropriate for the particular jurisdiction]*

[Auditor Address]

[Date]

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<sup>5</sup> Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

### **Illustration 3 – Corresponding Figures**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- **Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).**
- **The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.**
- **The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **The auditor is not required, and has otherwise has not decided, to communicate key audit matters in accordance with ISA 701.**
- **The auditor has obtained all of the other information prior to the date of the auditor’s report and has not identified a material misstatement of the other information.**
- **Corresponding figures are presented, and prior period’s financial statements were audited by a predecessor auditor.**
- **The auditor is not prohibited by law or regulation from referring to the predecessor auditor’s report on the corresponding figures and has decided to do so.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>6</sup>

#### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

#### Other Matter

The financial statements of the Company for the year ended December 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

#### Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[Reporting in accordance with the reporting requirements in ISA 720 (Revised – see Illustration 1 in Appendix 2 of ISA 720 (Revised)).]<sup>7</sup>

#### Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>8</sup>

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<sup>6</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

<sup>7</sup> ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

<sup>8</sup> Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

**Auditor’s Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

**Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

**Illustration 4 – Comparative Financial Statements**

**For purposes of this illustrative auditor’s report, the following are assumed:**

- **Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).**
- **The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.**
- **The auditor is required to report on both the current period financial statements and the prior period financial statements in connection with the current year’s audit.**
- **The auditor’s report on the prior period, as previously issued, included a qualified opinion.**
- **The matter giving rise to the modification is unresolved.**
- **The effects or possible effects of the matter on the current period’s figures are material to both the current period financial statements and prior period financial statements and require a modification to the auditor’s opinion.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **The auditor is not required, and has otherwise has not decided, to communicate key audit matters in accordance with ISA 701.**
- **The auditor has not obtained any other information prior to the date of the auditor’s report.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.**

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>9</sup>

#### Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statements of financial position as at December 31, 20X1 and 20X0, and the statements of comprehensive income, statements of changes in equity and statements of cash flows for the years then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1 and 20X0 and (*of*) its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements, which constitutes a departure from IFRSs. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by xxx in 20X1 and xxx in 20X0, property, plant and equipment should be reduced by accumulated depreciation of xxx in 20X1 and xxx in 20X0, and the accumulated loss should be increased by xxx in 20X1 and xxx in 20X0.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

#### Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>10</sup>

[*Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).*]

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<sup>9</sup> The sub-title “Report on the Audit of the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.

<sup>10</sup> Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

**Auditor’s Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

**Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

**INTERNATIONAL STANDARD ON AUDITING 720  
(REVISED)**

**THE AUDITOR’S RESPONSIBILITIES RELATING  
TO OTHER INFORMATION**

(Effective for audits of financial statements for periods  
ending on or after December 15, 2016)

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International Standard on Auditing (ISA) 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to other information, whether financial or non-financial information (other than financial statements and the auditor's report thereon), included in an entity's annual report. An entity's annual report may be a single document or a combination of documents that serve the same purpose.
2. This ISA is written in the context of an audit of financial statements by an independent auditor. Accordingly, the objectives of the auditor in this ISA are to be understood in the context of the overall objectives of the auditor as stated in paragraph 11 of ISA 200.<sup>1</sup> The requirements in the ISA are designed to enable the auditor to achieve the objectives specified in the ISAs, and thereby the overall objectives of the auditor. The auditor's opinion on the financial statements does not cover the other information, nor does this ISA require the auditor to obtain audit evidence beyond that required to form an opinion on the financial statements.
3. This ISA requires the auditor to read and consider the other information because other information that is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit may indicate that there is a material misstatement of the financial statements or that a material misstatement of the other information exists, either of which may undermine the credibility of the financial statements and the auditor's report thereon. Such material misstatements may also inappropriately influence the economic decisions of the users for whom the auditor's report is prepared.
4. This ISA may also assist the auditor in complying with relevant ethical requirements<sup>2</sup> that require the auditor to avoid being knowingly associated with information that the auditor believes contains a materially false or misleading statement, statements or information provided recklessly, or omits or obscures required information where such omission or obscurity would be misleading.
5. Other information may include amounts or other items that are intended to be the same as, to summarize, or to provide greater detail, about amounts or other items in the financial statements, and other amounts or other items about which the auditor has obtained knowledge in the audit. Other information may also include other matters.
6. The auditor's responsibilities relating to other information (other than applicable reporting responsibilities) apply regardless of whether the other information is obtained by the auditor prior to, or after, the date of the auditor's report.

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<sup>1</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

<sup>2</sup> International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code), paragraph R111.2

7. This ISA does not apply to:
  - (a) Preliminary announcements of financial information; or
  - (b) Securities offering documents, including prospectuses.
8. The auditor's responsibilities under this ISA do not constitute an assurance engagement on other information or impose an obligation on the auditor to obtain assurance about the other information.
9. Law or regulation may impose additional obligations on the auditor in relation to other information that are beyond the scope of this ISA.

### **Effective Date**

10. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2016.

### **Objectives**

11. The objectives of the auditor, having read the other information, are:
  - (a) To consider whether there is a material inconsistency between the other information and the financial statements;
  - (b) To consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit;
  - (c) To respond appropriately when the auditor identifies that such material inconsistencies appear to exist, or when the auditor otherwise becomes aware that other information appears to be materially misstated; and
  - (d) To report in accordance with this ISA.

### **Definitions**

12. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Annual report – A document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom, the purpose of which is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements. An annual report contains or accompanies the financial statements and the auditor's report thereon and usually includes information about the entity's developments, its future outlook and risks and uncertainties, a statement by the entity's governing body, and reports covering governance matters. (Ref: Para. A1–A5)
  - (b) Misstatement of the other information – A misstatement of the other information exists when the other information is incorrectly stated or

otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information). (Ref: Para. A6–A7)

- (c) Other information – Financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report. (Ref: Para. A8–A10)

## Requirements

### Obtaining the Other Information

13. The auditor shall: (Ref: Para. A11–A22)
  - (a) Determine, through discussion with management, which document(s) comprises the annual report, and the entity's planned manner and timing of the issuance of such document(s);
  - (b) Make appropriate arrangements with management to obtain in a timely manner and, if possible, prior to the date of the auditor's report, the final version of the document(s) comprising the annual report; and
  - (c) When some or all of the document(s) determined in (a) will not be available until after the date of the auditor's report, request management to provide a written representation that the final version of the document(s) will be provided to the auditor when available, and prior to its issuance by the entity, such that the auditor can complete the procedures required by this ISA. (Ref: Para. A22)

### Reading and Considering the Other Information

14. The auditor shall read the other information and, in doing so shall: (Ref: Para. A23–A24)
  - (a) Consider whether there is a material inconsistency between the other information and the financial statements. As the basis for this consideration, the auditor shall, to evaluate their consistency, compare selected amounts or other items in the other information (that are intended to be the same as, to summarize, or to provide greater detail about, the amounts or other items in the financial statements) with such amounts or other items in the financial statements; and (Ref: Para. A25–A29)
  - (b) Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit. (Ref: Para. A30–A36)
15. While reading the other information in accordance with paragraph 14, the auditor shall remain alert for indications that the other information not related

to the financial statements or the auditor's knowledge obtained in the audit appears to be materially misstated. (Ref: Para. A24, A37–A38)

### **Responding When a Material Inconsistency Appears to Exist or Other Information Appears to Be Materially Misstated**

16. If the auditor identifies that a material inconsistency appears to exist (or becomes aware that the other information appears to be materially misstated), the auditor shall discuss the matter with management and, if necessary, perform other procedures to conclude whether: (Ref: Para. A39–A43)
  - (a) A material misstatement of the other information exists;
  - (b) A material misstatement of the financial statements exists; or
  - (c) The auditor's understanding of the entity and its environment needs to be updated.

### **Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists**

17. If the auditor concludes that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management:
  - (a) Agrees to make the correction, the auditor shall determine that the correction has been made; or
  - (b) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.
18. If the auditor concludes that a material misstatement exists in other information obtained prior to the date of the auditor's report, and the other information is not corrected after communicating with those charged with governance, the auditor shall take appropriate action, including: (Ref: Para. A44)
  - (a) Considering the implications for the auditor's report and communicating with those charged with governance about how the auditor plans to address the material misstatement in the auditor's report (see paragraph 22(e)(ii)); or (Ref: Para. A45)
  - (b) Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation. (Ref: Para. A46–A47)
19. If the auditor concludes that a material misstatement exists in other information obtained after the date of the auditor's report, the auditor shall:
  - (a) If the other information is corrected, perform the procedures necessary in the circumstances; or (Ref: Para. A48)

- (b) If the other information is not corrected after communicating with those charged with governance, take appropriate action considering the auditor's legal rights and obligations, to seek to have the uncorrected material misstatement appropriately brought to the attention of users for whom the auditor's report is prepared. (Ref: Para. A49–A50)

**Responding When a Material Misstatement in the Financial Statements Exists or the Auditor's Understanding of the Entity and Its Environment Needs to Be Updated**

- 20. If, as a result of performing the procedures in paragraphs 14–15, the auditor concludes that a material misstatement in the financial statements exists or the auditor's understanding of the entity and its environment needs to be updated, the auditor shall respond appropriately in accordance with the other ISAs. (Ref: Para. A51)

**Reporting**

- 21. The auditor's report shall include a separate section with a heading "Other Information", or other appropriate heading, when, at the date of the auditor's report:
  - (a) For an audit of financial statements of a listed entity, the auditor has obtained, or expects to obtain, the other information; or
  - (b) For an audit of financial statements of an entity other than a listed entity, the auditor has obtained some or all of the other information. (Ref: Para. A52)
- 22. When the auditor's report is required to include an Other Information section in accordance with paragraph 21, this section shall include: (Ref: Para. A53)
  - (a) A statement that management is responsible for the other information;
  - (b) An identification of:
    - (i) Other information, if any, obtained by the auditor prior to the date of the auditor's report; and
    - (ii) For an audit of financial statements of a listed entity, other information, if any, expected to be obtained after the date of the auditor's report;
  - (c) A statement that the auditor's opinion does not cover the other information and, accordingly, that the auditor does not express (or will not express) an audit opinion or any form of assurance conclusion thereon;
  - (d) A description of the auditor's responsibilities relating to reading, considering and reporting on other information as required by this ISA; and
  - (e) When other information has been obtained prior to the date of the auditor's report, either:

- (i) A statement that the auditor has nothing to report; or
  - (ii) If the auditor has concluded that there is an uncorrected material misstatement of the other information, a statement that describes the uncorrected material misstatement of the other information.
23. When the auditor expresses a qualified or adverse opinion in accordance with ISA 705 (Revised),<sup>3</sup> the auditor shall consider the implications of the matter giving rise to the modification of opinion for the statement required in paragraph 22(e). (Ref: Para. A54–A58)

#### *Reporting Prescribed by Law or Regulation*

24. If the auditor is required by law or regulation of a specific jurisdiction to refer to the other information in the auditor's report using a specific layout or wording, the auditor's report shall refer to International Standards on Auditing only if the auditor's report includes, at a minimum: (Ref: Para. A59)
- (a) Identification of the other information obtained by the auditor prior to the date of the auditor's report;
  - (b) A description of the auditor's responsibilities with respect to the other information; and
  - (c) An explicit statement addressing the outcome of the auditor's work for this purpose.

#### **Documentation**

25. In addressing the requirements of ISA 230<sup>4</sup> as it applies to this ISA, the auditor shall include in the audit documentation:
- (a) Documentation of the procedures performed under this ISA; and
  - (b) The final version of the other information on which the auditor has performed the work required under this ISA.

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## **Application and Other Explanatory Material**

### **Definitions**

#### *Annual Report* (Ref: Para. 12(a))

- A1. Law, regulation or custom may define the content of an annual report, and the name by which it is to be referred, for entities in a particular jurisdiction; however, the content and the name may vary within a jurisdiction and from one jurisdiction to another.

<sup>3</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

<sup>4</sup> ISA 230, *Audit Documentation*, paragraphs 8–11

- A2. An annual report is typically prepared on an annual basis. However, when the financial statements being audited are prepared for a period less than or more than a year, an annual report may also be prepared that covers the same period as the financial statements.
- A3. In some cases, an entity's annual report may be a single document and referred to by the title "annual report" or by some other title. In other cases, law, regulation or custom may require the entity to report to owners (or similar stakeholders) information on the entity's operations and the entity's financial results and financial position as set out in the financial statements (i.e., an annual report) by way of a single document, or by way of two or more separate documents that in combination serve the same purpose. For example, depending on law, regulation or custom in a particular jurisdiction, one or more of the following documents may form part of the annual report:
- Management report, management commentary, or operating and financial review or similar reports by those charged with governance (for example, a directors' report).
  - Chairman's statement.
  - Corporate governance statement.
  - Internal control and risk assessment reports.
- A4. An annual report may be made available to users in printed form, or electronically, including on the entity's website. A document (or combination of documents) may meet the definition of an annual report, irrespective of the manner in which it is made available to users.
- A5. An annual report is different in nature, purpose and content from other reports, such as a report prepared to meet the information needs of a specific stakeholder group or a report prepared to comply with a specific regulatory reporting objective (even when such a report is required to be publicly available). Examples of reports that, when issued as standalone documents, are not typically part of the combination of documents that comprise an annual report (subject to law, regulation or custom), and that, therefore, are not other information within the scope of this ISA, include:
- Separate industry or regulatory reports (for example, capital adequacy reports), such as may be prepared in the banking, insurance, and pension industries.
  - Corporate social responsibility reports.
  - Sustainability reports.
  - Diversity and equal opportunity reports.
  - Product responsibility reports.
  - Labor practices and working conditions reports.
  - Human rights reports.

*Misstatement of the Other Information* (Ref: Para. 12(b))

- A6. When a particular matter is disclosed in the other information, the other information may omit or obscure information that is necessary for a proper understanding of that matter. For example, if the other information purports to address the key performance indicators used by management, then omission of a key performance indicator used by management could indicate that the other information is misleading.
- A7. The concept of materiality may be discussed in a framework applicable to the other information and, if so, such a framework may provide a frame of reference for the auditor in making judgments about materiality under this ISA. In many cases, however, there may be no applicable framework that includes a discussion of the concept of materiality as it applies to the other information. In such circumstances, the following characteristics provide the auditor with a frame of reference in determining if a misstatement of the other information is material:
- Materiality is considered in the context of the common information needs of users as a group. The users of the other information are expected to be the same as the users of the financial statements as such users may be expected to read the other information to provide context to the financial statements.
  - Judgments about materiality take into account the specific circumstances of the misstatement, considering whether users would be influenced by the effect of the uncorrected misstatement. Not all misstatements will influence the economic decisions of users.
  - Judgments about materiality involve both qualitative and quantitative considerations. Accordingly, such judgments may take into account the nature or magnitude of the items that the other information addresses in the context of the entity's annual report.

*Other Information* (Ref: Para. 12(c))

- A8. Appendix 1 contains examples of amounts or other items that may be included in the other information.
- A9. In some cases, the applicable financial reporting framework may require specific disclosures but permit them to be located outside of the financial statements.<sup>5</sup> As such disclosures are required by the applicable financial reporting framework, they form part of the financial statements. Accordingly, they do not constitute other information for the purpose of this ISA.

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<sup>5</sup> For example, International Financial Reporting Standards (IFRS) 7, *Financial Instruments: Disclosures*, permits certain disclosures required by the IFRSs to either be given in the financial statements or incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time.

A10. eXtensible Business Reporting Language (XBRL) tags do not represent other information as defined in this ISA.

**Obtaining the Other Information** (Ref: Para. 13)

A11. Determining the document(s) that is or comprises the annual report is often clear based on law, regulation or custom. In many cases, management or those charged with governance may have customarily issued a package of documents that together comprise the annual report, or may have committed to do so. In some cases, however, it may not be clear which document(s) is or comprises the annual report. In such cases, the timing and purpose of the documents (and for whom they are intended) are matters that may be relevant to the auditor's determination of which document(s) is or comprises the annual report.

A12. When the annual report is translated into other languages pursuant to law or regulation (such as may occur when a jurisdiction has more than one official language), or when multiple "annual reports" are prepared under different legislation (for example, when an entity is listed in more than one jurisdiction), consideration may need to be given as to whether one, or more than one of the "annual reports" form part of the other information. Local law or regulation may provide further guidance in this respect.

A13. Management, or those charged with governance, is responsible for preparing the annual report. The auditor may communicate with management or those charged with governance:

- The auditor's expectations in relation to obtaining the final version of the annual report (including a combination of documents that together comprise the annual report) in a timely manner prior to the date of the auditor's report such that the auditor can complete the procedures required by this ISA before the date of the auditor's report, or if that is not possible, as soon as practicable and in any case prior to the entity's issuance of such information.
- The possible implications when the other information is obtained after the date of the auditor's report.

A14. The communications referred to in paragraph A13 may be particularly appropriate for example:

- In an initial audit engagement.
- When there has been a change in management or those charged with governance.
- When other information is expected to be obtained after the date of the auditor's report.

A15. Where those charged with governance are to approve the other information prior to its issuance by the entity, the final version of such other information is the one that has been approved by those charged with governance for issuance.

- A16. In some cases, the entity's annual report may be a single document to be released, in accordance with law or regulation or the entity's reporting practice, shortly after the entity's financial reporting period such that it is available to the auditor prior to the date of the auditor's report. In other cases, such a document may not be required to be released until a later time, or at a time of the entity's choosing. There may also be circumstances when the entity's annual report is a combination of documents, each subject to different requirements or reporting practice by the entity with respect to the timing of their release.
- A17. There may be circumstances when, at the date of the auditor's report, the entity is considering the development of a document that may be part of the entity's annual report (for example, a voluntary report to stakeholders) but management is unable to confirm to the auditor the purpose or timing of such a document. If the auditor is unable to ascertain the purpose or timing of such a document, the document is not considered other information for purposes of this ISA.
- A18. Obtaining the other information in a timely manner prior to the date of the auditor's report enables any revisions that are found to be necessary to be made to the financial statements, the auditor's report, or the other information prior to their issuance. The audit engagement letter<sup>6</sup> may make reference to an agreement with management to make available to the auditor the other information in a timely manner, and if possible prior to the date of the auditor's report.
- A19. When other information is only made available to users via the entity's website, the version of the other information obtained from the entity, rather than directly from the entity's website, is the relevant document on which the auditor would perform procedures in accordance with this ISA. The auditor has no responsibility under this ISA to search for other information, including other information that may be on the entity's website, nor to perform any procedures to confirm that other information is appropriately displayed on the entity's website or otherwise has been appropriately transmitted or displayed electronically.
- A20. The auditor is not precluded from dating or issuing the auditor's report if the auditor has not obtained some or all of the other information.
- A21. When the other information is obtained after the date of the auditor's report, the auditor is not required to update the procedures performed in accordance with paragraphs 6 and 7 of ISA 560.<sup>7</sup>
- A22. ISA 580<sup>8</sup> establishes requirements and provides guidance on the use of written representations. The written representation required to be requested by paragraph 13(c) regarding other information that will be available only after the date of the auditor's report is intended to support the auditor's ability to complete the procedures required by this ISA with respect to such information.

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<sup>6</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph A24

<sup>7</sup> ISA 560, *Subsequent Events*

<sup>8</sup> ISA 580, *Written Representations*

In addition, the auditor may find it useful to request other written representations, for example, that:

- Management has informed the auditor of all the documents that it expects to issue that may comprise other information;
- The financial statements and any other information obtained by the auditor prior to the date of the auditor's report are consistent with one another, and the other information does not contain any material misstatements; and
- With regard to other information that has not been obtained by the auditor prior to the date of the auditor's report, that management intends to prepare and issue such other information and the expected timing of such issuance.

### **Reading and Considering the Other Information** (Ref: Para. 14–15)

A23. The auditor is required by ISA 200<sup>9</sup> to plan and perform the audit with professional skepticism. Maintaining professional skepticism when reading and considering the other information includes, for example, recognizing that management may be overly optimistic about the success of its plans, and being alert to information that may be inconsistent with:

- (a) The financial statements; or
- (b) The auditor's knowledge obtained in the audit.

A24. In accordance with ISA 220,<sup>10</sup> the engagement partner is required to take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements. In the context of this ISA, factors that may be taken into account when determining the appropriate engagement team members to address the requirements of paragraphs 14–15, include:

- The relative experience of engagement team members.
- Whether the engagement team members to be assigned the tasks have the relevant knowledge obtained in the audit to identify inconsistencies between the other information and that knowledge.
- The degree of judgment involved in addressing the requirements of paragraph 14–15. For example, performing procedures to evaluate the consistency of amounts in the other information that are intended to be the same as amounts in the financial statements may be carried out by less experienced engagement team members.

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<sup>9</sup> ISA 200, paragraph 15

<sup>10</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 15(a)

- Whether, in the case of a group audit, it is necessary to make inquiries of a component auditor in addressing the other information related to that component.

*Considering Whether There Is a Material Inconsistency between the Other Information and the Financial Statements (Ref: Para. 14(a))*

- A25. Other information may include amounts or other items that are intended to be the same as, to summarize, or to provide greater detail about, the amounts or other items in the financial statements. Examples of such amounts or other items may include:
- Tables, charts or graphs containing extracts of the financial statements.
  - A disclosure providing greater detail about a balance or account shown in the financial statements, such as “Revenue for 20X1 comprised XXX million from product X and YYY million from product Y.”
  - Descriptions of the financial results, such as “Total research and development expense was XXX in 20X1.”
- A26. In evaluating the consistency of selected amounts or other items in the other information with the financial statements, the auditor is not required to compare all amounts or other items in the other information that are intended to be the same as, to summarize, or to provide greater detail about, the amounts or other items in the financial statements, with such amounts or other items in the financial statements.
- A27. Selecting the amounts or other items to compare is a matter of professional judgment. Factors relevant to this judgment include:
- The significance of the amount or other item in the context in which it is presented, which may affect the importance that users would attach to the amount or other item (for example, a key ratio or amount).
  - If quantitative, the relative size of the amount compared with accounts or items in the financial statements or the other information to which they relate.
  - The sensitivity of the particular amount or other item in the other information, for example, share based payments for senior management.
- A28. Determining the nature and extent of procedures to address the requirement in paragraph 14(a) is a matter of professional judgment, recognizing that the auditor’s responsibilities under this ISA do not constitute an assurance engagement on the other information or impose an obligation to obtain assurance about the other information. Examples of such procedures include:
- For information that is intended to be the same as information in the financial statements, comparing the information to the financial statements.

- For information intended to convey the same meaning as disclosures in the financial statements, comparing the words used and considering the significance of differences in wording used and whether such differences imply different meanings.
- Obtaining a reconciliation between an amount within the other information and the financial statements from management and:
  - Comparing items in the reconciliation to the financial statements and the other information; and
  - Checking whether the calculations within the reconciliation are arithmetically accurate.

A29. Evaluating the consistency of selected amounts or other items in the other information with the financial statements includes, when relevant given the nature of the other information, the manner of their presentation compared to the financial statements.

*Considering Whether There Is a Material Inconsistency between the Other Information and the Auditor's Knowledge Obtained in the Audit* (Ref: Para. 14(b))

A30. Other information may include amounts or items that are related to the auditor's knowledge obtained in the audit (other than those in paragraph 14(a)). Examples of such amounts or items may include:

- A disclosure of the units produced, or a table summarizing such production by geographical region.
- A statement that "The company introduced product X and product Y during the year."
- A summary of the locations of the entity's major operations, such as "the entity's major center of operation is in country X, and there are also operations in countries Y and Z."

A31. The auditor's knowledge obtained in the audit includes the auditor's understanding of the entity and its environment, including the entity's internal control, obtained in accordance with ISA 315 (Revised).<sup>11</sup> ISA 315 (Revised) sets out the auditor's required understanding, which includes such matters as obtaining an understanding of:

- (a) The relevant industry, regulatory, and other external factors;
- (b) The nature of the entity;
- (c) The entity's selection and application of accounting policies;
- (d) The entity's objectives and strategies;

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<sup>11</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraphs 11–12

- (e) The measurement and review of the entity's financial performance; and
- (f) The entity's internal control.

- A32. The auditor's knowledge obtained in the audit may also include matters that are prospective in nature. Such matters may include, for example, business prospects and future cash flows that the auditor considered when evaluating the assumptions used by management in performing impairment tests on intangible assets such as goodwill, or when evaluating management's assessment of the entity's ability to continue as a going concern.
- A33. In considering whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit, the auditor may focus on those matters in the other information that are of sufficient importance that a misstatement of the other information in relation to that matter could be material.
- A34. In relation to many matters in the other information, the auditor's recollection of the audit evidence obtained and conclusions reached in the audit may be sufficient to enable the auditor to consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit. The more experienced and the more familiar with the key aspects of the audit the auditor is, the more likely it is that the auditor's recollection of relevant matters will be sufficient. For example, the auditor may be able to consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit in light of the auditor's recollection of discussions held with management or those charged with governance or findings from procedures carried out during the audit such as the reading of board minutes, without the need to take further action.
- A35. The auditor may determine that referring to relevant audit documentation or making inquiries of relevant members of the engagement team or relevant component auditors is appropriate as a basis for the auditor's consideration of whether a material inconsistency exists. For example:
- When the other information describes the planned cessation of a major product line and, although the auditor is aware of the planned cessation, the auditor may make inquiries of the relevant engagement team member who performed the audit procedures in this area to support the auditor's consideration of whether the description is materially inconsistent with the auditor's knowledge obtained during the audit.
  - When the other information describes important details of a lawsuit addressed in the audit, but the auditor cannot recall them adequately, it may be necessary to refer to the audit documentation where such details are summarized to support the auditor's recollection.
- A36. Whether, and if so the extent to which, the auditor refers to relevant audit documentation, or makes inquiries of relevant members of the engagement team

or relevant component auditors is a matter of professional judgment. However, it may not be necessary for the auditor to refer to relevant audit documentation, or to make inquiries of relevant members of the engagement team or relevant component auditors about any matter included in the other information.

*Remaining Alert for Other Indications that the Other Information Appears to Be Materially Misstated* (Ref: Para. 15)

A37. Other information may include discussion of matters that are not related to the financial statements and may also extend beyond the auditor's knowledge obtained in the audit. For example, the other information may include statements about the entity's greenhouse gas emissions.

A38. Remaining alert for other indications that the other information not related to the financial statements or the auditor's knowledge obtained in the audit appears to be materially misstated assists the auditor in complying with relevant ethical requirements that require the auditor to avoid being knowingly associated with other information that the auditor believes contains a materially false or misleading statement, a statement provided recklessly, or omits or obscures necessary information such that the other information is misleading.<sup>12</sup> Remaining alert for other indications that the other information appears to be materially misstated could potentially result in the auditor identifying such matters as:

- Differences between the other information and the general knowledge, apart from the knowledge obtained in the audit, of the engagement team member reading the other information that lead the auditor to believe that the other information appears to be materially misstated; or
- An internal inconsistency in the other information that leads the auditor to believe that the other information appears to be materially misstated.

**Responding When a Material Inconsistency Appears to Exist or Other Information Appears to Be Materially Misstated** (Ref: Para. 16)

A39. The auditor's discussion with management about a material inconsistency (or other information that appears to be materially misstated) may include requesting management to provide support for the basis of management's statements in the other information. Based on management's further information or explanations, the auditor may be satisfied that the other information is not materially misstated. For example, management explanations may indicate reasonable and sufficient grounds for valid differences of judgment.

A40. Conversely, the discussion with management may provide further information that supports the auditor's conclusion that a material misstatement of the other information exists.

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<sup>12</sup> IESBA Code, paragraph R111.2

- A41. It may be more difficult for the auditor to challenge management on matters of judgment than on those of a more factual nature. However, there may be circumstances where the auditor concludes that the other information contains a statement that is not consistent with the financial statements or the auditor's knowledge obtained in the audit. These circumstances may raise doubt about the other information, the financial statements, or the auditor's knowledge obtained in the audit.
- A42. As there is a wide range of possible material misstatements of the other information, the nature and extent of other procedures the auditor may perform to conclude whether a material misstatement of the other information exists are matters of the auditor's professional judgment in the circumstances.
- A43. When a matter is unrelated to the financial statements or the auditor's knowledge obtained in the audit, the auditor may not be able to fully assess management's responses to the auditor's inquiries. Nevertheless, based on management's further information or explanations, or following changes made by management to the other information, the auditor may be satisfied that a material inconsistency no longer appears to exist or that the other information no longer appears to be materially misstated. When the auditor is unable to conclude that a material inconsistency no longer appears to exist or that the other information no longer appears to be materially misstated, the auditor may request management to consult with a qualified third party (for example, a management's expert or legal counsel). In certain cases, after considering the responses from management's consultation, the auditor may not be able to conclude whether or not a material misstatement of the other information exists. Actions the auditor may then take include one or more of the following:
- Obtaining advice from the auditor's legal counsel;
  - Considering the implications for the auditor's report for example, whether to describe the circumstances when there is a limitation imposed by management; or
  - Withdrawing from the audit, where withdrawal is possible under applicable law or regulation.

### **Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists**

*Responding When the Auditor Concludes That a Material Misstatement Exists in Other Information Obtained prior to the Date of the Auditor's Report (Ref: Para. 18)*

- A44. The actions the auditor takes if the other information is not corrected after communicating with those charged with governance are a matter of the auditor's professional judgment. The auditor may take into account whether the rationale given by management and those charged with governance for not making the correction raises doubt about the integrity or honesty of management or those charged with governance, such as when the auditor suspects an intention to

mislead. The auditor may also consider it appropriate to seek legal advice. In some cases, the auditor may be required by law, regulation or other professional standards to communicate the matter to a regulator or relevant professional body.

Reporting Implications (Ref: Para. 18(a))

A45. In rare circumstances, a disclaimer of opinion on the financial statements may be appropriate when the refusal to correct the material misstatement of the other information casts such doubt on the integrity of management and those charged with governance as to call into question the reliability of audit evidence in general.

Withdrawal from the Engagement (Ref: Para. 18(b))

A46. Withdrawal from the engagement, where withdrawal is possible under applicable law or regulation, may be appropriate when the circumstances surrounding the refusal to correct the material misstatement of the other information cast such doubt on the integrity of management and those charged with governance as to call into question the reliability of representations obtained from them during the audit.

Considerations specific to public sector entities (Ref: Para. 18(b))

A47. In the public sector, withdrawal from the engagement may not be possible. In such cases, the auditor may issue a report to the legislature providing details of the matter or may take other appropriate actions.

*Responding When the Auditor Concludes That a Material Misstatement Exists in Other Information Obtained after the Date of the Auditor's Report* (Ref: Para. 19)

A48. If the auditor concludes that a material misstatement exists in other information obtained after the date of the auditor's report, and such a material misstatement has been corrected, the auditor's procedures necessary in the circumstances include determining that the correction has been made (in accordance with paragraph 17(a)) and may include reviewing the steps taken by management to communicate with those in receipt of the other information, if previously issued, to inform them of the revision.

A49. If those charged with governance do not agree to revise the other information, taking appropriate action to seek to have the uncorrected misstatement appropriately brought to the attention of users for whom the auditor's report is prepared requires the exercise of professional judgment, and may be affected by relevant law or regulation in the jurisdiction. Accordingly, the auditor may consider it appropriate to seek legal advice about the auditor's legal rights and obligations.

A50. When a material misstatement of the other information remains uncorrected, appropriate actions that the auditor may take to seek to have the uncorrected

material misstatement appropriately brought to the attention of users for whom the auditor's report is prepared, when permitted by law or regulation, include, for example:

- Providing a new or amended auditor's report to management including a modified section in accordance with paragraph 22, and requesting management to provide this new or amended auditor's report to users for whom the auditor's report is prepared. In doing so, the auditor may need to consider the effect, if any, on the date of the new or amended auditor's report, in view of the requirements of the ISAs or applicable law or regulation. The auditor may also review the steps taken by management to provide the new or amended auditor's report to such users;
- Bringing the material misstatement of the other information to the attention of the users for whom the auditor's report is prepared (for example, by addressing the matter in a general meeting of shareholders);
- Communicating with a regulator or relevant professional body about the uncorrected material misstatement; or
- Considering the implications for engagement continuance (see also paragraph A46).

### **Responding When a Material Misstatement in the Financial Statements Exists or the Auditor's Understanding of the Entity and Its Environment Needs to Be Updated** (Ref: Para. 20)

A51. In reading the other information, the auditor may become aware of new information that has implications for:

- The auditor's understanding of the entity and its environment and, accordingly, may indicate the need to revise the auditor's risk assessment.<sup>13</sup>
- The auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.<sup>14</sup>
- The auditor's responsibilities relating to subsequent events.<sup>15</sup>

### **Reporting** (Ref: Para. 21–24)

A52. For an audit of financial statements of an entity other than a listed entity, the auditor may consider that the identification in the auditor's report of other information that the auditor expects to obtain after the date of the auditor's report would be appropriate in order to provide additional transparency about the other information that is subject to the auditor's responsibilities under this

<sup>13</sup> ISA 315 (Revised), paragraphs 11, 31, and A1

<sup>14</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*

<sup>15</sup> ISA 560, paragraphs 10 and 14

ISA. The auditor may consider it appropriate to do so, for example, when management is able to represent to the auditor that such other information will be issued after the date of the auditor's report.

*Illustrative Statements* (Ref: Para. 21–22)

A53. Illustrative examples of the “Other Information” section of the auditor's report are included in Appendix 2.

*Reporting Implications When the Auditor's Opinion on the Financial Statements Is Qualified or Adverse* (Ref: Para. 23)

A54. A qualified or adverse auditor's opinion on the financial statements may not have an impact on the statement required by paragraph 22(e) if the matter in respect of which the auditor's opinion has been modified is not included or otherwise addressed in the other information and the matter does not affect any part of the other information. For example, a qualified opinion on the financial statements because of non-disclosure of directors' remuneration as required by the applicable financial reporting framework may have no implications for the reporting required under this ISA. In other circumstances, there may be implications for such reporting as described in paragraphs A55–A58.

**Qualified Opinion Due to a Material Misstatement in the Financial Statements**

A55. In circumstances when the auditor's opinion is qualified, consideration may be given as to whether the other information is also materially misstated for the same matter as, or a related matter to, the matter giving rise to the qualified opinion on the financial statements.

**Qualified Opinion Due to Limitation of Scope**

A56. When there is a limitation of scope with respect to a material item in the financial statements, the auditor will not have obtained sufficient appropriate audit evidence about that matter. In these circumstances, the auditor may be unable to conclude whether or not the amounts or other items in the other information related to this matter result in a material misstatement of the other information. Accordingly, the auditor may need to modify the statement required by paragraph 22(e) to refer to the auditor's inability to consider management's description of the matter in the other information in respect of which the auditor's opinion on the financial statements has been qualified as explained in the Basis for Qualified Opinion paragraph. The auditor is nevertheless required to report any other uncorrected material misstatements of the other information that have been identified.

**Adverse Opinion**

A57. An adverse opinion on the financial statements relating to a specific matter(s) described in the Basis for Adverse Opinion paragraph does not justify the omission of reporting of material misstatements of the other information that the

auditor has identified in the auditor's report in accordance with paragraph 22(e) (ii). When an adverse opinion has been expressed on the financial statements, the auditor may need to appropriately modify the statement required by paragraph 22(e) for example, to indicate that amounts or items in the other information is materially misstated for the same matter as, or a related matter to, the matter giving rise to the adverse opinion on the financial statements.

#### Disclaimer of Opinion

A58. When the auditor disclaims an opinion on the financial statements, providing further details about the audit, including a section to address other information may overshadow the disclaimer of opinion on the financial statements as a whole. Accordingly, in those circumstances, as required by ISA 705 (Revised), the auditor's report does not include a section addressing the reporting requirements under this ISA.

#### *Reporting Prescribed by Law or Regulation (Ref: Para. 24)*

A59. ISA 200<sup>16</sup> explains that the auditor may be required to comply with legal or regulatory requirements in addition to the ISA. Where this is the case, the auditor may be obliged to use a specific layout or wording in the auditor's report that differs from that described in this ISA. Consistency in the auditor's report, when the audit has been conducted in accordance with ISAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. When the differences between the legal or regulatory requirements to report with respect to the other information and this ISA relate only to the layout and wording in the auditor's report and, at a minimum, each of the elements identified in paragraph 24 is included in the auditor's report, the auditor's report may refer to International Standards on Auditing. Accordingly, in such circumstances the auditor is considered to have complied with the requirements of this ISA, even when the layout and wording used in the auditor's report are specified by legal or regulatory reporting requirements.

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<sup>16</sup> ISA 200, paragraph A57

## Appendix 1

(Ref: Para. 14, A8)

### Examples of Amounts or Other Items that May Be Included in the Other Information

The following are examples of amounts and other items that may be included in other information. This list is not intended to be exhaustive.

#### Amounts

- Items in a summary of key financial results, such as net income, earnings per share, dividends, sales and other operating revenues, and purchases and operating expenses.
- Selected operating data, such as income from continuing operations by major operating area, or sales by geographical segment or product line.
- Special items, such as asset dispositions, litigation provisions, asset impairments, tax adjustments, environmental remediation provisions, and restructuring and reorganization expenses.
- Liquidity and capital resource information, such as cash, cash equivalents and marketable securities; dividends; and debt, capital lease and minority interest obligations.
- Capital expenditures by segment or division.
- Amounts involved in, and related financial effects of, off-balance sheet arrangements.
- Amounts involved in guarantees, contractual obligations, legal or environmental claims, and other contingencies.
- Financial measures or ratios, such as gross margin, return on average capital employed, return on average shareholders' equity, current ratio, interest coverage ratio and debt ratio. Some of these may be directly reconcilable to the financial statements.

#### Other Items

- Explanations of critical accounting estimates and related assumptions.
- Identification of related parties and descriptions of transactions with them.
- Articulation of the entity's policies or approach to manage commodity, foreign exchange or interest rate risks, such as through the use of forward contracts, interest rate swaps, or other financial instruments.
- Descriptions of the nature of off-balance sheet arrangements.

- Descriptions of guarantees, indemnifications, contractual obligations, litigation or environmental liability cases, and other contingencies, including management's qualitative assessments of the entity's related exposures.
- Descriptions of changes in legal or regulatory requirements, such as new tax or environmental regulations, that have materially impacted the entity's operations or fiscal position, or will have a material impact on the entity's future financial prospects.
- Management's qualitative assessments of the impacts of new financial reporting standards that have come into effect during the period, or will come into effect in the following period, on the entity's financial results, financial position and cash flows.
- General descriptions of the business environment and outlook.
- Overview of strategy.
- Descriptions of trends in market prices of key commodities or raw materials.
- Contrasts of supply, demand and regulatory circumstances between geographic regions.
- Explanations of specific factors influencing the entity's profitability in specific segments.

**Appendix 2**

(Ref: Para. 21–22, A53)

**Illustrations of Independent Auditor's Reports Relating to Other Information**

- Illustration 1: An auditor's report of any entity, whether listed or other than listed, containing an unmodified opinion when the auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Illustration 2: An auditor's report of a listed entity containing an unmodified opinion when the auditor has obtained part of the other information prior to the date of the auditor's report, has not identified a material misstatement of the other information, and expects to obtain other information after the date of the auditor's report.
- Illustration 3: An auditor's report of an entity other than a listed entity containing an unmodified opinion when the auditor has obtained part of the other information prior to the date of the auditor's report, has not identified a material misstatement of the other information, and expects to obtain other information after the date of the auditor's report.
- Illustration 4: An auditor's report of a listed entity containing an unmodified opinion when the auditor has obtained no other information prior to the date of the auditor's report but expects to obtain other information after the date of the auditor's report.
- Illustration 5: An auditor's report of any entity, whether listed or other than listed, containing an unmodified opinion when the auditor has obtained all of the other information prior to the date of the auditor's report and has concluded that a material misstatement of the other information exists.
- Illustration 6: An auditor's report of any entity, whether listed or other than listed, containing a qualified opinion when the auditor has obtained all of the other information prior to the date of the auditor's report and there is a limitation of scope with respect to a material item in the consolidated financial statements which also affects the other information.
- Illustration 7: An auditor's report of any entity, whether listed or other than listed, containing an adverse opinion when the auditor has obtained all of the other information prior to the date of the auditor's report and the adverse opinion on the consolidated financial statements also affects the other information.

**Illustration 1 – An auditor’s report of any entity, whether listed or other than listed, containing an unmodified opinion when the auditor has obtained all of the other information prior to the date of the auditor’s report and has not identified a material misstatement of the other information.**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of any entity, whether listed or other than listed, using a fair presentation framework. The audit is not a group audit (i.e., ISA 600<sup>1</sup> does not apply).
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).<sup>2</sup>
- Key audit matters have been communicated in accordance with ISA 701.<sup>3</sup>
- The auditor has obtained all of the other information prior to the date of the auditor’s report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

<sup>1</sup> ISA 600, Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)

<sup>2</sup> ISA 570 (Revised), Going Concern

<sup>3</sup> ISA 701, Communicating Key Audit Matters in the Independent Auditor’s Report. The Key Audit Matters section is required for listed entities only.

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>4</sup>

#### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

#### [Key Audit Matters<sup>5</sup>

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

**Other Information [or another title if appropriate, such as "Information Other than the Financial Statements and Auditor's Report Thereon"]**

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<sup>4</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

<sup>5</sup> The Key Audit Matters section is required for listed entities only.

Management<sup>6</sup> is responsible for the other information. The other information comprises the [information included in the X report,<sup>7</sup> but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

### **Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>8</sup>**

*[Reporting in accordance with ISA 700 (Revised)<sup>9</sup> – see Illustration 1 in ISA 700 (Revised).]*

### **Auditor's Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

### **Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

[The engagement partner on the audit resulting in this independent auditor's report is [name].<sup>10</sup>]

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

<sup>6</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>7</sup> A more specific description of the other information, such as "the management report and chairman's statement," may be used to identify the other information.

<sup>8</sup> Throughout these illustrative auditor's reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

<sup>9</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

<sup>10</sup> The name of the engagement partner is included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat (see ISA 700 (Revised), paragraph 46).

**Illustration 2 – An auditor’s report of a listed entity containing an unmodified opinion when the auditor has obtained part of the other information prior to the date of the auditor’s report, has not identified a material misstatement of the other information, and expects to obtain other information after the date of the auditor’s report.**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- Key audit matters have been communicated in accordance with ISA 701.
- The auditor has obtained part of the other information prior to the date of the auditor’s report, has not identified a material misstatement of the other information, and expects to obtain other information after the date of the auditor’s report.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>11</sup>

#### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

#### Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

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<sup>11</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

**Other Information [for another title if appropriate, such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]**

Management<sup>12</sup> is responsible for the other information. The other information comprises the X report<sup>13</sup> (but does not include the financial statements and our auditor’s report thereon), which we obtained prior to the date of this auditor’s report, and the Y report, which is expected to be made available to us after that date.

Our opinion on the financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

If, based on the work we have performed on the other information that we obtained prior to the date of this auditor’s report, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

[When we read the Y report, if we conclude that there is a material misstatement therein, we are required to communicate the matter to those charged with governance and [*describe actions applicable in the jurisdiction.*]]<sup>14</sup>

**Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>15</sup>**

[*Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).*]

**Auditor’s Responsibilities for the Audit of the Financial Statements**

[*Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).*]

**Report on Other Legal and Regulatory Requirements**

[*Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).*]

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<sup>12</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>13</sup> A more specific description of the other information, such as “the management report and chair’s statement,” may be used to identify the other information.

<sup>14</sup> This additional paragraph may be useful when the auditor has identified an uncorrected material misstatement of the other information obtained after the date of the auditor’s report and has a legal obligation to take specific action in response.

<sup>15</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.

The engagement partner on the audit resulting in this independent auditor's report is [name].<sup>16</sup>

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>16</sup> The name of the engagement partner is included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat (see ISA 700 (Revised), paragraph 46).

**Illustration 3 – An auditor’s report of an entity other than a listed entity containing an unmodified opinion when the auditor has obtained part of the other information prior to the date of the auditor’s report, has not identified a material misstatement of the other information, and expects to obtain other information after the date of the auditor’s report.**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.
- The auditor has obtained part of the other information prior to the date of the auditor’s report, has not identified a material misstatement of the other information, and expects to obtain other information after the date of the auditor’s report.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- The auditor has no other reporting responsibilities required under law or regulation.

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### Other Information [or another title if appropriate, such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

Management<sup>17</sup> is responsible for the other information. The other information obtained at the date of this auditor's report is [information included in the X report,<sup>18</sup> but does not include the financial statements and our auditor's report thereon]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

If, based on the work we have performed on the other information obtained prior to the date of this auditor's report, we conclude that there is a material misstatement of

<sup>17</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>18</sup> A more specific description of the other information, such as "the management report and chair's statement," may be used to identify the other information.

this other information, we are required to report that fact. We have nothing to report in this regard.

**Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>19</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

**Auditor's Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>19</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

**Illustration 4 – An auditor’s report of a listed entity containing an unmodified opinion when the auditor has obtained no other information prior to the date of the auditor’s report but expects to obtain other information after the date of the auditor’s report.**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed entity using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- Key audit matters have been communicated in accordance with ISA 701.
- The auditor has obtained no other information prior to the date of the auditor’s report but expects to obtain other information after the date of the auditor’s report.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Report on the Audit of the Financial Statements<sup>20</sup>

#### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

#### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

#### Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

#### Other Information [or another title if appropriate, such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

Management<sup>21</sup> is responsible for the other information. The other information comprises the [information included in the X report,<sup>22</sup> but does not include the financial

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<sup>20</sup> The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

<sup>21</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>22</sup> A more specific description of the other information, such as "the management report and chair's statement," may be used to identify the other information.

statements and our auditor's report thereon]. The X report is expected to be made available to us after the date of this auditor's report.

Our opinion on the financial statements does not cover the other information and we will not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above when it becomes available and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

[When we read the X report, if we conclude that there is a material misstatement therein, we are required to communicate the matter to those charged with governance and *[describe actions applicable in the jurisdiction]*.]<sup>23</sup>

### **Responsibilities of Management and Those Charged with Governance for the Financial Statements**<sup>24</sup>

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

### **Auditor's Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

### **Report on Other Legal and Regulatory Requirements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

The engagement partner on the audit resulting in this independent auditor's report is *[name]*.

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

<sup>23</sup> This additional paragraph may be useful when the auditor has identified an uncorrected material misstatement of the other information obtained after the date of the auditor's report and has a legal obligation to take specific action in response.

<sup>24</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

**Illustration 5 – An auditor’s report of any entity, whether listed or other than listed, containing an unmodified opinion when the auditor has obtained all of the other information prior to the date of the auditor’s report and has concluded that a material misstatement of the other information exists.**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of any entity, whether listed or other than listed, using a fair presentation framework. The audit is not a group audit (i.e., ISA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- Key audit matters have been communicated in accordance with ISA 701.
- The auditor has obtained all of the other information prior to the date of the auditor’s report and has concluded that a material misstatement of the other information exists
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- The auditor has no other reporting responsibilities required under law or regulation.

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### Other Information [or another title if appropriate, such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

Management<sup>25</sup> is responsible for the other information. The other information comprises the [information included in the X report,<sup>26</sup> but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. As described below, we have concluded that such a material misstatement of the other information exists.

<sup>25</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>26</sup> A more specific description of the other information, such as "the management report and chairman's statement," may be used to identify the other information.

*[Description of material misstatement of the other information]*

**[Key Audit Matters]<sup>27</sup>**

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

*[Description of each key audit matter in accordance with ISA 701.]*

**Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>28</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

**Auditor's Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 1 in ISA 700 (Revised).]*

[The engagement partner on the audit resulting in this independent auditor's report is *[name]*.<sup>29</sup>]

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

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<sup>27</sup> The Key Audit Matters section is required for listed entities only.

<sup>28</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>29</sup> The name of the engagement partner is included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat (see ISA 700 (Revised), paragraph 46).

**Illustration 6 – An auditor’s report of any entity, whether listed or other than listed, containing a qualified opinion when the auditor has obtained all of the other information prior to the date of the auditor’s report and there is a limitation of scope with respect to a material item in the consolidated financial statements which also affects the other information.**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- **Audit of a complete set of consolidated financial statements of any entity, whether listed or other than listed, using a fair presentation framework. The audit is a group audit (i.e., ISA 600 applies).**
- **The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management’s responsibility for the consolidated financial statements in ISA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the consolidated financial statements (i.e., a qualified opinion is appropriate).**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **Key audit matters have been communicated in accordance with ISA 701.**
- **The auditor has obtained all of the other information prior to the date of the auditor’s report and the matter giving rise to the qualified opinion on the consolidated financial statements also affects the other information.**
- **Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.**
- **The auditor has no other reporting responsibilities required under law or regulation.**

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Qualified Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying consolidated financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Group as at December 31, 20X1, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

### Basis for Qualified Opinion

The Group's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the consolidated statement of financial position as at December 31, 20X1, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

### Other Information [or another title if appropriate, such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

Management<sup>30</sup> is responsible for the other information. The other information comprises the [information included in the X report,<sup>31</sup> but does not include the consolidated financial statements and our auditor's report thereon.]

<sup>30</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>31</sup> A more specific description of the other information, such as "the management report and chairman's statement," may be used to identify the other information.

Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. As described in the *Basis for Qualified Opinion* section above, we were unable to obtain sufficient appropriate evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of XYZ's net income for the year. Accordingly, we are unable to conclude whether or not the other information is materially misstated with respect to this matter.

### **[Key Audit Matters]<sup>32</sup>**

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section we have determined the matters described below to be the key audit matters to be communicated in our report.

*[Description of each key audit matter in accordance with ISA 701.]*

### **Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>33</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised).]*

### **Auditor's Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised).]*

[The engagement partner on the audit resulting in this independent auditor's report is *[name]*.<sup>34</sup>]

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

<sup>32</sup> The Key Audit Matters section is required for listed entities only.

<sup>33</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>34</sup> The name of the engagement partner is included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat (see ISA 700 (Revised), paragraph 46).

**Illustration 7 – An auditor’s report of any entity, whether listed or other than listed, containing an adverse opinion when the auditor has obtained all of the other information prior to the date of the auditor’s report and the adverse opinion on the consolidated financial statements also affects the other information.**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of any entity, whether listed or other than listed, using a fair presentation framework. The audit is a group audit (i.e., ISA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management’s responsibility for the consolidated financial statements in ISA 210.
- The consolidated financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements have not been determined because it was not practicable to do so (i.e., an adverse opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- Key audit matters have been communicated in accordance with ISA 701.
- The auditor has obtained all of the other information prior to the date of the auditor’s report and the matter giving rise to the adverse opinion on the consolidated financial statements also affects the other information.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- The auditor has no other reporting responsibilities required under law or regulation.

## INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

### Adverse Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the *Basis for Adverse Opinion* section of our report, the accompanying consolidated financial statements do not present fairly (or *do not give a true and fair view of*) the consolidated financial position of the Group as at December 31, 20X1, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

### Basis for Adverse Opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRSs, the Group should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

### Other Information [or another title if appropriate, such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

Management<sup>35</sup> is responsible for the other information. The other information comprises the [information included in the X report,<sup>36</sup> but does not include the consolidated financial statements and our auditor's report thereon.]

<sup>35</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>36</sup> A more specific description of the other information, such as "the management report and chairman's statement," may be used to identify the other information.

Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. As described in the *Basis for Adverse Opinion* section above, the Group should have consolidated XYZ Company and accounted for the acquisition based on provisional amounts. We have concluded that the other information is materially misstated for the same reason with respect to the amounts or other items in the X report affected by the failure to consolidate XYZ Company.

**[Key Audit Matters]<sup>37</sup>**

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Adverse Opinion* section we have determined the matters described below to be the key audit matters to be communicated in our report.

*[Description of each key audit matter in accordance with ISA 701.]*

**Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>38</sup>**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised).]*

**Auditor's Responsibilities for the Audit of the Financial Statements**

*[Reporting in accordance with ISA 700 (Revised) – see Illustration 2 in ISA 700 (Revised).]*

*[The engagement partner on the audit resulting in this independent auditor's report is [name].<sup>39</sup>]*

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address]*

*[Date]*

<sup>37</sup> The Key Audit Matters section is required for listed entities only.

<sup>38</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

<sup>39</sup> The name of the engagement partner is included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat (see ISA 700 (Revised), paragraph 46).

**INTERNATIONAL STANDARD ON AUDITING 800  
(REVISED)  
SPECIAL CONSIDERATIONS—AUDITS OF FINANCIAL  
STATEMENTS PREPARED IN ACCORDANCE WITH  
SPECIAL PURPOSE FRAMEWORKS**

(Effective for audits of financial statements for periods  
ending on or after December 15, 2016)

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Appendix: Illustrations of Independent Auditor’s Reports on Special Purpose Financial Statements	

International Standard on Auditing (ISA) 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

ISA

## Introduction

### Scope of this ISA

1. The International Standards on Auditing (ISAs) in the 100–700 series apply to an audit of financial statements. This ISA deals with special considerations in the application of those ISAs to an audit of financial statements prepared in accordance with a special purpose framework.
2. This ISA is written in the context of a complete set of financial statements prepared in accordance with a special purpose framework. ISA 805 (Revised)<sup>1</sup> deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement.
3. This ISA does not override the requirements of the other ISAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

### Effective Date

4. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2016.

## Objective

5. The objective of the auditor, when applying ISAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:
  - (a) The acceptance of the engagement;
  - (b) The planning and performance of that engagement; and
  - (c) Forming an opinion and reporting on the financial statements.

## Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Special purpose financial statements – Financial statements prepared in accordance with a special purpose framework. (Ref: Para. A4)
  - (b) Special purpose framework – A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.<sup>2</sup> (Ref: Para. A1–A4)

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<sup>1</sup> ISA 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*

<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(a)

7. Reference to “financial statements” in this ISA means “a complete set of special purpose financial statements. The requirements of the applicable financial reporting framework determine the presentation structure, and content of the financial statements, and what constitutes a complete set of financial statements. Reference to “special purpose financial statements” includes the related disclosures.

## Requirements

### Considerations When Accepting the Engagement

#### *Acceptability of the Financial Reporting Framework*

8. ISA 210 requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements.<sup>3</sup> In an audit of special purpose financial statements, the auditor shall obtain an understanding of: (Ref: Para. A5–A8)
  - (a) The purpose for which the financial statements are prepared;
  - (b) The intended users; and
  - (c) The steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances.

### Considerations When Planning and Performing the Audit

9. ISA 200 requires the auditor to comply with all ISAs relevant to the audit.<sup>4</sup> In planning and performing an audit of special purpose financial statements, the auditor shall determine whether application of the ISAs requires special consideration in the circumstances of the engagement. (Ref: Para. A9–A12)
10. ISA 315 (Revised) requires the auditor to obtain an understanding of the entity’s selection and application of accounting policies.<sup>5</sup> In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements. An interpretation is significant when adoption of another reasonable interpretation would have produced a material difference in the information presented in the financial statements.

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<sup>3</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

<sup>4</sup> ISA 200, paragraph 18

<sup>5</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 11(c)

## Forming an Opinion and Reporting Considerations

11. When forming an opinion and reporting on special purpose financial statements, the auditor shall apply the requirements in ISA 700 (Revised).<sup>6</sup> (Ref: Para. A13–A19)

### *Description of the Applicable Financial Reporting Framework*

12. ISA 700 (Revised) requires the auditor to evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.<sup>7</sup> In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.
13. ISA 700 (Revised) deals with the form and content of the auditor's report, including the specific ordering for certain elements. In the case of an auditor's report on special purpose financial statements:
- (a) The auditor's report shall also describe the purpose for which the financial statements are prepared and, if necessary, the intended users, or refer to a note in the special purpose financial statements that contains that information; and
  - (b) If management has a choice of financial reporting frameworks in the preparation of such financial statements, the explanation of management's<sup>8</sup> responsibility for the financial statements shall also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

### *Alerting Readers that the Financial Statements Are Prepared in Accordance with a Special Purpose Framework*

14. The auditor's report on special purpose financial statements shall include an Emphasis of Matter paragraph alerting users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework and that, as a result, the financial statements may not be suitable for another purpose. (Ref: Para. A20–A21)

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<sup>6</sup> ISA 700\_(Revised), *Forming an Opinion and Reporting on Financial Statements*

<sup>7</sup> ISA 700 (Revised), paragraph 15

<sup>8</sup> Or other term that is appropriate in the context of the legal framework in the particular jurisdiction

## Application and Other Explanatory Material

### Definition of Special Purpose Framework (Ref: Para. 6)

- A1. Examples of special purpose frameworks are:
- A tax basis of accounting for a set of financial statements that accompany an entity's tax return;
  - The cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested to prepare for creditors;
  - The financial reporting provisions established by a regulator to meet the requirements of that regulator; or
  - The financial reporting provisions of a contract, such as a bond indenture, a loan agreement, or a project grant.
- A2. There may be circumstances where a special purpose framework is based on a financial reporting framework established by an authorized or recognized standards setting organization or by law or regulation, but does not comply with all the requirements of that framework. An example is a contract that requires financial statements to be prepared in accordance with most, but not all, of the Financial Reporting Standards of Jurisdiction X. When this is acceptable in the circumstances of the engagement, it is inappropriate for the description of the applicable financial reporting framework in the special purpose financial statements to imply full compliance with the financial reporting framework established by the authorized or recognized standards setting organization or by law or regulation. In the above example of the contract, the description of the applicable financial reporting framework may refer to the financial reporting provisions of the contract, rather than make any reference to the Financial Reporting Standards of Jurisdiction X.
- A3. In the circumstances described in paragraph A2, the special purpose framework may not be a fair presentation framework even if the financial reporting framework on which it is based is a fair presentation framework. This is because the special purpose framework may not comply with all the requirements of the financial reporting framework established by the authorized or recognized standards setting organization or by law or regulation that are necessary to achieve fair presentation of the financial statements.
- A4. Financial statements prepared in accordance with a special purpose framework may be the only financial statements an entity prepares. In such circumstances, those financial statements may be used by users other than those for whom the financial reporting framework is designed. Despite the broad distribution of the financial statements in those circumstances, the financial statements are still considered to be special purpose financial statements for purposes of the ISAs. The requirements in paragraphs 13–14 are designed to avoid misunderstandings about the purpose for which the financial statements are prepared. Disclosures

comprise explanatory or descriptive information, set out as required, expressly permitted or otherwise allowed by the applicable financial reporting framework, on the face of financial statements, or in the notes, or incorporated therein by cross-reference.<sup>9</sup>

## Considerations When Accepting the Engagement

### *Acceptability of the Financial Reporting Framework* (Ref: Para. 8)

- A5. In the case of special purpose financial statements, the financial information needs of the intended users are a key factor in determining the acceptability of the financial reporting framework applied in the preparation of the financial statements.
- A6. The applicable financial reporting framework may encompass the financial reporting standards established by an organization that is authorized or recognized to promulgate standards for special purpose financial statements. In that case, those standards will be presumed acceptable for that purpose if the organization follows an established and transparent process involving deliberation and consideration of the views of relevant stakeholders. In some jurisdictions, law or regulation may prescribe the financial reporting framework to be used by management in the preparation of special purpose financial statements for a certain type of entity. For example, a regulator may establish financial reporting provisions to meet the requirements of that regulator. In the absence of indications to the contrary, such a financial reporting framework is presumed acceptable for special purpose financial statements prepared by such entity.
- A7. Where the financial reporting standards referred to in paragraph A6 are supplemented by legislative or regulatory requirements, ISA 210 requires the auditor to determine whether any conflicts between the financial reporting standards and the additional requirements exist, and prescribes actions to be taken by the auditor if such conflicts exist.<sup>10</sup>
- A8. The applicable financial reporting framework may encompass the financial reporting provisions of a contract, or sources other than those described in paragraphs A6 and A7. In that case, the acceptability of the financial reporting framework in the circumstances of the engagement is determined by considering whether the framework exhibits attributes normally exhibited by acceptable financial reporting frameworks as described in Appendix 2 of ISA 210. In the case of a special purpose framework, the relative importance to a particular engagement of each of the attributes normally exhibited by acceptable financial reporting frameworks is a matter of professional judgment. For example, for purposes of establishing the value of net assets of an entity at the date of its sale, the vendor and the purchaser may have agreed that very prudent estimates

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<sup>9</sup> ISA 200, paragraph 13(f)

<sup>10</sup> ISA 210, paragraph 18

of allowances for uncollectible accounts receivable are appropriate for their needs, even though such financial information is not neutral when compared with financial information prepared in accordance with a general purpose framework.

### Considerations When Planning and Performing the Audit (Ref: Para. 9)

- A9. ISA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements, and (b) all ISAs relevant to the audit. It also requires the auditor to comply with each requirement of an ISA unless, in the circumstances of the audit, the entire ISA is not relevant or the requirement is not relevant because it is conditional and the condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an ISA by performing alternative audit procedures to achieve the aim of that requirement.<sup>11</sup>
- A10. Application of some of the requirements of the ISAs in an audit of special purpose financial statements may require special consideration by the auditor. For example, in ISA 320, judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.<sup>12</sup> In the case of an audit of special purpose financial statements, however, those judgments are based on a consideration of the financial information needs of the intended users.
- A11. In the case of special purpose financial statements, such as those prepared in accordance with the requirements of a contract, management may agree with the intended users on a threshold below which misstatements identified during the audit will not be corrected or otherwise adjusted. The existence of such a threshold does not relieve the auditor from the requirement to determine materiality in accordance with ISA 320 for purposes of planning and performing the audit of the special purpose financial statements.
- A12. ISA 260 (Revised) requires the auditor to determine the appropriate person(s) within the entity's governance structure with whom to communicate.<sup>13</sup> ISA 260 (Revised) notes that, in some cases, all of those charged governance are involved in managing the entity, and the application of the communication requirements is modified to recognize this position.<sup>14</sup> When a complete set of general purpose financial statements is also prepared by the entity, those person(s) responsible for the oversight of the preparation of the special purpose financial statements may not be the same as those charged with governance responsible for the oversight of the preparation of those general purpose financial statements.

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<sup>11</sup> ISA 200, paragraphs 14, 18, and 22–23

<sup>12</sup> ISA 320, *Materiality in Planning and Performing an Audit*, paragraph 2

<sup>13</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

<sup>14</sup> ISA 260 (Revised), paragraph A8

## Forming an Opinion and Reporting Considerations (Ref: Para. 11)

A13. The Appendix to this ISA contains illustrations of independent auditor's reports on special purpose financial statements. Other illustrations of auditor's reports may be relevant to reporting on special purpose financial statements (see for example, the Appendices to ISA 700 (Revised), ISA 705 (Revised),<sup>15</sup> ISA 570 (Revised),<sup>16</sup> ISA 720 (Revised),<sup>17</sup> and ISA 706 (Revised)).<sup>18</sup>

### *Application of ISA 700 (Revised) When Reporting on Special Purpose Financial Statements*

A14. Paragraph 11 of this ISA explains that the auditor is required to apply ISA 700 (Revised) when forming an opinion and reporting on special purpose financial statements. In doing so, the auditor is also required to apply the reporting requirements in other ISAs and may find the special considerations addressed in paragraphs A15–A19 below helpful.

### Going Concern

A15. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis of accounting is relevant (e.g., the going concern basis of accounting is not relevant for some financial statements prepared on a tax basis in particular jurisdictions).<sup>19</sup> Depending on the applicable financial reporting framework used in the preparation of the special purpose financial statements, the description in the auditor's report of management's responsibilities<sup>20</sup> relating to going concern may need to be adapted as necessary. The description in the auditor's report of the auditor's responsibilities<sup>21</sup> may also need to be adapted as necessary depending on how ISA 570 (Revised) applies in the circumstances of the engagement.

### Key Audit Matters

A16. ISA 700 (Revised) requires the auditor to communicate key audit matters in accordance with ISA 701<sup>22</sup> for audits of complete sets of general purpose financial statements of listed entities. For audits of special purpose financial statements, ISA 701 only applies when communication of key audit matters in the auditor's report on the special purpose financial statements is required by law or regulation or the auditor otherwise decides to communicate key audit

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<sup>15</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

<sup>16</sup> ISA 570 (Revised), *Going Concern*

<sup>17</sup> ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

<sup>18</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

<sup>19</sup> ISA 570 (Revised), paragraph 2

<sup>20</sup> See ISA 700 (Revised), paragraphs 34(b) and A48.

<sup>21</sup> See ISA 700 (Revised), paragraph 39(b)(iv).

<sup>22</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

matters. When key audit matters are communicated in the auditor’s report on special purpose financial statements, ISA 701 applies in its entirety.<sup>23</sup>

#### Other Information

A17. ISA 720 (Revised) deals with the auditor’s responsibilities relating to other information. In the context of this ISA, reports containing or accompanying the special purpose financial statements—the purpose of which is to provide owners (or similar stakeholders) with information on matters presented in the special purpose financial statements—are considered to be annual reports for the purpose of ISA 720 (Revised). In the case of financial statements prepared using a special purpose framework, the term “similar stakeholders” includes the specific users whose financial information needs are met by the design of the special purpose framework used to prepare the special purpose financial statements. When the auditor determines that the entity plans to issue such a report, the requirements in ISA 720 (Revised) apply to the audit of the special purpose financial statements.

#### Name of the Engagement Partner

A18. The requirement in ISA 700 (Revised) for the auditor to include the name of the engagement partner in the auditor’s report also applies to audits of special purpose financial statements of listed entities.<sup>24</sup> The auditor may be required by law or regulation to include the name of the engagement partner in the auditor’s report or may otherwise decide to do so when reporting on special purpose financial statements of entities other than listed entities.

#### *Inclusion of a Reference to the Auditor’s Report on the Complete Set of General Purpose Financial Statements*

A19. The auditor may deem it appropriate to refer, in an Other Matter paragraph in the auditor’s report on the special purpose financial statements, to the auditor’s report on the complete set of general purpose financial statements or to matter(s) reported therein (see ISA 706 (Revised)).<sup>25</sup> For example, the auditor may consider it appropriate to refer in the auditor’s report on the special purpose financial statements to a Material Uncertainty Related to Going Concern section included in the auditor’s report on the complete set of general purpose financial statements.

#### *Alerting Readers that the Financial Statements Are Prepared in Accordance with a Special Purpose Framework (Ref: Para. 14)*

A20. The special purpose financial statements may be used for purposes other than those for which they were intended. For example, a regulator may require certain entities to place the special purpose financial statements on public record.

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<sup>23</sup> ISA 700 (Revised), paragraph 31

<sup>24</sup> See ISA 700 (Revised), paragraphs 45 and A56–A58

<sup>25</sup> See ISA 706 (Revised), paragraphs 10–11.

To avoid misunderstandings, the auditor alerts users of the auditor’s report by including an Emphasis of Matter paragraph explaining that the financial statements are prepared in accordance with a special purpose framework and, therefore, may not be suitable for another purpose. ISA 706 (Revised) requires this paragraph to be included within a separate section of the auditor’s report with an appropriate heading that includes the term “Emphasis of Matter”.<sup>26</sup>

*Restriction on Distribution or Use* (Ref: Para. 14)

A21. In addition to the alert required by paragraph 14, the auditor may consider it appropriate to indicate that the auditor’s report is intended solely for the specific users. Depending on the law or regulation of the particular jurisdiction, this may be achieved by restricting the distribution or use of the auditor’s report. In these circumstances, the paragraph referred to in paragraph 14 may be expanded to include these other matters, and the heading modified accordingly (see illustrations in the Appendix to this ISA).

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<sup>26</sup> See paragraph 9(a) of ISA 706 (Revised)

## Appendix

(Ref: Para. A14)

### **Illustrations of Independent Auditor’s Reports on Special Purpose Financial Statements**

- Illustration 1: An auditor’s report on a complete set of financial statements of an entity other than a listed entity prepared in accordance with the financial reporting provisions of a contract (for purposes of this illustration, a compliance framework).
- Illustration 2: An auditor’s report on a complete set of financial statements of an entity other than a listed entity prepared in accordance with the tax basis of accounting in Jurisdiction X (for purposes of this illustration, a compliance framework).
- Illustration 3: An auditor’s report on a complete set of financial statements of a listed entity prepared in accordance with the financial reporting provisions established by a regulator (for purposes of this illustration, a fair presentation framework).

**Illustration 1: An auditor’s report on a complete set of financial statements of an entity other than a listed entity prepared in accordance with the financial reporting provisions of a contract (for purposes of this illustration, a compliance framework).**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- The financial statements have been prepared by management of the entity in accordance with the financial reporting provisions of a contract (that is, a special purpose framework). Management does not have a choice of financial reporting frameworks.
- The applicable financial reporting framework is a compliance framework.
- An auditor’s report on the complete set of general purpose financial statements was not issued.
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- Distribution and use of the auditor’s report are restricted.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.
- The auditor has determined that there is no other information (i.e., the requirements of ISA 720 (Revised) do not apply).
- Those responsible for oversight of the financial reporting process differ from those responsible for the preparation of the financial statements.
- The auditor has no other reporting responsibilities required under local law or regulation.

## INDEPENDENT AUDITOR’S REPORT

[Appropriate Addressee]

### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements of the Company for the year ended December 31, 20X1 are prepared in all material respects, in accordance with the financial reporting provisions of Section Z of the contract dated January 1, 20X1 between the Company and DEF Company (“the contract”).

### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### Emphasis of Matter – Basis of Accounting and Restriction on Distribution and Use

We draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the Company in complying with the financial reporting provisions of the contract referred to above. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for the Company and DEF Company and should not be distributed to or used by parties other than the Company or DEF Company. Our opinion is not modified in respect of this matter.

### Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>1</sup>

Management is responsible for the preparation of the financial statements in accordance with the financial reporting provisions of Section Z of the contract and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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<sup>1</sup> Throughout these illustrative auditor’s reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of ISA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of ISA 700 (Revised) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.<sup>2</sup>
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

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<sup>2</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

- Conclude on the appropriateness of management’s use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company’s ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor’s report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor’s report. However, future events or conditions may cause the Company to cease to continue as a going concern.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

*Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

[Auditor address] [Placement of date and address reversed)]

[Date]

**Illustration 2: An auditor’s report on a complete set of financial statements of an entity other than a listed entity prepared in accordance with the tax basis of accounting in Jurisdiction X (for purposes of this illustration, a compliance framework).**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- **Audit of a complete set of financial statements that have been prepared by management of a partnership in accordance with the tax basis of accounting in Jurisdiction X (that is, a special purpose framework) to assist the partners in preparing their individual income tax returns. Management does not have a choice of financial reporting frameworks.**
- **The applicable financial reporting framework is a compliance framework.**
- **The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.**
- **The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.**
- **The relevant ethical requirements that apply to the audit are those of the jurisdiction.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).**
- **Distribution of the auditor’s report is restricted.**
- **The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.**
- **The auditor has determined that there is no other information (i.e., the requirements of ISA 720 (Revised) do not apply).**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **The auditor has no other reporting responsibilities required under local law or regulation.**

## INDEPENDENT AUDITOR’S REPORT

[Appropriate Addressee]

### Opinion

We have audited the financial statements of ABC Partnership (the Partnership), which comprise the balance sheet as at December 31, 20X1 and the income statement for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements of the Partnership for the year ended December 31, 20X1 are prepared, in all material respects, in accordance with [*describe the applicable income tax law*] of Jurisdiction X.

### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Partnership in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### Emphasis of Matter – Basis of Accounting and Restriction on Distribution

We draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the partners of the Partnership in preparing their individual income tax returns. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for the Partnership and its partners and should not be distributed to parties other than the Partnership or its partners. Our opinion is not modified in respect of this matter.

### Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>3</sup>

Management is responsible for the preparation of the financial statements in accordance with the tax basis of accounting in Jurisdiction X and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company’s ability to continue as a going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting unless man-

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<sup>3</sup> Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

agement either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Partnership's financial reporting process.

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of ISA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of ISA 700 (Revised) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Partnership's internal control.<sup>4</sup>
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw

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<sup>4</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

attention in our auditor’s report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor’s report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor address]* [Placement of date and address reversed])

*[Date]*

Illustration 3: An auditor’s report on a complete set of financial statements of a listed entity prepared in accordance with the financial reporting provisions established by a regulator (for purposes of this illustration, a fair presentation framework).

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed entity that have been prepared by management of the entity in accordance with the financial reporting provisions established by a regulator (that is, a special purpose framework) to meet the requirements of that regulator. Management does not have a choice of financial reporting frameworks.
- The applicable financial reporting framework is a fair presentation framework.
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised). The disclosure of the material uncertainty in the financial statements is adequate.
- Distribution or use of the auditor’s report is not restricted.
- The auditor is required by the regulator to communicate key audit matters in accordance with ISA 701.
- The Other Matter paragraph refers to the fact that the auditor has also issued an auditor’s report on financial statements prepared by ABC Company for the same period in accordance with a general purpose framework.
- The auditor has determined that there is no other information (i.e., the requirements of ISA 720 (Revised) do not apply).
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- The auditor has no other reporting responsibilities required under local law or regulation.

## INDEPENDENT AUDITOR'S REPORT

[To the Shareholders of ABC Company or Appropriate Addressee]

### Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with the financial reporting provisions of Section Y of Regulation Z.

### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### Emphasis of Matter – Basis of Accounting

We draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the Company to meet the requirements of Regulator DEF. As a result, the financial statements may not be suitable for another purpose. Our opinion is not modified in respect of this matter.

### Material Uncertainty Related to Going Concern

We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

### Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters

were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the Material Uncertainty Related to Going Concern section above, we have determined the matters described below to be key audit matters to be communicated in our report.

*[Description of each key audit matter in accordance with ISA 701 as applied to this audit.]*

### **Other Matter**

The Company has prepared a separate set of financial statements for the year ended December 31, 20X1 in accordance with International Financial Reporting Standards on which we issued a separate auditor's report to the shareholders of the Company dated March 31, 20X2.

### **Responsibilities of Management and Those Charged with Governance for the Financial Statements<sup>5</sup>**

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the financial reporting provisions of Section Y of Regulation Z<sup>6</sup> and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material

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<sup>5</sup> Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

<sup>6</sup> Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of a financial statements that give a true and fair view in accordance with the financial reporting provisions of section Y of Regulation Z and for such ..."

if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of ISA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of ISA 700 (Revised) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company internal control.<sup>7</sup>
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

<sup>7</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, actions taken to eliminate threats or safeguards applied.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The engagement partner on the audit resulting in this independent auditor's report is [name].

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor address]* [Placement of date and address reversed]

*[Date]*

**INTERNATIONAL STANDARD ON AUDITING  
805 (REVISED)  
SPECIAL CONSIDERATIONS—AUDITS OF SINGLE  
FINANCIAL STATEMENTS AND SPECIFIC ELEMENTS,  
ACCOUNTS OR ITEMS OF A FINANCIAL STATEMENT**

(Effective for audits for periods  
ending on or after December 15, 2016)

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International Standard on Auditing (ISA) 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.



## Introduction

### Scope of this ISA

1. The International Standards on Auditing (ISAs) in the 100–700 series apply to an audit of financial statements and are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. This ISA deals with special considerations in the application of those ISAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, ISA 800 (Revised)<sup>1</sup> also applies to the audit. (Ref: Para. A1–A4)
2. This ISA does not apply to the report of a component auditor, issued as a result of work performed on the financial information of a component at the request of a group engagement team for purposes of an audit of group financial statements (see ISA 600).<sup>2</sup>
3. This ISA does not override the requirements of the other ISAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

### Effective Date

4. This ISA is effective for audits of single financial statements or of specific elements, accounts or items for periods ending on or after December 15, 2016. In the case of audits of single financial statements or of specific elements, accounts or items of a financial statement as at a specific date, this ISA is effective for audits of such information as at a date on or after December 15, 2016.

## Objective

5. The objective of the auditor, when applying ISAs in an audit of a single financial statement or of a specific element, account or item of a financial statement, is to address appropriately the special considerations that are relevant to:
  - (a) The acceptance of the engagement;
  - (b) The planning and performance of that engagement; and
  - (c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement.

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<sup>1</sup> ISA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*

<sup>2</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

## Definitions

6. For purposes of this ISA, reference to:
- (a) “Element of a financial statement” or “element” means an “element, account or item of a financial statement;”
  - (b) “International Financial Reporting Standards” means the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board; and
  - (c) A single financial statement or to a specific element of a financial statement includes the related disclosures. The related disclosures ordinarily comprise explanatory or other descriptive information relevant to the financial statement or to the element. (Ref: Para. A2)

## Requirements

### Considerations When Accepting the Engagement

#### *Application of ISAs*

7. ISA 200 requires the auditor to comply with all ISAs relevant to the audit.<sup>3</sup> In the case of an audit of a single financial statement or of a specific element of a financial statement, this requirement applies irrespective of whether the auditor is also engaged to audit the entity’s complete set of financial statements. If the auditor is not also engaged to audit the entity’s complete set of financial statements, the auditor shall determine whether the audit of a single financial statement or of a specific element of those financial statements in accordance with ISAs is practicable. (Ref: Para. A5–A6)

#### *Acceptability of the Financial Reporting Framework*

8. ISA 210 requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements.<sup>4</sup> In the case of an audit of a single financial statement or of a specific element of a financial statement, this shall include whether application of the financial reporting framework will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element, and the effect of material transactions and events on the information conveyed in the financial statement or the element. (Ref: Para. A7)

<sup>3</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 18

<sup>4</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

### *Form of Opinion*

9. ISA 210 requires that the agreed terms of the audit engagement include the expected form of any reports to be issued by the auditor.<sup>5</sup> In the case of an audit of a single financial statement or of a specific element of a financial statement, the auditor shall consider whether the expected form of opinion is appropriate in the circumstances. (Ref: Para. A8–A9)

### **Considerations When Planning and Performing the Audit**

10. ISA 200 states that ISAs are written in the context of an audit of financial statements; they are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.<sup>6,7</sup> In planning and performing the audit of a single financial statement or of a specific element of a financial statement, the auditor shall adapt all ISAs relevant to the audit as necessary in the circumstances of the engagement. (Ref: Para. A10–A15)

### **Forming an Opinion and Reporting Considerations**

11. When forming an opinion and reporting on a single financial statement or on a specific element of a financial statement, the auditor shall apply the requirements in ISA 700 (Revised),<sup>8</sup> and, when applicable, ISA 800 (Revised) adapted as necessary in the circumstances of the engagement. (Ref: Para. A16–A22)

### *Reporting on the Entity's Complete Set of Financial Statements and on a Single Financial Statement or on a Specific Element of Those Financial Statements*

12. If the auditor undertakes an engagement to report on a single financial statement or on a specific element of a financial statement in conjunction with an engagement to audit the entity's complete set of financial statements, the auditor shall express a separate opinion for each engagement.
13. The audited single financial statement or the audited specific element of a financial statement may be published together with the entity's audited complete set of financial statements. If the auditor concludes that the presentation of the single financial statement or of the specific element of a financial statement does not differentiate it sufficiently from the complete set of financial statements, the auditor shall ask management to rectify the situation. Subject to paragraphs 15 and 16, the auditor shall also differentiate the opinion on the single financial statement or on the specific element of a financial statement from the opinion on the complete set of financial statements. The auditor shall not issue the auditor's

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<sup>5</sup> ISA 210, paragraph 10(e)

<sup>6</sup> ISA 200, paragraph 2

<sup>7</sup> ISA 200, paragraph 13(f), explains that the term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework.

<sup>8</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

report containing the opinion on the single financial statement or on the specific element of a financial statement until satisfied with the differentiation.

Considering the Implications of Certain Matters Included in the Auditor's Report on the Entity's Complete Set of Financial Statements for the Audit of the Single Financial Statement or the Specific Element of a Financial Statement and for the Auditor's Report Thereon.

14. If the auditor's report on an entity's complete set of financial statements includes:
- (a) A modified opinion in accordance with ISA 705 (Revised);<sup>9</sup>
  - (b) An Emphasis of Matter paragraph or an Other Matter paragraph in accordance with ISA 706 (Revised);<sup>10</sup>
  - (c) A Material Uncertainty Related to Going Concern section in accordance with ISA 570 (Revised);<sup>11</sup>
  - (d) Communication of key audit matters in accordance with ISA 701;<sup>12</sup> or
  - (e) A statement that describes an uncorrected material misstatement of the other information in accordance with ISA 720 (Revised);<sup>13</sup>

the auditor shall consider the implications, if any, that these matters have for the audit of the single financial statement or of the specific element of a financial statement and for the auditor's report thereon. (Ref: Para. A23–A27)

#### Adverse Opinion or Disclaimer of Opinion in the Auditor's Report on the Entity's Complete Set of Financial Statements

15. If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole, ISA 705 (Revised) does not permit the auditor to include in the same auditor's report an unmodified opinion on a single financial statement that forms part of those financial statements or on a specific element of those financial statements.<sup>14</sup> This is because such an unmodified opinion would contradict the adverse opinion or disclaimer of opinion on the entity's complete set of financial statements as a whole. (Ref: Para. A28)
16. If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole but, in the context of a separate audit of a specific element of those

<sup>9</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

<sup>10</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

<sup>11</sup> ISA 570 (Revised), *Going Concern*, paragraph 22

<sup>12</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraph 13

<sup>13</sup> ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, paragraph 22(e)(ii)

<sup>14</sup> ISA 705 (Revised), paragraph 15

financial statements, the auditor nevertheless considers it appropriate to express an unmodified opinion on that element, the auditor shall only do so if:

- (a) The auditor is not prohibited by law or regulation from doing so;
  - (b) That opinion is expressed in an auditor’s report that is not published together with the auditor’s report containing the adverse opinion or disclaimer of opinion; and
  - (c) The element does not constitute a major portion of the entity’s complete set of financial statements.
17. The auditor shall not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole. This is the case even if the auditor’s report on the single financial statement is not published together with the auditor’s report containing the adverse opinion or disclaimer of opinion. This is because a single financial statement is deemed to constitute a major portion of those financial statements.

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## Application and Other Explanatory Material

### Scope of this ISA (Ref: Para. 1, 6(c))

- A1. ISA 200 defines the term “historical financial information” as information expressed in financial terms in relation to a particular entity, derived primarily from that entity’s accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.<sup>15</sup>
- A2. ISA 200 defines the term “financial statements” as a structured representation of historical financial information, including disclosures, intended to communicate an entity’s economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The term “financial statements” ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement. Disclosures comprise explanatory or descriptive information, set out as required, expressly permitted or otherwise allowed by the applicable financial reporting framework, on the face of a financial statement, or in the notes, or incorporated therein by cross-reference.<sup>16</sup> As noted in paragraph 6(c), reference to a single financial statement or specific element of a financial statement includes the related disclosures.

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<sup>15</sup> ISA 200, paragraph 13(g)

<sup>16</sup> ISA 200, paragraph 13(f)

- A3. ISAs are written in the context of an audit of financial statements;<sup>17</sup> they are to be adapted as necessary in the circumstances when applied to an audit of other historical financial information, such as a single financial statement or a specific element of a financial statement. This ISA assists in this regard. (Appendix 1 lists examples of such other historical financial information.)
- A4. A reasonable assurance engagement other than an audit of historical financial information is performed in accordance with International Standard on Assurance Engagements (ISAE) 3000 (Revised).<sup>18</sup>

### Considerations When Accepting the Engagement

#### *Application of ISAs* (Ref: Para. 7)

- A5. ISA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements, and (b) all ISAs relevant to the audit. It also requires the auditor to comply with each requirement of an ISA unless, in the circumstances of the audit, the entire ISA is not relevant or the requirement is not relevant because it is conditional and the condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an ISA by performing alternative audit procedures to achieve the aim of that requirement.<sup>19</sup>
- A6. Compliance with the requirements of ISAs relevant to the audit of a single financial statement or of a specific element of a financial statement may not be practicable when the auditor is not also engaged to audit the entity's complete set of financial statements. In such cases, the auditor often does not have the same understanding of the entity and its environment, including its internal control, as an auditor who also audits the entity's complete set of financial statements. The auditor also does not have the audit evidence about the general quality of the accounting records or other accounting information that would be acquired in an audit of the entity's complete set of financial statements. Accordingly, the auditor may need further evidence to corroborate audit evidence acquired from the accounting records. In the case of an audit of a specific element of a financial statement, certain ISAs require audit work that may be disproportionate to the element being audited. For example, although the requirements of ISA 570 (Revised) are likely to be relevant in the circumstances of an audit of a schedule of accounts receivable, complying with those requirements may not be practicable because of the audit effort required. If the auditor concludes that an audit of a single financial statement or of a specific element of a financial statement in accordance with ISAs may not be practicable, the auditor may

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<sup>17</sup> ISA 200, paragraph 2

<sup>18</sup> ISAE 3000 (Revised), *Assurance Engagements other than Audits or Reviews of Historical Financial Information*

<sup>19</sup> ISA 200, paragraphs 14, 18, and 22–23

discuss with management whether another type of engagement might be more practicable.

*Acceptability of the Financial Reporting Framework* (Ref: Para. 8)

A7. A single financial statement or a specific element of a financial statement may be prepared in accordance with an applicable financial reporting framework that is based on a financial reporting framework established by an authorized or recognized standards setting organization for the preparation of a complete set of financial statements (for example, IFRSs). If this is the case, determination of the acceptability of the applicable framework may involve considering whether that framework includes all the requirements of the framework on which it is based that are relevant to the presentation of a single financial statement or of a specific element of a financial statement that provides adequate disclosures.

*Form of Opinion* (Ref: Para. 9)

A8. The form of opinion to be expressed by the auditor depends on the applicable financial reporting framework and any applicable laws or regulations.<sup>20</sup> In accordance with ISA 700 (Revised):<sup>21</sup>

(a) When expressing an unmodified opinion on a complete set of financial statements prepared in accordance with a fair presentation framework, the auditor's opinion, unless otherwise required by law or regulation, uses one of the following phrases:

(i) the financial statements present fairly, in all material respects, in accordance with [the applicable financial reporting framework];  
or

(ii) the financial statements give a true and fair view in accordance with [the applicable financial reporting framework]; and

(b) When expressing an unmodified opinion on a complete set of financial statements prepared in accordance with a compliance framework, the auditor's opinion states that the financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework].

A9. In the case of a single financial statement or of a specific element of a financial statement, the applicable financial reporting framework may not explicitly address the presentation of the financial statement or of the specific element of the financial statement. This may be the case when the applicable financial reporting framework is based on a financial reporting framework established by an authorized or recognized standards setting organization for the preparation of a complete set of financial statements (for example,

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<sup>20</sup> ISA 200, paragraph 8

<sup>21</sup> ISA 700 (Revised), paragraphs 25–26

IFRSs). The auditor therefore considers whether the expected form of opinion is appropriate in the light of the applicable financial reporting framework. Factors that may affect the auditor’s consideration as to whether to use the phrases “presents fairly, in all material respects,” or “gives a true and fair view” in the auditor’s opinion include:

- Whether the applicable financial reporting framework is explicitly or implicitly restricted to the preparation of a complete set of financial statements.
- Whether the single financial statement or the specific element of a financial statement will:
  - Comply fully with each of those requirements of the framework relevant to the particular financial statement or the particular element, and the presentation of the financial statement or the specific element of a financial statement include the related disclosures.
  - If necessary to achieve fair presentation, provide disclosures beyond those specifically required by the framework or, in exceptional circumstances, depart from a requirement of the framework.

The auditor’s decision as to the expected form of opinion is a matter of professional judgment. It may be affected by whether use of the phrases “presents fairly, in all material respects,” or “gives a true and fair view” in the auditor’s opinion on a single financial statement or on a specific element of a financial statement prepared in accordance with a fair presentation framework is generally accepted in the particular jurisdiction.

### **Considerations When Planning and Performing the Audit** (Ref: Para. 10)

- A10. The relevance of each of the ISAs requires careful consideration. Even when only a specific element of a financial statement is the subject of the audit, ISAs such as ISA 240,<sup>22</sup> ISA 550<sup>23</sup> and ISA 570 (Revised) are, in principle, relevant. This is because the element could be misstated as a result of fraud, the effect of related party transactions, or the incorrect application of the going concern basis of accounting under the applicable financial reporting framework.
- A11. ISA 260 (Revised) requires the auditor to determine the appropriate person(s) within the entity’s governance structure with whom to communicate.<sup>24</sup> ISA 260 (Revised) notes that, in some cases, all of those charged with governance are involved in managing the entity, and the application of communication

<sup>22</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

<sup>23</sup> ISA 550, *Related Parties*

<sup>24</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 11

requirements is modified to recognize this position.<sup>25</sup> When a complete set of financial statements is also prepared by the entity, those person(s) responsible for the oversight of the preparation of the single financial statement or the element may not be the same as those charged with governance responsible for the oversight of the preparation of the complete set of financial statements.

- A12. Furthermore, ISAs are written in the context of an audit of financial statements; they are to be adapted as necessary in the circumstances when applied to the audit of a single financial statement<sup>26</sup> or of a specific element of a financial statement. For example, written representations from management about the complete set of financial statements would be replaced by written representations about the presentation of the financial statement or the element in accordance with the applicable financial reporting framework.
- A13. Matters included in the auditor's report on the complete set of financial statements may have implications for the audit of a single financial statement or of an element of a financial statement (see paragraph 14). When planning and performing an audit of a single financial statement or a specific element of a financial statement in conjunction with the audit of the entity's complete set of financial statements, the auditor may be able to use audit evidence obtained as part of the audit of the entity's complete set of financial statements in the audit of the financial statement or the element. ISAs, however, require the auditor to plan and perform the audit of the financial statement or element to obtain sufficient appropriate audit evidence on which to base the opinion on the financial statement or on the element.
- A14. The individual financial statements that comprise a complete set of financial statements, and many of the specific elements of those financial statements, including their related disclosures, are interrelated. Accordingly, when auditing a single financial statement or a specific element of a financial statement, the auditor may not be able to consider the financial statement or the element in isolation. Consequently, the auditor may need to perform procedures in relation to the interrelated items to meet the objective of the audit.
- A15. Furthermore, the materiality determined for a single financial statement or for a specific element of a financial statement may be lower than the materiality determined for the entity's complete set of financial statements; this will affect the nature, timing and extent of the audit procedures and the evaluation of uncorrected misstatements.

### **Forming an Opinion and Reporting Considerations (Ref: Para. 11)**

- A16. ISA 700 (Revised) requires the auditor, in forming an opinion, to evaluate whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events

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<sup>25</sup> ISA 260 (Revised), paragraph 10(b), 13, A1 (third bullet), A2 and A8.

<sup>26</sup> ISA 200, paragraph 2

on the information conveyed in the financial statements.<sup>27</sup> In the case of a single financial statement or of a specific element of a financial statement, it is important that the financial statement or the element, in view of the requirements of the applicable financial reporting framework, provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element, and the effect of material transactions and events on the information conveyed in the financial statement or the element.

- A17. Appendix 2 contains illustrations of independent auditor's reports on a single financial statement and on a specific element of a financial statement. Other illustrations of auditor's reports may be relevant to reporting on a single financial statement or on a specific element of a financial statement (see, for example, the Appendices to ISA 700 (Revised), ISA 705 (Revised), ISA 570 (Revised), ISA 720 (Revised), and ISA 706 (Revised)).

*Application of ISA 700 (Revised) When Reporting on a Single Financial Statement or on a Specific Element of a Financial Statement*

- A18. Paragraph 11 of this ISA explains that the auditor is required to apply the requirements in ISA 700 (Revised), adapted as necessary in the circumstances of the engagement, when forming an opinion and reporting on a single financial statement or on a specific element of a financial statement. In doing so, the auditor is also required to apply the reporting requirements in other ISAs adapted as necessary in the circumstances of the engagement, and may find the considerations addressed in paragraphs A19–A21 below helpful.

Going Concern

- A19. Depending on the applicable financial reporting framework used in the preparation of the single financial statement or the specific element of a financial statement, the description in the auditor's report of management's responsibilities<sup>28</sup> relating to going concern may need to be adapted as necessary. The description in the auditor's report of the auditor's responsibilities<sup>29</sup> may also need to be adapted as necessary depending on how ISA 570 (Revised) applies in the circumstances of the engagement.

Key Audit Matters

- A20. ISA 700 (Revised) requires the auditor to communicate key audit matters in accordance with ISA 701 for audits of complete sets of general purpose financial statements of listed entities.<sup>30</sup> For audits of a single financial statement or a specific element of a financial statement, ISA 701 only applies when communication of key audit matters in the auditor's report on such financial

<sup>27</sup> ISA 700 (Revised), paragraph 13(e)

<sup>28</sup> See ISA 700 (Revised), paragraphs 34(b) and A48.

<sup>29</sup> See ISA 700 (Revised), paragraphs 39(b)(iv).

<sup>30</sup> ISA 700 (Revised), paragraph 30

statements or elements is required by law or regulation, or the auditor otherwise decides to communicate key audit matters. When key audit matters are communicated in the auditor's report on a single financial statement or a specific element of a financial statement, ISA 701 applies in its entirety.<sup>31</sup>

#### Other Information

A21. ISA 720 (Revised) deals with the auditor's responsibilities relating to other information. In the context of this ISA, reports containing or accompanying the single financial statement or specific element of a financial statement—the purpose of which is to provide owners (or similar stakeholders) with information on matters presented in the single financial statement or the specific element of a financial statement—are considered to be annual reports for purposes of ISA 720 (Revised). When the auditor determines that the entity plans to issue such a report, the requirements in ISA 720 (Revised) apply to the audit of the single financial statement or the element.

#### Name of the Engagement Partner

A22. The requirement in ISA 700 (Revised) for the auditor to include the name of the engagement partner in the auditor's report also applies to audits of single financial statements of listed entities or specific elements of financial statements of listed entities.<sup>32</sup> The auditor may be required by law or regulation to include the name of the engagement partner in the auditor's report or may otherwise decide to do so when reporting on a single financial statement or on an element of a financial statement of entities other than listed entities.

#### *Reporting on the Entity's Complete Set of Financial Statements and on a Single Financial Statement or on a Specific Element of a Financial Statement* (Ref: Para. 14)

Considering the Implications of Certain Matters Included in the Auditor's Report on the Entity's Complete Set of Financial Statements for the Audit of the Single Financial Statement or the Specific Element of a Financial Statement and for the Auditor's Report Thereon

A23. Paragraph 14 requires the auditor to consider the implications, if any, of certain matters included in the auditor's report on the complete set of financial statements for the audit of the single financial statement or the specific element of a financial statement and for the auditor's report thereon. Considering whether a matter included in the auditor's report on the complete set of financial statements is relevant in the context of an engagement to report on a single financial statement or a specific element of a financial statement involves professional judgment.

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<sup>31</sup> ISA 700 (Revised), paragraph 31

<sup>32</sup> See ISA 700 (Revised), paragraphs 46 and A61–A63.

A24. Factors that may be relevant in considering those implications include:

- The nature of the matter(s) being described in the auditor's report on the complete set of financial statements and the extent to which it relates to what is included in the single financial statement or a specific element of a financial statement.
- The pervasiveness of the matter(s) described in the auditor's report on the complete set of financial statements.
- The nature and extent of the differences between the applicable financial reporting frameworks.
- The extent of the difference between the period(s) covered by the complete set of the financial statements compared to the period(s) or dates of the single financial statement or the element of a financial statement.
- The time elapsed since the date of the auditor's report on the complete set of the financial statements.

A25. For example, in the case when there is a qualification of the auditor's opinion in relation to accounts receivable in the auditor's report on the complete set of financial statements, and the single financial statement includes accounts receivable, or the specific element of a financial statement relates to accounts receivable, it is likely that there would be implications for the audit. On the other hand, if the qualification of the auditor's opinion on the complete set of financial statements relates to classification of long-term debt, then it is less likely that there would be implications for an audit of the single financial statement that is the income statement, or if the specific element of the financial statement relates to accounts receivable.

A26. Key audit matters that are communicated in the auditor's report on the complete set of financial statements may have implications for an audit of a single financial statement or the specific element of the financial statement. The information included in the Key Audit Matters section about how the matter was addressed in the audit of the complete set of financial statements may be useful to the auditor's determination of how to address the matter when it is relevant to the audit of the single financial statement or the specific element of the financial statement.

Inclusion of a reference to the auditor's report on the complete set of financial statements

A27. Even when certain matters included in the auditor's report on the complete set of financial statements do not have implications for the audit of, or for the auditor's report on, the single financial statement or the specific element of a financial statement, the auditor may deem it appropriate to refer to the matter(s) in an Other Matter paragraph in an auditor's report on the single

financial statement or on the specific element of a financial statement (see ISA 706 Revised)).<sup>33</sup> For example, the auditor may consider it appropriate to refer in the auditor's report on the single financial statement or a specific element of the financial statement to a Material Uncertainty Related to Going Concern section included in the auditor's report on the complete set of financial statements.

Adverse Opinion or Disclaimer of Opinion in the Auditor's Report on the Entity's Complete Set of Financial Statements (Ref: Para. 15)

A28. In the auditor's report on an entity's complete set of financial statements, the expression of a disclaimer of opinion regarding the results of operations and cash flows, where relevant, and an unmodified opinion regarding the financial position is permitted since the disclaimer of opinion is being issued in respect of the results of operations and cash flows only and not in respect of the financial statements as a whole.<sup>34</sup>

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<sup>33</sup> See ISA 706 (Revised), paragraphs 10–11.

<sup>34</sup> ISA 510, *Initial Audit Engagements—Opening Balances*, paragraph A8, and ISA 705 (Revised), paragraph A16

## Appendix 1

(Ref: Para. A3)

### Examples of Specific Elements, Accounts or Items of a Financial Statement

- Accounts receivable, allowance for doubtful accounts receivable, inventory, the liability for accrued benefits of a private pension plan, the recorded value of identified intangible assets, or the liability for “incurred but not reported” claims in an insurance portfolio, including related notes.
- A schedule of externally managed assets and income of a private pension plan, including related notes.
- A schedule of net tangible assets, including related notes.
- A schedule of disbursements in relation to a lease property, including explanatory notes.
- A schedule of profit participation or employee bonuses, including explanatory notes.

## Appendix 2

(Ref: Para. A17)

### **Illustrations of Independent Auditor's Reports on a Single Financial Statement and on a Specific Element of a Financial Statement**

- Illustration 1: An auditor's report on a single financial statement of an entity other than a listed entity prepared in accordance with a general purpose framework (for purposes of this illustration, a fair presentation framework).
- Illustration 2: An auditor's report on a single financial statement of an entity other than a listed entity prepared in accordance with a special purpose framework (for purposes of this illustration, a fair presentation framework).
- Illustration 3: An auditor's report on a specific element of a financial statement of a listed entity prepared in accordance with a special purpose framework (for purposes of this illustration, a compliance framework).

**Illustration 1: An auditor’s report on a single financial statement of an entity other than a listed entity prepared in accordance with a general purpose framework (for purposes of this illustration, a fair presentation framework).**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a balance sheet (that is, a single financial statement) of an entity other than a listed entity.
- The balance sheet has been prepared by management of the entity in accordance with the requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing a balance sheet.
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The applicable financial reporting framework is a fair presentation framework designed to meet the common financial information needs of a wide range of users.
- The auditor has determined that it is appropriate to use the phrase “presents fairly, in all material respects,” in the auditor’s opinion.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised). The disclosure of the material uncertainty in the single financial statement is adequate.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701 in the context of the audit of the balance sheet.
- The auditor has determined that there is no other information (i.e., the requirements of ISA 720 (Revised) do not apply).
- Those responsible for oversight of the financial statement differ from those responsible for the preparation of the financial statement.
- The auditor has no other reporting responsibilities required under local law or regulation.

## INDEPENDENT AUDITOR’S REPORT

[Appropriate Addressee]

### Opinion

We have audited the balance sheet of ABC Company (the Company) as at December 31, 20X1 and notes to the financial statement, including a summary of significant accounting policies (together “the financial statement”).

In our opinion, the accompanying financial statement presents fairly, in all material respects, the financial position of the Company as at December 31, 20X1 in accordance with those requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing such a financial statement. [Opinion section positioned first as required in ISA 700 (Revised)]

### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statement* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statement in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion. [The first and last sentences in this section used to be in the Auditor’s Responsibility section. Also, the Basis for Opinion section is positioned immediately after the Opinion section as required in ISA 700 (Revised).]

### Material Uncertainty Related to Going Concern

We draw attention to Note 6 in the financial statement, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company’s current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company’s ability to continue as a going concern. Our opinion is not modified in respect of this matter.

### Responsibilities of Management and Those Charged with Governance for the Financial Statement<sup>35</sup>

Management is responsible for the preparation and fair presentation of the financial statement in accordance with those requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing such a financial statement, and for such internal

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<sup>35</sup> Throughout these illustrative auditor’s reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

control as management determines is necessary to enable the preparation of a financial statement that is free from material misstatement, whether due to fraud or error.

In preparing the financial statement, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

### **Auditor's Responsibilities for the Audit of the Financial Statement**

Our objectives are to obtain reasonable assurance about whether the financial statement as a whole is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this financial statement.

Paragraph 41(b) of ISA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of ISA 700 (Revised) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statement, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.<sup>36</sup>

<sup>36</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statement.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates, if any, and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statement, including the disclosures, and whether the financial statement represents the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor address]* [Placement of date and address reversed)]

*[Date]*

**Illustration 2: An auditor’s report on a single financial statement of an entity other than a listed entity prepared in accordance with a special purpose framework.**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of a statement of cash receipts and disbursements (that is, a single financial statement) of an entity other than a listed entity.
- An auditor’s report on the complete set of financial statements was not issued.
- The financial statement has been prepared by management of the entity in accordance with the cash receipts and disbursements basis of accounting to respond to a request for cash flow information received from a creditor. Management has a choice of financial reporting frameworks.
- The applicable financial reporting framework is a fair presentation framework designed to meet the financial information needs of specific users.<sup>37</sup>
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The auditor has determined that it is appropriate to use the phrase “presents fairly, in all material respects,” in the auditor’s opinion.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Distribution or use of the auditor’s report is not restricted.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701 in the context of the audit of the statement of cash receipts and disbursements.
- The auditor has determined that there is no other information (i.e., the requirements of ISA 720 (Revised) do not apply).
- Management is responsible for the preparation of the financial statement and oversight of the financial reporting process to prepare this financial statement.
- The auditor has no other reporting responsibilities required under local law or regulation.

<sup>37</sup> ISA 800 (Revised) contains requirements and guidance on the form and content of financial statements prepared in accordance with a special purpose framework.

## INDEPENDENT AUDITOR’S REPORT

[Appropriate Addressee]

### Opinion

We have audited the statement of cash receipts and disbursements of ABC Company (the Company) for the year ended December 31, 20X1 and notes to the statement of cash receipts and disbursements, including a summary of significant accounting policies (together “the financial statement”).

In our opinion, the accompanying financial statement presents fairly, in all material respects, the cash receipts and disbursements of the Company for the year ended December 31, 20X1 in accordance with the cash receipts and disbursements basis of accounting described in Note X. [Opinion section positioned first as required in ISA 700 (Revised)]

### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statement* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statement in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion. [The first and last sentences in this section used to be in the Auditor’s Responsibility section. Also, the Basis for Opinion section is positioned immediately after the Opinion section as required in ISA 700 (Revised).]

### Emphasis of Matter – Basis of Accounting

We draw attention to Note X to the financial statement, which describes the basis of accounting. The financial statement is prepared to provide information to XYZ Creditor. As a result, the statement may not be suitable for another purpose. Our opinion is not modified in respect of this matter.

### Responsibilities of Management and Those Charged with Governance for the Financial Statement<sup>38</sup>

Management is responsible for preparation and fair presentation of the financial statement in accordance with the cash receipts and disbursements basis of accounting described in Note X; this includes determining that the cash receipts and disbursements basis of accounting is an acceptable basis for the preparation of the financial statement in the circumstances, and for such internal control as management determines is necessary to enable the preparation of a financial statement that is free from material misstatement, whether due to fraud or error.

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<sup>38</sup> Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

In preparing the financial statement, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

### **Auditor's Responsibilities for the Audit of the Financial Statement**

Our objectives are to obtain reasonable assurance about whether the financial statement as a whole is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this financial statement.

Paragraph 41(b) of ISA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of ISA 700 (Revised) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statement, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.<sup>39</sup>
- Conclude on the appropriateness of management's use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw

<sup>39</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statement.

attention in our auditor's report to the related disclosures in the financial statement or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates, if any, and related disclosures made by management.
- Evaluate the overall presentation, structure and content of the financial statement, including the disclosures, and whether the financial statement represents the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor address]* [Placement of date and address reversed)]

*[Date]*

**Illustration 3: An auditor’s report on a specific element of a financial statement of a listed entity prepared in accordance with a special purpose framework.**

For purposes of this illustrative auditor’s report, the following circumstances are assumed:

- Audit of an accounts receivable schedule (that is, element, account or item of a financial statement).
- The financial information has been prepared by management of the entity in accordance with the financial reporting provisions established by a regulator to meet the requirements of that regulator. Management does not have a choice of financial reporting frameworks.
- The applicable financial reporting framework is a compliance framework designed to meet the financial information needs of specific users.<sup>40</sup>
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Distribution of the auditor’s report is restricted.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with ISA 570 (Revised).
- The auditor is not required, and has otherwise not decided to communicate key audit matters in accordance with ISA 701 in the context of the audit of the accounts receivable schedule.
- The auditor has determined that there is no other information (i.e., the requirements of ISA 720 (Revised) do not apply).
- Those responsible for oversight of the financial statement differ from those responsible for the preparation of the financial statement.
- The auditor has no other reporting responsibilities required under local law or regulation.

<sup>40</sup> ISA 800 (Revised) contains requirements and guidance on the form and content of financial statements prepared in accordance with a special purpose framework.

## INDEPENDENT AUDITOR’S REPORT

[To the Shareholders of ABC Company or Other Appropriate Addressee]

### Opinion

We have audited the accounts receivable schedule of ABC Company (the Company) as at December 31, 20X1 (“the schedule”).

In our opinion, the financial information in the schedule of the Company as at December 31, 20X1 is prepared, in all material respects, in accordance with [describe the financial reporting provisions established by the regulator]. [Opinion section positioned first as required ISA 700 (Revised)]

### Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Schedule* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the schedule in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion. [The first and last sentences in this section used to be in the Auditor’s Responsibility section. Also, the Basis for Opinion section is positioned immediately after opinion section as required in ISA 700 (Revised).]

### Emphasis of Matter – Basis of Accounting and Restriction on Distribution

We draw attention to Note X to the schedule, which describes the basis of accounting. The schedule is prepared to assist the Company to meet the requirements of Regulator DEF. As a result, the schedule may not be suitable for another purpose. Our report is intended solely for the Company and Regulator DEF and should not be distributed to parties other than the Company or Regulator DEF. Our opinion is not modified in respect of this matter.

### Responsibilities of Management and Those Charged with Governance for the Schedule<sup>41</sup>

Management is responsible for the preparation of the schedule in accordance with [describe the financial reporting provisions established by the regulator], and for such internal control as management determines is necessary to enable the preparation of the schedule that is free from material misstatement, whether due to fraud or error.

In preparing the schedule, management is responsible for assessing the Company’s ability to continue as a going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting unless management

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<sup>41</sup> Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

### **Auditor's Responsibilities for the Audit of the Schedule**

Our objectives are to obtain reasonable assurance about whether the schedule is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this schedule.

Paragraph 41(b) of ISA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of ISA 700 (Revised) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the schedule, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.<sup>42</sup>
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the schedule or, if

<sup>42</sup> This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the schedule

such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates, if any, and related disclosures made by management.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, actions taken to eliminate threats or safeguards applied.

The engagement partner on the audit resulting in this independent auditor's report is [name].

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor address]* [Placement of date and address reversed]

[Date]

**INTERNATIONAL STANDARD ON AUDITING 810  
(REVISED)**

**ENGAGEMENTS TO REPORT ON SUMMARY  
FINANCIAL STATEMENTS**

(Effective for engagements to report on summary financial statements  
for periods ending on or after December 15, 2016)

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**ISA**

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International Standard on Auditing (ISA) 810 (Revised), *Engagements to Report on Summary Financial Statements*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to an engagement to report on summary financial statements derived from financial statements audited in accordance with ISAs by that same auditor.

### Effective Date

2. This ISA is effective for engagements to report on summary financial statements for periods ending on or after December 15, 2016.

## Objectives

3. The objectives of the auditor are:
  - (a) To determine whether it is appropriate to accept the engagement to report on summary financial statements; and
  - (b) If engaged to report on summary financial statements:
    - (i) To form an opinion on the summary financial statements based on an evaluation of the conclusions drawn from the evidence obtained; and
    - (ii) To express clearly that opinion through a written report that also describes the basis for that opinion.

## Definitions

4. For purposes of this ISA, the following terms have the meanings attributed below:
  - (a) Applied criteria – The criteria applied by management in the preparation of the summary financial statements.
  - (b) Audited financial statements – Financial statements<sup>1</sup> audited by the auditor in accordance with ISAs, and from which the summary financial statements are derived.
  - (c) Summary financial statements – Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes

<sup>1</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(f), defines the term “financial statements.”

therein for a period of time.<sup>2</sup> Different jurisdictions may use different terminology to describe such historical financial information.

## Requirements

### Engagement Acceptance

5. The auditor shall accept an engagement to report on summary financial statements in accordance with this ISA only when the auditor has been engaged to conduct an audit in accordance with ISAs of the financial statements from which the summary financial statements are derived. (Ref: Para. A1)
6. Before accepting an engagement to report on summary financial statements, the auditor shall: (Ref: Para. A2)
  - (a) Determine whether the applied criteria are acceptable; (Ref: Para. A3–A7)
  - (b) Obtain the agreement of management that it acknowledges and understands its responsibility:
    - (i) For the preparation of the summary financial statements in accordance with the applied criteria;
    - (ii) To make the audited financial statements available to the intended users of the summary financial statements without undue difficulty (or, if law or regulation provides that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements, to describe that law or regulation in the summary financial statements); and
    - (iii) To include the auditor's report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them.
  - (c) Agree with management the form of opinion to be expressed on the summary financial statements (see paragraphs 9–11).
7. If the auditor concludes that the applied criteria are unacceptable or is unable to obtain the agreement of management set out in paragraph 6(b), the auditor shall not accept the engagement to report on the summary financial statements, unless required by law or regulation to do so. An engagement conducted in accordance with such law or regulation does not comply with this ISA. Accordingly, the auditor's report on the summary financial statements shall not indicate that the engagement was conducted in accordance with this ISA. The auditor shall include appropriate reference to this fact in the terms of the engagement. The auditor shall also determine the effect that this may have

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<sup>2</sup> ISA 200, paragraph 13(f)

on the engagement to audit the financial statements from which the summary financial statements are derived.

### **Nature of Procedures**

8. The auditor shall perform the following procedures, and any other procedures that the auditor may consider necessary, as the basis for the auditor's opinion on the summary financial statements:
  - (a) Evaluate whether the summary financial statements adequately disclose their summarized nature and identify the audited financial statements.
  - (b) When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:
    - (i) From whom or where the audited financial statements are available; or
    - (ii) The law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.
  - (c) Evaluate whether the summary financial statements adequately disclose the applied criteria.
  - (d) Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be recalculated from the related information in the audited financial statements.
  - (e) Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.
  - (f) Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.
  - (g) Evaluate whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary financial statements. (Ref: Para. A8)

### **Form of Opinion**

9. When the auditor has concluded that an unmodified opinion on the summary financial statements is appropriate, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases: (Ref: Para. A9)

- (a) The accompanying summary financial statements are consistent, in all material respects, with the audited financial statements, in accordance with [*the applied criteria*]; or
  - (b) The accompanying summary financial statements are a fair summary of the audited financial statements, in accordance with [*the applied criteria*].
10. If law or regulation prescribes the wording of the opinion on summary financial statements in terms that are different from those described in paragraph 9, the auditor shall:
- (a) Apply the procedures described in paragraph 8 and any further procedures necessary to enable the auditor to express the prescribed opinion; and
  - (b) Evaluate whether users of the summary financial statements might misunderstand the auditor’s opinion on the summary financial statements and, if so, whether additional explanation in the auditor’s report on the summary financial statements can mitigate possible misunderstanding.
11. If, in the case of paragraph 10(b), the auditor concludes that additional explanation in the auditor’s report on the summary financial statements cannot mitigate possible misunderstanding, the auditor shall not accept the engagement, unless required by law or regulation to do so. An engagement conducted in accordance with such law or regulation does not comply with this ISA. Accordingly, the auditor’s report on the summary financial statements shall not indicate that the engagement was conducted in accordance with this ISA.

**Timing of Work and Events Subsequent to the Date of the Auditor’s Report on the Audited Financial Statements**

12. The auditor’s report on the summary financial statements may be dated later than the date of the auditor’s report on the audited financial statements. In such cases, the auditor’s report on the summary financial statements shall state that the summary financial statements and audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor’s report on the audited financial statements. (Ref: Para. A10)
13. The auditor may become aware of facts that existed at the date of the auditor’s report on the audited financial statements, but of which the auditor previously was unaware. In such cases, the auditor shall not issue the auditor’s report on the summary financial statements until the auditor’s consideration of such facts in relation to the audited financial statements in accordance with ISA 560<sup>3</sup> has been completed.

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<sup>3</sup> ISA 560, *Subsequent Events*

## Information in Documents Containing Summary Financial Statements

14. The auditor shall read the information included in a document containing the summary financial statements and the auditor's report thereon and consider whether there is a material inconsistency between that information and the summary financial statements.
15. If the auditor identifies a material inconsistency, the auditor shall discuss the matter with management and determine whether the summary financial statements or the information included in the document containing the summary financial statements and the auditor's report thereon needs to be revised. If the auditor determines that the information needs to be revised and management refuses to revise the information as necessary, the auditor shall take appropriate action in the circumstances, including considering the implications for the auditor's report on the summary financial statements. (Ref: Para. A11–A16)

## Auditor's Report on Summary Financial Statements

### *Elements of the Auditor's Report*

16. The auditor's report on summary financial statements shall include the following elements:<sup>4</sup> (Ref: Para. A23)
  - (a) A title clearly indicating it as the report of an independent auditor. (Ref: Para. A17)
  - (b) An addressee. (Ref: Para. A18)
  - (c) Identification of the summary financial statements on which the auditor is reporting, including the title of each statement included in the summary financial statements. (Ref: Para. A19)
  - (d) Identification of the audited financial statements.
  - (e) Subject to paragraph 20, a clear expression of an opinion (see paragraphs 9–11).
  - (f) A statement indicating that the summary financial statements do not contain all the disclosures required by the financial reporting framework applied in the preparation of the audited financial statements, and that reading the summary financial statements and the auditor's report thereon is not a substitute for reading the audited financial statements and the auditor's report thereon.
  - (g) Where applicable, the statement required by paragraph 12.
  - (h) Reference to the auditor's report on the audited financial statements, the date of that report, and, subject to paragraphs 19–20, the fact that an unmodified opinion is expressed on the audited financial statements.

<sup>4</sup> Paragraphs 19–20, which deal with circumstances where the auditor's report on the audited financial statements has been modified, require additional elements to those listed in this paragraph.

- (i) A description of management's<sup>5</sup> responsibility for the summary financial statements, explaining that management<sup>6</sup> is responsible for the preparation of the summary financial statements in accordance with the applied criteria.
  - (j) A statement that the auditor is responsible for expressing an opinion, based on the auditor's procedures conducted in accordance with this ISA, on whether the summary financial statements are consistent, in all material respects, with [or *are a fair summary of*] the audited financial statements.
  - (k) The auditor's signature.
  - (l) The auditor's address.
  - (m) The date of the auditor's report. (Ref: Para. A20)
17. If the addressee of the summary financial statements is not the same as the addressee of the auditor's report on the audited financial statements, the auditor shall evaluate the appropriateness of using a different addressee. (Ref: Para. A18)
18. The auditor shall date the auditor's report on the summary financial statements no earlier than: (Ref: Para. A20)
- (a) The date on which the auditor has obtained sufficient appropriate evidence on which to base the opinion, including evidence that the summary financial statements have been prepared and those with the recognized authority have asserted that they have taken responsibility for them; and
  - (b) The date of the auditor's report on the audited financial statements.

*Reference to the Auditor's Report on the Audited Financial Statements* (Ref: Para. A23)

19. When the auditor's report on the audited financial statements includes:
- (a) A qualified opinion in accordance with ISA 705 (Revised);<sup>7</sup>
  - (b) An Emphasis of Matter paragraph or an Other Matter paragraph in accordance with ISA 706 (Revised);<sup>8</sup>
  - (c) *A Material Uncertainty Related to Going Concern* section in accordance with ISA 570 (Revised);<sup>9</sup>

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<sup>5</sup> Or other term that is appropriate in the context of the legal framework in the particular jurisdiction

<sup>6</sup> Or other term that is appropriate in the context of the legal framework in the particular jurisdiction

<sup>7</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

<sup>8</sup> ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

<sup>9</sup> ISA 570 (Revised), *Going Concern*, paragraph 22

- (d) Communication of key audit matters in accordance with ISA 701;<sup>10</sup> or
- (e) A statement that describes an uncorrected material misstatement of the other information in accordance with ISA 720 (Revised);<sup>11</sup>

and the auditor is satisfied that the summary financial statements are consistent, in all material respects, with or are a fair summary of the audited financial statements, in accordance with the applied criteria, the auditor's report on the summary financial statements shall, in addition to the elements in paragraph 16:

- (i) State that the auditor's report on the audited financial statements includes a qualified opinion, an Emphasis of Matter paragraph, an Other Matter paragraph, a *Material Uncertainty Related to Going Concern* section, communication of key audit matters, or a statement that describes an uncorrected material misstatement of the other information; and (Ref: Para. A21)
  - (ii) Describe: (Ref: Para. A22)
    - a. The basis for the qualified opinion on the audited financial statements and the effect thereof, if any, on the summary financial statements;
    - b. The matter referred to in the Emphasis of Matter paragraph, the Other Matter paragraph, or the *Material Uncertainty Related to Going Concern* section in the auditor's report on the audited financial statements and the effect(s) thereof, if any, on the summary financial statements; or
    - c. The uncorrected material misstatement of the other information and the effect(s) thereof, if any, on the information included in a document containing the summary financial statements and the auditor's report thereon. (Ref: Para. A15)
20. When the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion, the auditor's report on the summary financial statements shall, in addition to the elements in paragraph 16:
- (a) State that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion;
  - (b) Describe the basis for that adverse opinion or disclaimer of opinion; and
  - (c) State that, as a result of the adverse opinion or disclaimer of opinion on the audited financial statements, it is inappropriate to express an opinion on the summary financial statements. (Ref: Para. A23)

<sup>10</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

<sup>11</sup> ISA 720 (Revised), *The Auditor's Responsibilities Related to Other Information*

*Modified Opinion on the Summary Financial Statements*

21. If the summary financial statements are not consistent, in all material respects, with or are not a fair summary of the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor shall express an adverse opinion on the summary financial statements. (Ref: Para. A23)

**Restriction on Distribution or Use or Alerting Readers to the Basis of Accounting**

22. When distribution or use of the auditor's report on the audited financial statements is restricted, or the auditor's report on the audited financial statements alerts readers that the audited financial statements are prepared in accordance with a special purpose framework, the auditor shall include a similar restriction or alert in the auditor's report on the summary financial statements.

**Comparatives**

23. If the audited financial statements contain comparatives, but the summary financial statements do not, the auditor shall determine whether such omission is reasonable in the circumstances of the engagement. The auditor shall determine the effect of an unreasonable omission on the auditor's report on the summary financial statements. (Ref: Para. A24)
24. If the summary financial statements contain comparatives that were reported on by another auditor, the auditor's report on the summary financial statements shall also contain the matters that ISA 710 requires the auditor to include in the auditor's report on the audited financial statements.<sup>12</sup> (Ref: Para. A25)

**Unaudited Supplementary Information Presented with Summary Financial Statements**

25. The auditor shall evaluate whether any unaudited supplementary information presented with the summary financial statements is clearly differentiated from the summary financial statements. If the auditor concludes that the entity's presentation of the unaudited supplementary information is not clearly differentiated from the summary financial statements, the auditor shall ask management to change the presentation of the unaudited supplementary information. If management refuses to do so, the auditor shall explain in the auditor's report on the summary financial statements that such information is not covered by that report. (Ref: Para. A26)

**Auditor Association**

26. If the auditor becomes aware that the entity plans to state that the auditor has reported on summary financial statements in a document containing the

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<sup>12</sup> ISA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*

summary financial statements, but does not plan to include the related auditor's report, the auditor shall request management to include the auditor's report in the document. If management does not do so, the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document. (Ref: Para. A27)

27. The auditor may be engaged to report on the financial statements of an entity, while not engaged to report on the summary financial statements. If, in this case, the auditor becomes aware that the entity plans to make a statement in a document that refers to the auditor and the fact that summary financial statements are derived from the financial statements audited by the auditor, the auditor shall be satisfied that:

- (a) The reference to the auditor is made in the context of the auditor's report on the audited financial statements; and
- (b) The statement does not give the impression that the auditor has reported on the summary financial statements.

If (a) or (b) are not met, the auditor shall request management to change the statement to meet them, or not to refer to the auditor in the document. Alternatively, the entity may engage the auditor to report on the summary financial statements and include the related auditor's report in the document. If management does not change the statement, delete the reference to the auditor, or include an auditor's report on the summary financial statements in the document containing the summary financial statements, the auditor shall advise management that the auditor disagrees with the reference to the auditor, and the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately referring to the auditor. (Ref: Para. A27)

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## Application and Other Explanatory Material

### Engagement Acceptance (Ref: Para. 5–6)

- A1. The audit of the financial statements from which the summary financial statements are derived provides the auditor with the necessary knowledge to discharge the auditor's responsibilities in relation to the summary financial statements in accordance with this ISA. Application of this ISA will not provide sufficient appropriate evidence on which to base the opinion on the summary financial statements if the auditor has not also audited the financial statements from which the summary financial statements are derived.
- A2. Management's agreement with the matters described in paragraph 6 may be evidenced by its written acceptance of the terms of the engagement.

*Criteria* (Ref: Para. 6(a))

- A3. The preparation of summary financial statements requires management to determine the information that needs to be reflected in the summary financial statements so that they are consistent, in all material respects, with or represent a fair summary of the audited financial statements. Because summary financial statements by their nature contain aggregated information and limited disclosure, there is an increased risk that they may not contain the information necessary so as not to be misleading in the circumstances. This risk increases when established criteria for the preparation of summary financial statements do not exist.
- A4. Factors that may affect the auditor's determination of the acceptability of the applied criteria include:
- The nature of the entity;
  - The purpose of the summary financial statements;
  - The information needs of the intended users of the summary financial statements; and
  - Whether the applied criteria will result in summary financial statements that are not misleading in the circumstances.
- A5. The criteria for the preparation of summary financial statements may be established by an authorized or recognized standards setting organization or by law or regulation. Similar to the case of financial statements, as explained in ISA 210,<sup>13</sup> in many such cases, the auditor may presume that such criteria are acceptable.
- A6. Where established criteria for the preparation of summary financial statements do not exist, criteria may be developed by management, for example, based on practice in a particular industry. Criteria that are acceptable in the circumstances will result in summary financial statements that:
- (a) Adequately disclose their summarized nature and identify the audited financial statements;
  - (b) Clearly describe from whom or where the audited financial statements are available or, if law or regulation provides that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements, that law or regulation;
  - (c) Adequately disclose the applied criteria;
  - (d) Agree with or can be recalculated from the related information in the audited financial statements; and

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<sup>13</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraphs A3 and A8–A9

- (e) In view of the purpose of the summary financial statements, contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.

A7. Adequate disclosure of the summarized nature of the summary financial statements and the identity of the audited financial statements, as referred to in paragraph A6(a), may, for example, be provided by a title such as “Summary Financial Statements Prepared from the Audited Financial Statements for the Year Ended December 31, 20X1.”

**Evaluating the Availability of the Audited Financial Statements** (Ref: Para. 8(g))

- A8. The auditor’s evaluation whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty is affected by factors such as whether:
- The summary financial statements describe clearly from whom or where the audited financial statements are available;
  - The audited financial statements are on public record; or
  - Management has established a process by which the intended users of the summary financial statements can obtain ready access to the audited financial statements.

**Form of Opinion** (Ref: Para. 9)

A9. A conclusion, based on an evaluation of the evidence obtained by performing the procedures in paragraph 8, that an unmodified opinion on the summary financial statements is appropriate enables the auditor to express an opinion containing one of the phrases in paragraph 9. The auditor’s decision as to which of the phrases to use may be affected by generally accepted practice in the particular jurisdiction.

**Timing of Work and Events Subsequent to the Date of the Auditor’s Report on the Audited Financial Statements** (Ref: Para. 12)

A10. The procedures described in paragraph 8 are often performed during or immediately after the audit of the financial statements. When the auditor reports on the summary financial statements after the completion of the audit of the financial statements, the auditor is not required to obtain additional audit evidence on the audited financial statements, or report on the effects of events that occurred subsequent to the date of the auditor’s report on the audited financial statements since the summary financial statements are derived from the audited financial statements and do not update them.

**Information in Documents Containing Summary Financial Statements**  
(Ref: Para. 14–15)

A11. ISA 720 (Revised) deals with the auditor’s responsibilities relating to other information in an audit of financial statements. In the context of ISA 720

(Revised), other information is financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report. An annual report contains or accompanies the financial statements and the auditor's report thereon.

- A12. In contrast, paragraphs 14–15 deal with the auditor's responsibilities relating to information included in a document that also contains the summary financial statements and the auditor's report thereon. This information may include:
- Some or all of the same matters as those dealt with in the other information included in the annual report (e.g., when the summary financial statements and the auditor's report thereon are included in a summary annual report); or
  - Matters that are not dealt with in the other information included in the annual report.
- A13. In reading the information included in a document containing the summary financial statements and the auditor's report thereon, the auditor may become aware that such information is misleading and may need to take appropriate action. Relevant ethical requirements<sup>14</sup> require the auditor to avoid being knowingly associated with information that the auditor believes contains a materially false or misleading statement, statements or information provided recklessly, or omits or obscures required information where such omission or obscurity would be misleading.

*Information in a Document Containing the Summary Financial Statements that Deals with Some or All of the Same Matters as the Other Information in the Annual Report*

- A14. When information is included in a document containing the summary financial statements and the auditor's report thereon and that information deals with some or all of the same matters as the other information included in the annual report, the work performed on that other information in accordance with ISA 720 (Revised) may be adequate for the purposes of paragraphs 14–15 of this ISA.
- A15. When an uncorrected material misstatement of the other information has been identified in the auditor's report on the audited financial statements and that uncorrected material misstatement relates to a matter that is dealt with in the information in a document containing the summary financial statements and the auditor's report thereon, a material inconsistency between the summary financial statements and that information may exist or the information may be misleading.

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<sup>14</sup> International Ethics Standards Board for Accountants' *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code), paragraph R111.2

*Information in a Document Containing the Summary Financial Statements that Deals with Matters Not Dealt with in the Other Information in the Annual Report*

A16. ISA 720 (Revised), adapted as necessary in the circumstances, may be helpful to the auditor in determining the appropriate action to respond to management's refusal to make necessary revisions to the information, including considering the implications for the auditor's report on the summary financial statements.

## **Auditor's Report on Summary Financial Statements**

### *Elements of the Auditor's Report*

#### Title (Ref: Para. 16(a))

A17. A title indicating the report is the report of an independent auditor, for example, "Report of the Independent Auditor," affirms that the auditor has met all of the relevant ethical requirements regarding independence. This distinguishes the report of the independent auditor from reports issued by others.

#### Addressee (Ref: Para. 16(b), 17)

A18. Factors that may affect the auditor's evaluation of the appropriateness of the addressee of the summary financial statements include the terms of the engagement, the nature of the entity, and the purpose of the summary financial statements.

#### Identification of the Summary Financial Statements (Ref: Para. 16(c))

A19. When the auditor is aware that the summary financial statements will be included in a document that contains information other than the summary financial statements and the auditor's report thereon, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the summary financial statements are presented. This helps readers to identify the summary financial statements to which the auditor's report relates.

#### Date of the Auditor's Report (Ref: Para. 16(m), 18)

A20. The person or persons with recognized authority to conclude that the summary financial statements have been prepared and take responsibility for them depend on the terms of the engagement, the nature of the entity, and the purpose of the summary financial statements.

#### Reference to the Auditor's Report on the Audited Financial Statements (Ref: Para. 19)

A21. Paragraph 19(i) of this ISA requires the auditor to include a statement in the auditor's report on the summary financial statements when the auditor's report on the audited financial statements includes communication of one or more key audit matters described in accordance with ISA 701.<sup>15</sup> However, the auditor is

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<sup>15</sup> ISA 701, paragraph 13

not required to describe the individual key audit matters in the auditor’s report on the summary financial statements.

- A22. The statement(s) and description(s) required by paragraph 19 are intended to draw attention to those matters and are not a substitute for reading the auditor’s report on the audited financial statements. The required descriptions are intended to convey the nature of the matter(s), and need not repeat the corresponding text in the auditor’s report on the audited financial statements in its entirety.

Illustrations (Ref: Para. 16, 19–21)

- A23. The Appendix to this ISA contains illustrations of auditors’ reports on summary financial statements that variously:
- (a) Contain unmodified opinions;
  - (b) Are derived from audited financial statements on which the auditor issued modified opinions;
  - (c) Contain a modified opinion;
  - (d) Are derived from audited financial statements where the auditor’s report thereon includes a statement describing an uncorrected material misstatement of the other information in accordance with ISA 720 (Revised); and
  - (e) Are derived from audited financial statements where the auditor’s report thereon includes a *Material Uncertainty Related to Going Concern* section and communication of other key audit matters.

**Comparatives** (Ref: Para. 23–24)

- A24. If the audited financial statements contain comparatives, there is a presumption that the summary financial statements also would contain comparatives. Comparatives in the audited financial statements may be regarded as corresponding figures or as comparative financial information. ISA 710 describes how this difference affects the auditor’s report on the financial statements, including, in particular, reference to other auditors who audited the financial statements for the prior period.
- A25. Circumstances that may affect the auditor’s determination whether an omission of comparatives is reasonable include the nature and objective of the summary financial statements, the applied criteria, and the information needs of the intended users of the summary financial statements.

**Unaudited Supplementary Information Presented with Summary Financial Statements** (Ref: Para. 25)

- A26. ISA 700 (Revised)<sup>16</sup> contains requirements and guidance to be applied when unaudited supplementary information is presented with audited financial

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<sup>16</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 53–54

statements that, adapted as necessary in the circumstances, may be helpful in applying the requirement in paragraph 25.

**Auditor Association** (Ref: Para. 26–27)

- A27. Other appropriate actions the auditor may take when management does not take the requested action may include informing the intended users and other known third-party users of the inappropriate reference to the auditor. The auditor's course of action depends on the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

**Appendix**

(Ref: Para. A23)

**Illustrations of Independent Auditor's Reports on Summary Financial Statements**

- Illustration 1: An auditor's report on summary financial statements prepared in accordance with established criteria. An unmodified opinion is expressed on the audited financial statements. The auditor's report on the summary financial statements is dated later than the date of the auditor's report on the financial statements from which summary financial statements are derived. The auditor's report on the audited financial statements includes a *Material Uncertainty Related to Going Concern* section and communication of other key audit matters.
- Illustration 2: An auditor's report on summary financial statements prepared in accordance with criteria developed by management and adequately disclosed in the summary financial statements. The auditor has determined that the applied criteria are acceptable in the circumstances. An unmodified opinion is expressed on the audited financial statements. The auditor's report on the summary financial statements is dated the same as the date of the auditor's report on the financial statements from which the summary financial statements are derived. The auditor's report on the audited financial statements includes a statement that describes an uncorrected material misstatement of the other information. The other information to which this uncorrected material misstatement relates is also information included in a document containing the summary financial statements and the auditor's report thereon.
- Illustration 3: An auditor's report on summary financial statements prepared in accordance with criteria developed by management and adequately disclosed in the summary financial statements. The auditor has determined that the applied criteria are acceptable in the circumstances. A qualified opinion is expressed on the audited financial statements. The auditor's report on the summary financial statements is dated the same as the date of the auditor's report on the financial statements from which the summary financial statements are derived.
- Illustration 4: An auditor's report on summary financial statements prepared in accordance with criteria developed by management and adequately disclosed in the summary financial statements. The auditor has determined that the applied criteria are acceptable in the circumstances. An adverse opinion is expressed on the audited financial statements. The auditor's report on the summary financial statements is dated the same as the date of the auditor's report on the financial statements from which the summary financial statements are derived.

- Illustration 5: An auditor's report on summary financial statements prepared in accordance with established criteria. An unmodified opinion is expressed on the audited financial statements. The auditor concludes that it is not possible to express an unmodified opinion on the summary financial statements. The auditor's report on the summary financial statements is dated the same as the date of the auditor's report on the financial statements from which the summary financial statements are derived.

**Illustration 1:**

**Circumstances include the following:**

- **An unmodified opinion is expressed on the audited financial statements of a listed entity.**
- **Established criteria for the preparation of summary financial statements exist.**
- **The auditor’s report on the summary financial statements is dated later than the date of the auditor’s report on the financial statements from which the summary financial statements are derived.**
- **The auditor’s report on the audited financial statements includes a *Material Uncertainty Related to Going Concern* section.**
- **The auditor’s report on the audited financial statements includes communication of other key audit matters.<sup>17</sup>**

## **REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS**

[Appropriate Addressee]

### **Opinion**

The summary financial statements, which comprise the summary balance sheet as at December 31, 20X1, the summary income statement, summary statement of changes in equity and summary cash flow statement for the year then ended, and related notes, are derived from the audited financial statements of ABC Company for the year ended December 31, 20X1.

In our opinion, the accompanying summary financial statements are consistent, in all material respects, with (or *a fair summary of*) the audited financial statements, in accordance with [describe established criteria].

### **Summary Financial Statements**

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements of ABC Company]. Reading the summary financial statements and the auditor’s report thereon, therefore, is not a substitute for reading the audited financial statements and the auditor’s report thereon. The summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date of our report on the audited financial statements.

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<sup>17</sup> As explained in paragraph 15 of ISA 701, a material uncertainty related to going concern is, by its nature, a key audit matter but is required to be reported in a separate section of the auditor’s report in accordance with paragraph 22 of ISA 570 (Revised).

### The Audited Financial Statements and Our Report Thereon

We expressed an unmodified audit opinion on the audited financial statements in our report dated February 15, 20X2. That report also includes:

- A *Material Uncertainty Related to Going Concern* section that draws attention to Note 6 in the audited financial statements. Note 6 of the audited financial statements indicates that ABC Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, ABC Company's current liabilities exceeded its total assets by YYY. These events or conditions, along with other matters as set forth in Note 6 of the audited financial statements, indicate that a material uncertainty exists that may cast significant doubt on ABC Company's ability to continue as a going concern. These matters are addressed in Note 5 of the summary financial statements.
- The communication of other<sup>18</sup> key audit matters. [Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period.]<sup>19</sup>

### Management's<sup>20</sup> Responsibility for the Summary Financial Statements

Management is responsible for the preparation of the financial statements in accordance with [describe established criteria].

### Auditor's Responsibility

Our responsibility is to express an opinion on whether the summary financial statements are consistent, in all material respects, with (or *are a fair summary of*) the audited financial statements based on our procedures, which were conducted in accordance with International Standard on Auditing (ISA) 810 (Revised), *Engagements to Report on Summary Financial Statements*.

[Auditor's signature]

[Auditor's address]

[Date of the auditor's report]

<sup>18</sup> In the circumstances where there is no material uncertainty related to going concern, inclusion of the word "other" in the statement for the communication of key audit matters would not be necessary.

<sup>19</sup> The auditor may include additional explanation about key audit matters considered helpful to users of the auditor's report on the summary financial statements.

<sup>20</sup> Or other term that is appropriate in the context of the legal framework in the particular jurisdiction

**Illustration 2:**

**Circumstances include the following:**

- **An unmodified opinion is expressed on the audited financial statements.**
- **Criteria are developed by management and adequately disclosed in Note X. The auditor has determined that the criteria are acceptable in the circumstances.**
- **The auditor’s report on the summary financial statements is dated the same as the date of the auditor’s report on the financial statements from which the summary financial statements are derived.**
- **The auditor’s report on the audited financial statements includes a statement that describes an uncorrected material misstatement of the other information. The other information to which this uncorrected material misstatement relates is also information included in a document containing the summary financial statements and the auditor’s report thereon.**

## **REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS**

[Appropriate Addressee]

### **Opinion**

The summary financial statements, which comprise the summary balance sheet as at December 31, 20X1, the summary income statement, summary statement of changes in equity and summary cash flow statement for the year then ended, and related notes, are derived from the audited financial statements of ABC Company for the year ended December 31, 20X1.

In our opinion, the accompanying summary financial statements are consistent, in all material respects, with (or *a fair summary of*) the audited financial statements, on the basis described in Note X.

### **Summary Financial Statements**

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements of ABC Company]. Reading the summary financial statements and the auditor’s report thereon, therefore, is not a substitute for reading the audited financial statements and the auditor’s report thereon.

### **The Audited Financial Statements and Our Report Thereon**

We expressed an unmodified audit opinion on the audited financial statements in our report dated February 15, 20X2. [The audited financial statements are included in the 20X1 Annual Report. The auditor’s report on the audited financial statements includes a statement that describes an uncorrected material misstatement of other information within Management’s Discussion and Analysis of the 20X1 Annual Report.

Management's Discussion and Analysis, and the uncorrected material misstatement of the other information therein, are also contained in the 20X1 Summary Annual Report.] *[Describe the uncorrected material misstatement of the other information].*

### **Management's<sup>21</sup> Responsibility for the Summary Financial Statements**

Management is responsible for the preparation of the summary financial statements on the basis described in Note X.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on whether the summary financial statements are consistent, in all material respects, with (or *are a fair summary of*) the audited financial statements based on our procedures, which were conducted in accordance with International Standard on Auditing (ISA) 810 (Revised), *Engagements to Report on Summary Financial Statements*.

[Auditor's signature]

[Auditor's address]

[Date of the auditor's report]

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<sup>21</sup> Or other term that is appropriate in the context of the legal framework in the particular jurisdiction

**Illustration 3:**

**Circumstances include the following:**

- **A qualified opinion is expressed on the audited financial statements.**
- **Criteria are developed by management and adequately disclosed in Note X. The auditor has determined that the criteria are acceptable in the circumstances.**
- **The auditor’s report on the summary financial statements is dated the same as the date of the auditor’s report on the financial statements from which the summary financial statements are derived.**

## **REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS**

[Appropriate Addressee]

### **Opinion**

The summary financial statements, which comprise the summary statement of financial position as at December 31, 20X1, the summary statement of comprehensive income, summary statement of changes in equity and summary statement of cash flows for the year then ended, and related notes, are derived from the audited financial statements of ABC Company (the Company) for the year ended December 31, 20X1. We expressed a qualified audit opinion on those financial statements in our report dated February 15, 20X2.<sup>22</sup>

In our opinion, the accompanying summary financial statements are consistent, in all material respects, with (or *a fair summary of*) the audited financial statements, on the basis described in Note X. However, the summary financial statements are misstated to the equivalent extent as the audited financial statements of ABC Company for the year ended December 31, 20X1.

### **Summary Financial Statements**

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements of ABC Company]. Reading the summary financial statements and the auditor’s report thereon, therefore, is not a substitute for reading the audited financial statements and the auditor’s report thereon.

### **The Audited Financial Statements and Our Report Thereon**

We expressed a qualified audit opinion on the audited financial statements in our report dated February 15, 20X2. The basis for our qualified audit opinion was [that management has not stated the inventories at the lower of cost and net realizable value

<sup>22</sup> The positioning of this reference to the qualified opinion in the auditor’s report on the audited financial statements in the Opinion paragraph on the summary financial statements assists users in understanding that although the auditor has expressed an unmodified opinion on the summary financial statements, the summary financial statements reflect audited financial statements that are materially misstated.

but has stated them solely at cost, which constitutes a departure from International Financial Reporting Standards]. The Company's records indicate that had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

### **Management's<sup>23</sup> Responsibility for the Summary Financial Statements**

Management is responsible for the preparation of the summary financial statements on the basis described in Note X.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on whether the summary financial statements are consistent, in all material respects, with (or *are a fair summary of*) the audited financial statements based on our procedures, which were conducted in accordance with International Standard on Auditing (ISA) 810 (Revised), *Engagements to Report on Summary Financial Statements*.

[Auditor's signature]

[Auditor's address]

[Date of the auditor's report]

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<sup>23</sup> Or other term that is appropriate in the context of the legal framework in the particular jurisdiction

**Illustration 4:**

**Circumstances include the following:**

- **An adverse opinion is expressed on the audited financial statements.**
- **Criteria are developed by management and adequately disclosed in Note X. The auditor has determined that the criteria are acceptable in the circumstances.**
- **The auditor's report on the summary financial statements is dated the same as the date of the auditor's report on the financial statements from which the summary financial statements are derived.**

## **REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS**

[Appropriate Addressee]

### **Denial of Opinion**

The summary financial statements, which comprise the summary balance sheet as at December 31, 20X1, the summary income statement, summary statement of changes in equity and summary cash flow statement for the year then ended, and related notes, are derived from the audited financial statements of ABC Company for the year ended December 31, 20X1.

As a result of the adverse opinion on the audited financial statements discussed in *The Audited Financial Statements and our Report Thereon* section of our report, it is inappropriate to express an opinion on the accompanying summary financial statements.

### **Summary Financial Statements**

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements of ABC Company]. Reading the summary financial statements and the auditor's report thereon, therefore, is not a substitute for reading the audited financial statements and the auditor's report thereon.

### **The Audited Financial Statements and Our Report Thereon**

In our report dated February 15, 20X2, we expressed an adverse opinion on the audited financial statements of ABC Company for the year ended December 31, 20X1. The basis for our adverse opinion was [describe basis for adverse audit opinion].

### **Management's<sup>24</sup> Responsibility for the Summary Financial Statements**

Management is responsible for the preparation of the financial statements on the basis described in Note X.

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<sup>24</sup> Or other term that is appropriate in the context of the legal framework in the particular jurisdiction

**Auditor’s Responsibility**

Our responsibility is to express an opinion on whether the summary financial statements are consistent, in all material respects, with (or *are a fair summary of*) the audited financial statements based on our procedures, which were conducted in accordance with International Standard on Auditing (ISA) 810 (Revised), *Engagements to Report on Summary Financial Statements*.

[Auditor’s signature]

[Auditor’s address]

[Date of the auditor’s report]

**Illustration 5:**

**Circumstances include the following:**

- **An unmodified opinion is expressed on the audited financial statements.**
- **Established criteria for the preparation of summary financial statements exist.**
- **The auditor concludes that it is not possible to express an unmodified opinion on the summary financial statements.**
- **The auditor's report on the summary financial statements is dated the same as the date of the auditor's report on the financial statements from which the summary financial statements are derived.**

## **REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS**

[Appropriate Addressee]

### **Adverse Opinion**

The summary financial statements, which comprise the summary balance sheet as at December 31, 20X1, the summary income statement, summary statement of changes in equity and summary cash flow statement for the year then ended, and related notes, are derived from the audited financial statements of ABC Company for the year ended December 31, 20X1.

In our opinion, because of the significance of the matter described in the *Basis for Adverse Opinion* section, the accompanying summary financial statements are not consistent with (or a *fair summary of*) the audited financial statements of ABC Company for the year ended December 31, 20X1, in accordance with [describe established criteria].

### **Basis for Adverse Opinion**

[Describe matter that caused the summary financial statements not to be consistent, in all material respects, with (or a *fair summary of*) the audited financial statements, in accordance with the applied criteria.

### **Summary Financial Statements**

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements of ABC Company]. Reading the summary financial statements and the auditor's report thereon, therefore, is not a substitute for reading the audited financial statements and the auditor's report thereon.

### **The Audited Financial Statements and Our Report Thereon**

We expressed an unmodified audit opinion on the audited financial statements in our report dated February 15, 20X2.

**Management’s<sup>25</sup> Responsibility for the Summary Audited Financial Statements**

Management is responsible for the preparation of the summary financial statements in accordance with [describe established criteria].

**Auditor’s Responsibility**

Our responsibility is to express an opinion on whether the summary financial statements are consistent, in all material respects, with (or *are a fair summary of*) the audited financial statements based on our procedures, which were conducted in accordance with International Standard on Auditing (ISA) 810 (Revised), *Engagements to Report on Summary Financial Statements*.

[Auditor’s signature]

[Auditor’s address]

[Date of the auditor’s report]

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<sup>25</sup> Or other term that is appropriate in the context of the legal framework in the particular jurisdiction

**INTERNATIONAL AUDITING PRACTICE NOTE 1000**  
**SPECIAL CONSIDERATIONS IN AUDITING**  
**FINANCIAL INSTRUMENTS**

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International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*, should be read in conjunction with the *Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*. IAPNs do not impose additional requirements on auditors beyond those included in the International Standards on Auditing (ISAs), nor do they change the auditor’s responsibility to comply with all ISAs relevant to the audit. IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance.

IAPN 1000 has not been updated for changes to ISA 540 (Revised). Therefore, all references to ISA 540 in IAPN 1000 refer to ISA 540 as it has been presented in the 2018 IAASB Handbook. IAPN 1000 will be updated for conforming changes arising for the projects to revise ISA 540 and ISA 315 (Revised) in the 2021 IAASB Handbook.

## Introduction

1. Financial instruments may be used by financial and non-financial entities of all sizes for a variety of purposes. Some entities have large holdings and transaction volumes while other entities may only engage in a few financial instrument transactions. Some entities may take positions in financial instruments to assume and benefit from risk while other entities may use financial instruments to reduce certain risks by hedging or managing exposures. This International Auditing Practice Note (IAPN) is relevant to all of these situations.
2. The following International Standards on Auditing (ISAs) are particularly relevant to audits of financial instruments:
  - (a) ISA 540<sup>1</sup> deals with the auditor's responsibilities relating to auditing accounting estimates, including accounting estimates related to financial instruments measured at fair value;
  - (b) ISA 315 (Revised)<sup>2</sup> and ISA 330<sup>3</sup> deal with identifying and assessing risks of material misstatement and responding to those risks; and
  - (c) ISA 500<sup>4</sup> explains what constitutes audit evidence and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.
3. The purpose of this IAPN is to provide:
  - (a) Background information about financial instruments (Section I); and
  - (b) Discussion of audit considerations relating to financial instruments (Section II).

IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance.

4. This IAPN is relevant to entities of all sizes, as all entities may be subject to risks of material misstatement when using financial instruments.

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<sup>1</sup> ISA 540, *Auditing Accounting Estimates and Related Disclosures*

<sup>2</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>3</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>4</sup> ISA 500, *Audit Evidence*

5. The guidance on valuation<sup>5</sup> in this IAPN is likely to be more relevant for financial instruments measured or disclosed at fair value, while the guidance on areas other than valuation applies equally to financial instruments either measured at fair value or amortized cost. This IAPN is also applicable to both financial assets and financial liabilities. This IAPN does not deal with instruments such as:
- (a) The simplest financial instruments such as cash, simple loans, trade accounts receivable and trade accounts payable;
  - (b) Investments in unlisted equity instruments; or
  - (c) Insurance contracts.
6. Also, this IAPN does not deal with specific accounting issues relevant to financial instruments, such as hedge accounting, profit or loss on inception (often known as “Day 1” profit or loss), offsetting, risk transfers or impairment, including loan loss provisioning. Although these subject matters can relate to an entity’s accounting for financial instruments, a discussion of the auditor’s consideration regarding how to address specific accounting requirements is beyond the scope of this IAPN.
7. An audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities. Such responsibilities subsume making fair value measurements. This IAPN does not impose responsibilities on management or those charged with governance nor override laws and regulation that govern their responsibilities.
8. This IAPN has been written in the context of general purpose fair presentation financial reporting frameworks, but may also be useful, as appropriate in the circumstance, in other financial reporting frameworks such as special purpose financial reporting frameworks.
9. This IAPN focuses on the assertions of valuation, and presentation and disclosure, but also covers, in less detail, completeness, accuracy, existence, and rights and obligations.
10. Financial instruments are susceptible to estimation uncertainty, which is defined in ISA 540 as “the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.”<sup>6</sup> Estimation uncertainty is affected by the complexity of financial instruments, among other factors. The nature and reliability of information available to support the measurement of financial instruments varies widely, which affects the estimation uncertainty associated with their measurement. This IAPN uses the term “measurement uncertainty” to refer to the estimation uncertainty associated with fair value measurements.

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<sup>5</sup> In this IAPN, the terms “valuation” and “measurement” are used interchangeably.

<sup>6</sup> ISA 540, paragraph 7(c)

## Section I—Background Information about Financial Instruments

11. Different definitions of financial instruments may exist among financial reporting frameworks. For example, International Financial Reporting Standards (IFRS) define a financial instrument as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.<sup>7</sup> Financial instruments may be cash, the equity of another entity, the contractual right or obligation to receive or deliver cash or exchange financial assets or liabilities, certain contracts settled in an entity's own equity instruments, certain contracts on non-financial items, or certain contracts issued by insurers that do not meet the definition of an insurance contract. This definition encompasses a wide range of financial instruments from simple loans and deposits to complex derivatives, structured products, and some commodity contracts.
12. Financial instruments vary in complexity, though the complexity of the financial instrument can come from difference sources, such as:
  - A very high volume of individual cash flows, where a lack of homogeneity requires analysis of each one or a large number of grouped cash flows to evaluate, for example, credit risk (for example, collateralized debt obligations (CDOs)).
  - Complex formulae for determining the cash flows.
  - Uncertainty or variability of future cash flows, such as that arising from credit risk, option contracts or financial instruments with lengthy contractual terms.

The higher the variability of cash flows to changes in market conditions, the more complex and uncertain the fair value measurement of the financial instrument is likely to be. In addition, sometimes financial instruments that, ordinarily, are relatively easy to value become complex to value because of particular circumstances, for example, instruments for which the market has become inactive or which have lengthy contractual terms. Derivatives and structured products become more complex when they are a combination of individual financial instruments. In addition, the accounting for financial instruments under certain financial reporting frameworks or certain market conditions may be complex.

13. Another source of complexity is the volume of financial instruments held or traded. While a “plain vanilla” interest rate swap may not be complex, an entity holding a large number of them may use a sophisticated information system to identify, value and transact these instruments.

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<sup>7</sup> International Accounting Standard (IAS) 32, *Financial Instruments: Presentation*, paragraph 11

**Purpose and Risks of Using Financial Instruments**

14. Financial instruments are used for:
- Hedging purposes (that is, to change an existing risk profile to which an entity is exposed). This includes:
    - The forward purchase or sale of currency to fix a future exchange rate;
    - Converting future interest rates to fixed rates or floating rates through the use of swaps; and
    - The purchase of option contracts to provide an entity with protection against a particular price movement, including contracts which may contain embedded derivatives;
  - Trading purposes (for example, to enable an entity to take a risk position to benefit from short term market movements); and
  - Investment purposes (for example, to enable an entity to benefit from long term investment returns).
15. The use of financial instruments can reduce exposures to certain business risks, for example changes in exchange rates, interest rates and commodity prices, or a combination of those risks. On the other hand, the inherent complexities of some financial instruments also may result in increased risk.
16. Business risk and the risk of material misstatement increase when management and those charged with governance:
- Do not fully understand the risks of using financial instruments and have insufficient skills and experience to manage those risks;
  - Do not have the expertise to value them appropriately in accordance with the applicable financial reporting framework;
  - Do not have sufficient controls in place over financial instrument activities; or
  - Inappropriately hedge risks or speculate.
17. Management's failure to fully understand the risks inherent in a financial instrument can have a direct effect on management's ability to manage these risks appropriately, and may ultimately threaten the viability of the entity.
18. The principal types of risk applicable to financial instruments are listed below. This list is not meant to be exhaustive and different terminology may be used to describe these risks or classify the components of individual risks.
- (a) Credit (or counterparty) risk is the risk that one party to a financial instrument will cause a financial loss to another party by failing to discharge an obligation and is often associated with default. Credit risk

includes settlement risk, which is the risk that one side of a transaction will be settled without consideration being received from the customer or counterparty.

- (b) Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Examples of market risk include currency risk, interest rate risk, commodity and equity price risk.
- (c) Liquidity risk includes the risk of not being able to buy or sell a financial instrument at an appropriate price in a timely manner due to a lack of marketability for that financial instrument.
- (d) Operational risk relates to the specific processing required for financial instruments. Operational risk may increase as the complexity of a financial instrument increases, and poor management of operational risk may increase other types of risk. Operational risk includes:
  - (i) The risk that confirmation and reconciliation controls are inadequate resulting in incomplete or inaccurate recording of financial instruments;
  - (ii) The risks that there is inappropriate documentation of transactions and insufficient monitoring of these transactions;
  - (iii) The risk that transactions are incorrectly recorded, processed or risk managed and, therefore, do not reflect the economics of the overall trade;
  - (iv) The risk that undue reliance is placed by staff on the accuracy of valuation techniques, without adequate review, and transactions are therefore incorrectly valued or their risk is improperly measured;
  - (v) The risk that the use of financial instruments is not adequately incorporated into the entity's risk management policies and procedures;
  - (vi) The risk of loss resulting from inadequate or failed internal processes and systems, or from external events, including the risk of fraud from both internal and external sources;
  - (vii) The risk that there is inadequate or non-timely maintenance of valuation techniques used to measure financial instruments; and
  - (viii) Legal risk, which is a component of operational risk, and 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

or incorrect 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 financial instruments.

19. Other considerations relevant to risks of using financial instruments include:
- The risk of fraud that may be increased if, for example, an employee in a position to perpetrate a financial fraud understands both the financial instruments and the processes for accounting for them, but management and those charged with governance have a lesser degree of understanding.
  - The risk that master netting arrangements<sup>8</sup> may not be properly reflected in the financial statements.
  - The risk that some financial instruments may change between being assets or liabilities during their term and that such change may occur rapidly.

### **Controls Relating to Financial Instruments**

20. The extent of an entity's use of financial instruments and the degree of complexity of the instruments are important determinants of the necessary level of sophistication of the entity's internal control. For example, smaller entities may use less structured products and simple processes and procedures to achieve their objectives.
21. Often, it is the role of those charged with governance to set the tone regarding, and approve and oversee the extent of use of, financial instruments while it is management's role to manage and monitor the entity's exposures to those risks. Management and, where appropriate, those charged with governance are also responsible for designing and implementing a system of internal control to enable the preparation of financial statements in accordance with the applicable financial reporting framework. An entity's internal control over financial instruments is more likely to be effective when management and those charged with governance have:
- (a) Established an appropriate control environment, active participation by those charged with governance in controlling the use of financial instruments, a logical organizational structure with clear assignment of authority and responsibility, and appropriate human resource policies and procedures. In particular, clear rules are needed on the extent to which those responsible for financial instrument activities are permitted to act. Such rules have regard to any legal or regulatory restrictions on

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<sup>8</sup> An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a master netting arrangement with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default of any one contract.

using financial instruments. For example, certain public sector entities may not have the power to conduct business using derivatives;

- (b) Established a risk management process relative to the size of the entity and the complexity of its financial instruments (for example, in some entities a formal risk management function may exist);
- (c) Established information systems that provide those charged with governance with an understanding of the nature of the financial instrument activities and the associated risks, including adequate documentation of transactions;
- (d) Designed, implemented and documented a system of internal control to:
  - Provide reasonable assurance that the entity’s use of financial instruments is within its risk management policies;
  - Properly present financial instruments in the financial statements;
  - Ensure that the entity is in compliance with applicable laws and regulations; and
  - Monitor risk.

The Appendix provides examples of controls that may exist in an entity that deals in a high volume of financial instrument transactions; and

- (e) Established appropriate accounting policies, including valuation policies, in accordance with the applicable financial reporting framework.

22. Key elements of risk management processes and internal control relating to an entity’s financial instruments include:

- Setting an approach to define the amount of risk exposure that the entity is willing to accept when engaging in financial instrument transactions (this may be referred to as its “risk appetite”), including policies for investing in financial instruments, and the control framework in which the financial instrument activities are conducted;
- Establishing processes for the documentation and authorization of new types of financial instrument transactions which consider the accounting, regulatory, legal, financial and operational risks that are associated with such instruments;
- Processing financial instrument transactions, including confirmation and reconciliation of cash and asset holdings to external statements, and the payments process;
- Segregation of duties between those investing or trading in the financial instruments and those responsible for processing, valuing and confirming such instruments. For example, a model development function that is

involved in assisting in pricing deals is less objective than one that is functionally and organizationally separate from the front office;

- Valuation processes and controls, including controls over data obtained from third-party pricing sources; and
- Monitoring of controls.

23. The nature of risks often differs between entities with a high volume and variety of financial instruments and those with only a few financial instrument transactions. This results in different approaches to internal control. For example:

- Typically, an institution with high volumes of financial instruments will have a dealing room type environment in which there are specialist traders and segregation of duties between those traders and the back office (which refers to the operations function that data-checks trades that have been conducted, ensuring that they are not erroneous, and transacting the required transfers). In such environments, the traders will typically initiate contracts verbally over the phone or via an electronic trading platform. Capturing relevant transactions and accurately recording financial instruments in such an environment is significantly more challenging than for an entity with only a few financial instruments, whose existence and completeness often can be confirmed with a bank confirmation to a few banks.
- On the other hand, entities with only a small number of financial instruments often do not have segregation of duties, and access to the market is limited. In such cases, although it may be easier to identify financial instrument transactions, there is a risk that management may rely on a limited number of personnel, which may increase the risk that unauthorized transactions may be initiated or transactions may not be recorded.

### **Completeness, Accuracy and Existence**

24. Paragraphs 25–33 describe controls and processes which may be in place in entities with a high volume of financial instrument transactions, including those with trading rooms. By contrast, an entity that does not have a high volume of financial instrument transactions may not have these controls and processes but may instead confirm their transactions with the counterparty or clearing house. Doing so may be relatively straightforward in that the entity may only transact with one or two counterparties.

#### *Trade Confirmations and Clearing Houses*

25. Generally, for transactions undertaken by financial institutions, the terms of financial instruments are documented in confirmations exchanged between counterparties and legal agreements. Clearing houses serve to monitor the

exchange of confirmations by matching trades and settling them. A central clearing house is associated with an exchange and entities that clear through clearing houses typically have processes to manage the information delivered to the clearing house.

26. Not all transactions are settled through such an exchange. In many other markets there is an established practice of agreeing the terms of transactions before settlement begins. To be effective, this process needs to be run separately from those who trade the financial instruments to minimize the risk of fraud. In other markets, transactions are confirmed after settlement has begun and sometimes confirmation backlogs result in settlement beginning before all terms have been fully agreed. This presents additional risk because the transacting entities need to rely on alternative means of agreeing trades. These may include:
- Enforcing rigorous reconciliations between the records of those trading the financial instruments and those settling them (strong segregation of duties between the two are important), combined with strong supervisory controls over those trading the financial instruments to ensure the integrity of the transactions;
  - Reviewing summary documentation from counterparties that highlights the key terms even if the full terms have not been agreed; and
  - Thorough review of traders' profits and losses to ensure that they reconcile to what the back office has calculated.

#### *Reconciliations with Banks and Custodians*

27. Some components of financial instruments, such as bonds and shares, may be held in separate depositories. In addition, most financial instruments result in payments of cash at some point and often these cash flows begin early in the contract's life. These cash payments and receipts will pass through an entity's bank account. Regular reconciliation of the entity's records to external banks' and custodians' records enables the entity to ensure transactions are properly recorded.
28. It should be noted that not all financial instruments result in a cash flow in the early stages of the contract's life or are capable of being recorded with an exchange or custodian. Where this is the case, reconciliation processes will not identify an omitted or inaccurately recorded trade and confirmation controls are more important. Even where such a cash flow is accurately recorded in the early stages of an instrument's life, this does not ensure that all characteristics or terms of the instrument (for example, the maturity or an early termination option) have been recorded accurately.
29. In addition, cash movements may be quite small in the context of the overall size of the trade or the entity's own balance sheet and may therefore be difficult to identify. The value of reconciliations is enhanced when finance, or other back office staff, review entries in all general ledger accounts to ensure that

they are valid and supportable. This process will help identify if the other side to cash entries relating to financial instruments has not been properly recorded. Reviewing suspense and clearing accounts is important regardless of the account balance, as there may be offsetting reconciling items in the account.

30. In entities with a high volume of financial instrument transactions, reconciliation and confirmation controls may be automated and, if so, adequate IT controls need to be in place to support them. In particular, controls are needed to ensure that data is completely and accurately picked up from external sources (such as banks and custodians) and from the entity's records and is not tampered with before or during reconciliation. Controls are also needed to ensure that the criteria on which entries are matched are sufficiently restrictive to prevent inaccurate clearance of reconciling items.

#### *Other Controls over Completeness, Accuracy and Existence*

31. The complexity inherent in some financial instruments means that it will not always be obvious how they should be recorded in the entity's systems. In such cases, management may set up control processes to monitor policies that prescribe how particular types of transactions are measured, recorded and accounted for. These policies are typically established and reviewed in advance by suitably qualified personnel who are capable of understanding the full effects of the financial instruments being booked.
32. Some transactions may be cancelled or amended after initial execution. Application of appropriate controls relating to cancellation or amendment can mitigate the risks of material misstatement due to fraud or error. In addition, an entity may have a process in place to reconfirm trades that are cancelled or amended.
33. In financial institutions with a high volume of trading, a senior employee typically reviews daily profits and losses on individual traders' books to evaluate whether they are reasonable based on the employee's knowledge of the market. Doing so may enable management to determine that particular trades were not completely or accurately recorded, or may identify fraud by a particular trader. It is important that there are transaction authorization procedures that support the more senior review.

### **Valuation of Financial Instruments**

#### *Financial Reporting Requirements*

34. In many financial reporting frameworks, financial instruments, including embedded derivatives, are often measured at fair value for the purpose of balance sheet presentation, calculating profit or loss, and/or disclosure. In general, the objective of fair value measurement is to arrive at the price at which an orderly transaction would take place between market participants at the measurement date under current market conditions; that is, it is not the

transaction price for a forced liquidation or distressed sale. In meeting this objective, all relevant available market information is taken into account.

35. Fair value measurements of financial assets and financial liabilities may arise both at the initial recording of transactions and later when there are changes in value. Changes in fair value measurements that occur over time may be treated in different ways under different financial reporting frameworks. For example, such changes may be recorded as profit or loss, or may be recorded in the other comprehensive income. Also, depending on the applicable financial reporting framework, the whole financial instrument or only a component of it (for example, an embedded derivative when it is separately accounted for) may be required to be measured at fair value.
36. Some financial reporting frameworks establish a fair value hierarchy to develop increased consistency and comparability in fair value measurements and related disclosures. The inputs may be classified into different levels such as:
- Level 1 inputs—Quoted prices (unadjusted) in active markets for identical financial assets or financial liabilities that the entity can access at the measurement date.
  - Level 2 inputs—Inputs other than quoted prices included within level 1 that are observable for the financial asset or financial liability, either directly or indirectly. If the financial asset or financial liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the financial asset or financial liability. Level 2 inputs include the following:
    - Quoted prices for similar financial assets or financial liabilities in active markets.
    - Quoted prices for identical or similar financial assets or financial liabilities in markets that are not active.
    - Inputs other than quoted prices that are observable for the financial asset or financial liability (for example, interest rates and yield curves observable at commonly quoted intervals, implied volatilities and credit spreads).
    - Inputs that are derived principally from, or corroborated by, observable market data by correlation or other means (market-corroborated inputs).
  - Level 3 inputs—Unobservable inputs for the financial asset or financial liability. Unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the financial asset or financial liability at the measurement date.

In general, measurement uncertainty increases as a financial instrument moves from level 1 to level 2, or level 2 to level 3. Also, within level 2 there may be a wide range of measurement uncertainty depending on the observability of inputs, the complexity of the financial instrument, its valuation, and other factors.

37. Certain financial reporting frameworks may require or permit the entity to adjust for measurement uncertainties, in order to adjust for risks that a market participant would make in the pricing to take account of the uncertainties of the risks associated with the pricing or cash flows of the financial instrument. For example:

- Model adjustments. Some models may have a known deficiency or the result of calibration may highlight the deficiency for the fair value measurement in accordance with the financial reporting framework.
- Credit-risk adjustments. Some models do not take into account credit risk, including counterparty risk or own credit risk.
- Liquidity adjustments. Some models calculate a mid-market price, even though the financial reporting framework may require use of a liquidity adjusted amount such as a bid/offer spread. Another, more judgmental, liquidity adjustment recognizes that some financial instruments are illiquid which affects the valuation.
- Other risk adjustments. A value measured using a model that does not take into account all other factors that market participants would consider in pricing the financial instrument may not represent fair value on the measurement date, and therefore may need to be adjusted separately to comply with the applicable financial reporting framework.

Adjustments are not appropriate if they adjust the measurement and valuation of the financial instrument away from fair value as defined by the applicable financial reporting framework, for example for conservatism.

#### *Observable and Unobservable Inputs*

38. As mentioned above, financial reporting frameworks often categorize inputs according to the degree of observability. As activity in a market for financial instruments declines and the observability of inputs declines, measurement uncertainty increases. The nature and reliability of information available to support valuation of financial instruments varies depending on the observability of inputs to its measurement, which is influenced by the nature of the market (for example, the level of market activity and whether it is through an exchange or over-the-counter (OTC)). Accordingly, there is a continuum of the nature and reliability of evidence used to support valuation, and it becomes more difficult for management to obtain information to support a valuation when markets become inactive and inputs become less observable.

39. When observable inputs are not available, an entity uses unobservable inputs (level 3 inputs) that reflect the assumption that market participants would use when pricing the financial asset or the financial liability, including assumptions about risk. Unobservable inputs are developed using the best information available in the circumstances. In developing unobservable inputs, an entity may begin with its own data, which is adjusted if reasonably available information indicates that (a) other market participants would use different data or (b) there is something particular to the entity that is not available to other market participants (for example, an entity-specific synergy).

#### *Effects of Inactive Markets*

40. Measurement uncertainty increases and valuation is more complicated when the markets in which financial instruments or their component parts are traded become inactive. There is no clear point at which an active market becomes inactive, though financial reporting frameworks may provide guidance on this issue. Characteristics of an inactive market include a significant decline in the volume and level of trading activity, available prices vary significantly over time or among market participants or the prices are not current. However, assessing whether a market is inactive requires judgment.
41. When markets are inactive, prices quoted may be stale (that is, out of date), may not represent prices at which market participants may trade or may represent forced transactions (such as when a seller is required to sell an asset to meet regulatory or legal requirements, needs to dispose of an asset immediately to create liquidity or the existence of a single potential buyer as a result of the legal or time restrictions imposed). Accordingly, valuations are developed based on level 2 and level 3 inputs. Under such circumstances, entities may have:
- A valuation policy that includes a process for determining whether level 1 inputs are available;
  - An understanding of how particular prices or inputs from external sources used as inputs to valuation techniques were calculated in order to assess their reliability. For example, in an active market, a broker quote on a financial instrument that has not traded is likely to reflect actual transactions on a similar financial instrument, but, as the market becomes less active, the broker quote may rely more on proprietary valuation techniques to determine prices;
  - An understanding of how deteriorating business conditions affect the counterparty, as well as whether deteriorating business conditions in entities similar to the counterparty may indicate that the counterparty may not fulfill its obligations (that is, non-performance risk);
  - Policies for adjusting for measurement uncertainties. Such adjustments can include model adjustments, lack of liquidity adjustments, credit risk adjustments, and other risk adjustments;

- The capability to calculate the range of realistic outcomes given the uncertainties involved, for example by performing a sensitivity analysis; and
  - Policies for identifying when a fair value measurement input moves to a different level of the fair value hierarchy.
42. Particular difficulties may develop where there is severe curtailment or even cessation of trading in particular financial instruments. In these circumstances, financial instruments that have previously been valued using market prices may need to be valued using a model.

#### *Management's Valuation Process*

43. Techniques that management may use to value their financial instruments include observable prices, recent transactions, and models that use observable or unobservable inputs. Management may also make use of:
- (a) A third-party pricing source, such as a pricing service or broker quote; or
  - (b) A valuation expert.

Third-party pricing sources and valuation experts may use one or more of these valuation techniques.

44. In many financial reporting frameworks, the best evidence of a financial instrument's fair value is found in contemporaneous transactions in an active market (that is, level 1 inputs). In such cases, the valuation of a financial instrument may be relatively simple. Quoted prices for financial instruments that are listed on exchanges or traded in liquid over-the-counter markets may be available from sources such as financial publications, the exchanges themselves or third-party pricing sources. When using quoted prices, it is important that management understand the basis on which the quote is given to ensure that the price reflects market conditions at the measurement date. Quoted prices obtained from publications or exchanges may provide sufficient evidence of fair value when, for example:
- (a) The prices are not out of date or "stale" (for example, if the quote is based on the last traded price and the trade occurred some time ago); and
  - (b) The quotes are prices at which dealers would actually trade the financial instrument with sufficient frequency and volume.
45. Where there is no current observable market price for the financial instrument (that is, a level 1 input), it will be necessary for the entity to gather other price indicators to use in a valuation technique to value the financial instrument. Price indicators may include:
- Recent transactions, including transactions after the date of the financial statements in the same instrument. Consideration is given to whether an adjustment needs to be made for changes in market conditions between

the measurement date and the date the transaction was made, as these transactions are not necessarily indicative of the market conditions that existed at the date of the financial statements. In addition it is possible that the transaction represents a forced transaction and is therefore not indicative of a price in an orderly trade.

- Current or recent transactions in similar instruments, often known as “proxy pricing.” Adjustments will need to be made to the price of the proxy to reflect the differences between them and the instrument being priced, for example, to take account of differences in liquidity or credit risk between the two instruments.
- Indices for similar instruments. As with transactions in similar instruments, adjustments will need to be made to reflect the difference between the instrument being priced and the instrument(s) from which the index used is derived.

46. It is expected that management will document its valuation policies and model used to value a particular financial instrument, including the rationale for the model(s) used, the selection of assumptions in the valuation methodology, and the entity’s consideration of whether adjustments for measurement uncertainty are necessary.

#### Models

47. Models may be used to value financial instruments when the price cannot be directly observed in the market. Models can be as simple as a commonly used bond pricing formula or involve complex, specifically developed software tools to value financial instruments with level 3 inputs. Many models are based on discounted cash flow calculations.
48. Models comprise a methodology, assumptions and data. The methodology describes rules or principles governing the relationship between the variables in the valuation. Assumptions include estimates of uncertain variables which are used in the model. Data may comprise actual or hypothetical information about the financial instrument, or other inputs to the financial instrument.
49. Depending on the circumstances, matters that the entity may address when establishing or validating a model for a financial instrument include whether:
- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity’s validation process may include evaluation of:
    - The methodology’s theoretical soundness and mathematical integrity, including the appropriateness of parameters and sensitivities.

- The consistency and completeness of the model's inputs with market practices, and whether the appropriate inputs are available for use in the model.
- There are appropriate change control policies, procedures and security controls over the model.
- The model is appropriately changed or adjusted on a timely basis for changes in market conditions.
- The model is periodically calibrated, reviewed and tested for validity by a separate and objective function. Doing so is a means of ensuring that the model's output is a fair representation of the value that marketplace participants would ascribe to a financial instrument.
- The model maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs.
- Adjustments are made to the output of the model to reflect the assumptions marketplace participants would use in similar circumstances.
- The model is adequately documented, including the model's intended applications and limitations and its key parameters, required data, results of any validation analysis performed and any adjustments made to the output of the model.

#### An Example of a Common Financial Instrument

50. The following describes how models may be applied to value a common financial instrument, known as an asset backed security.<sup>9</sup> Because asset backed securities are often valued based on level 2 or 3 inputs, they are frequently valued using models and involve:

- Understanding the type of security—considering (a) the underlying collateral; and (b) the terms of the security. The underlying collateral is used to estimate the timing and amounts of cash flows such as mortgage or credit card interest and principal payments.
- Understanding the terms of the security—this includes evaluating contractual cash flow rights, such as the order of repayment, and any default events. The order of repayment, often known as seniority, refers to terms which require that some classes of security holders (senior debt) are repaid before others (subordinated debt). The rights of each class of security holder to the cash flows, frequently referred to as the cash flow “waterfall,” together with assumptions of the timing and amount of cash flows are used to derive a set of estimated cash flows for each class of

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<sup>9</sup> An asset backed security is a financial instrument which is backed by a pool of underlying assets (known as the collateral, such as credit card receivables or vehicle loans) and derives value and income from those underlying assets.

security holder. The expected cash flows are then discounted to derive an estimated fair value.

51. The cash flows of an asset backed security may be affected by prepayments of the underlying collateral and by potential default risk and resulting estimated loss severities. Prepayment assumptions, if applicable, are generally based on evaluating market interest rates for similar collateral to the rates on the collateral underlying the security. For example, if market interest rates for mortgages have declined then the underlying mortgages in a security may experience higher prepayment rates than originally expected. Estimating potential default and loss severity involves close evaluation of the underlying collateral and borrowers to estimate default rates. For example, when the underlying collateral comprises residential mortgages, loss severities may be affected by estimates of residential housing prices over the term of the security.

### Third-Party Pricing Sources

52. Entities may use third-party pricing sources in order to obtain fair value information. The preparation of an entity's financial statements, including the valuation of financial instruments and the preparation of financial statement disclosures relating to these instruments, may require expertise that management does not possess. Entities may not be able to develop appropriate valuation techniques, including models that may be used in a valuation, and may use a third-party pricing source to arrive at a valuation or to provide disclosures for the financial statements. This may particularly be the case in smaller entities or in entities that do not engage in a high volume of financial instruments transactions (for example, non-financial institutions with treasury departments). Even though management has used a third-party pricing source, management is ultimately responsible for the valuation.
53. Third-party pricing sources may also be used because the volume of securities to price over a short timeframe may not be possible by the entity. This is often the case for traded investment funds that must determine a net asset value each day. In other cases, management may have their own pricing process but use third-party pricing sources to corroborate their own valuations.
54. For one or more of these reasons most entities use third-party pricing sources when valuing securities either as a primary source or as a source of corroboration for their own valuations. Third-party pricing sources generally fall into the following categories:
  - Pricing services, including consensus pricing services; and
  - Brokers providing broker quotes.

### Pricing services

55. Pricing services provide entities with prices and price-related data for a variety of financial instruments, often performing daily valuations of large numbers

of financial instruments. These valuations may be made by collecting market data and prices from a wide variety of sources, including market makers, and, in certain instances, using internal valuations techniques to derive estimated fair values. Pricing services may combine a number of approaches to arrive at a price. Pricing services are often used as a source of prices based on level 2 inputs. Pricing services may have strong controls around how prices are developed and their customers often include a wide variety of parties, including buy and sell side investors, back and middle office functions, auditors and others.

56. Pricing services often have a formalized process for customers to challenge the prices received from the pricing services. These challenge processes usually require the customer to provide evidence to support an alternative price, with challenges categorized based on the quality of evidence provided. For example, a challenge based on a recent sale of that instrument that the pricing service was not aware of may be upheld, whereas a challenge based on a customer's own valuation technique may be more heavily scrutinized. In this way, a pricing service with a large number of leading participants, both buy and sell side, may be able to constantly correct prices to more fully reflect the information available to market participants.

#### Consensus pricing services

57. Some entities may use pricing data from consensus pricing services which differ from other pricing services. Consensus pricing services obtain pricing information about an instrument from several participating entities (subscribers). Each subscriber submits prices to the pricing service. The pricing service treats this information confidentially and returns to each subscriber the consensus price, which is usually an arithmetical average of the data after a data cleansing routine has been employed to eliminate outliers. For some markets, such as for exotic derivatives, consensus prices might constitute the best available data. However, many factors are considered when assessing the representational faithfulness of the consensus prices including, for example:
- Whether the prices submitted by the subscribers reflect actual transactions or just indicative prices based on their own valuation techniques.
  - The number of sources from which prices have been obtained.
  - The quality of the sources used by the consensus pricing service.
  - Whether participants include leading market participants
58. Typically consensus prices are only available to subscribers who have submitted their own prices to the service. Accordingly not all entities will have direct access to consensus prices. Because a subscriber generally cannot know how the prices submitted were estimated, other sources of evidence in addition to information from consensus pricing services may be needed for management to support their valuation. In particular, this may be the case if the sources are providing indicative prices based on their own valuation techniques

and management is unable to obtain an understanding of how these sources calculated their prices.

#### Brokers providing broker quotes

59. As brokers provide quotes only as an incidental service for their clients, quotes they provide differ in many respects from prices obtained in pricing services. Brokers may be unwilling to provide information about the process used to develop their quote, but may have access to information on transactions about which a pricing service may not be aware. Broker quotes may be executable or indicative. Indicative quotes are a broker's best estimate of fair value, whereas an executable quote shows that the broker is willing to transact at this price. Executable quotes are strong evidence of fair value. Indicative quotes are less so because of the lack of transparency into the methods used by the broker to establish the quote. In addition the rigor of controls over the brokers' quote often will differ depending on whether the broker also holds the same security in its own portfolio. Broker quotes are often used for securities with level 3 inputs and sometimes may be the only external information available.

#### Further considerations relating to third-party pricing sources

60. Understanding how the pricing sources calculated a price enables management to determine whether such information is suitable for use in its valuation, including as an input to a valuation technique and in what level of inputs the security should be categorized for disclosure purposes. For example, third-party pricing sources may value financial instruments using proprietary models, and it is important that management understands the methodology, assumptions and data used.
61. If fair value measurements obtained from third-party pricing sources are not based on the current prices of an active market, it will be necessary for management to evaluate whether the fair value measurements were derived in a manner that is consistent with the applicable financial reporting framework. Management's understanding of the fair value measurement includes:
- How the fair value measurement was determined—for example, whether the fair value measurement was determined by a valuation technique, in order to assess whether it is consistent with the fair value measurement objective;
  - Whether the quotes are indicative prices, indicative spread, or binding offers; and
  - How frequently the fair value measurement is estimated by the third-party pricing sources—in order to assess whether it reflects market conditions at the measurement date.

Understanding the bases on which third-party pricing sources have determined their quotes in the context of the particular financial instruments held by the

entity assists management in evaluating the relevance and reliability of this evidence to support its valuations.

62. It is possible that there will be disparities between price indicators from different sources. Understanding how the price indicators were derived, and investigating these disparities, assists management in corroborating the evidence used in developing its valuation of financial instruments in order to evaluate whether the valuation is reasonable. Simply taking the average of the quotes provided, without doing further research, may not be appropriate, because one price in the range may be the most representative of fair value and this may not be the average. To evaluate whether its valuations of financial instruments are reasonable, management may:

- Consider whether actual transactions represent forced transactions rather than transactions between willing buyers and willing sellers. This may invalidate the price as a comparison;
- Analyze the expected future cash flows of the instrument. This could be performed as an indicator of the most relevant pricing data;
- Depending on the nature of what is unobservable, extrapolate from observed prices to unobserved ones (for example, there may be observed prices for maturities up to ten years but not longer, but the ten year price curve may be capable of being extrapolated beyond ten years as an indicator). Care is needed to ensure that extrapolation is not carried so far beyond the observable curve that its link to observable prices becomes too tenuous to be reliable;
- Compare prices within a portfolio of financial instruments to each other to make sure that they are consistent among similar financial instruments;
- Use more than one model to corroborate the results from each one, having regard to the data and assumptions used in each; or
- Evaluate movements in the prices for related hedging instruments and collateral.

In coming to its judgment as to its valuation, an entity may also consider other factors that may be specific to the entity's circumstances.

#### Use of Valuation Experts

63. Management may engage a valuation expert from an investment bank, broker, or other valuation firm to value some or all of its securities. Unlike pricing services and broker quotes, generally the methodology and data used are more readily available to management when they have engaged an expert to perform a valuation on their behalf. Even though management has engaged an expert, management is ultimately responsible for the valuation used.

*Issues Related to Financial Liabilities*

64. Understanding the effect of credit risk is an important aspect of valuing both financial assets and financial liabilities. This valuation reflects the credit quality and financial strength of both the issuer and any credit support providers. In some financial reporting frameworks, the measurement of a financial liability assumes that it is transferred to a market participant at the measurement date. Where there is not an observable market price for a financial liability, its value is typically measured using the same method as a counterparty would use to measure the value of the corresponding asset, unless there are factors specific to the liability (such as third-party credit enhancement). In particular, the entity's own credit risk<sup>10</sup> can often be difficult to measure.

**Presentation and Disclosure about Financial Instruments**

65. Most financial reporting frameworks require disclosures in the financial statements to enable users of the financial statements to make meaningful assessments of the effects of the entity's financial instrument activities, including the risks and uncertainties associated with financial instruments.
66. Most frameworks require the disclosure of quantitative and qualitative information (including accounting policies) relating to financial instruments. The accounting requirements for fair value measurements in financial statement presentation and disclosures are extensive in most financial reporting frameworks and encompass more than just valuation of the financial instruments. For example, qualitative disclosures about financial instruments provide important contextual information about the characteristics of the financial instruments and their future cash flows that may help inform investors about the risks to which entities are exposed.

*Categories of Disclosures*

67. Disclosure requirements include:
- (a) Quantitative disclosures that are derived from the amounts included in the financial statements—for example, categories of financial assets and liabilities;
  - (b) Quantitative disclosures that require significant judgment—for example, sensitivity analysis for each type of market risk to which the entity is exposed; and
  - (c) Qualitative disclosures—for example, those that describe the entity's governance over financial instruments; objectives; controls, policies and processes for managing each type of risk arising from financial instruments; and the methods used to measure the risks.

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<sup>10</sup> Own credit risk is the amount of change in fair value that is not attributable to changes in market conditions.

68. The more sensitive the valuation is to movements in a particular variable, the more likely it is that disclosure will be necessary to indicate the uncertainties surrounding the valuation. Certain financial reporting frameworks may also require disclosure of sensitivity analyses, including the effects of changes in assumptions used in the entity's valuation techniques. For example, the additional disclosures required for financial instruments with fair value measurements that are categorized within level 3 inputs of the fair value hierarchy are aimed at informing users of financial statements about the effects of those fair value measurements that use the most subjective inputs.
69. Some financial reporting frameworks require disclosure of information that enables users of the financial statements to evaluate the nature and extent of the risks arising from financial instruments to which the entity is exposed at the reporting date. This disclosure may be contained in the notes to the financial statements, or in management's discussion and analysis within its annual report cross-referenced from the audited financial statements. The extent of disclosure depends on the extent of the entity's exposure to risks arising from financial instruments. This includes qualitative disclosures about:
- The exposures to risk and how they arise, including the possible effects on an entity's future liquidity and collateral requirements;
  - The entity's objectives, policies and processes for managing the risk and the methods used to measure the risk; and
  - Any changes in exposures to risk or objectives, policies or processes for managing risk from the previous period.

## **Section II—Audit Considerations Relating to Financial Instruments**

70. Certain factors may make auditing financial instruments particularly challenging. For example:
- It may be difficult for both management and the auditor to understand the nature of financial instruments and what they are used for, and the risks to which the entity is exposed.
  - Market sentiment and liquidity can change quickly, placing pressure on management to manage their exposures effectively.
  - Evidence supporting valuation may be difficult to obtain.
  - Individual payments associated with certain financial instruments may be significant, which may increase the risk of misappropriation of assets.
  - The amounts recorded in the financial statements relating to financial instruments may not be significant, but there may be significant risks and exposures associated with these financial instruments.
  - A few employees may exert significant influence on the entity's financial instruments transactions, in particular where their compensation

arrangements are tied to revenue from financial instruments, and there may be possible undue reliance on these individuals by others within the entity.

These factors may cause risks and relevant facts to be obscured, which may affect the auditor's assessment of the risks of material misstatement, and latent risks can emerge rapidly, especially in adverse market conditions.

### **Professional Skepticism<sup>11</sup>**

71. Professional skepticism is necessary to the critical assessment of audit evidence and assists the auditor in remaining alert for possible indications of management bias. This includes questioning contradictory audit evidence and the reliability of documents, responses to inquiries and other information obtained from management and those charged with governance. It also includes being alert to conditions that may indicate possible misstatement due to error or fraud and considering the sufficiency and appropriateness of audit evidence obtained in light of the circumstances.
72. Application of professional skepticism is required in all circumstances, and the need for professional skepticism increases with the complexity of financial instruments, for example with regard to:
  - Evaluating whether sufficient appropriate audit evidence has been obtained, which can be particularly challenging when models are used or in determining if markets are inactive.
  - Evaluating management's judgments, and the potential for management bias, in applying the entity's applicable financial reporting framework, in particular management's choice of valuation techniques, use of assumptions in valuation techniques, and addressing circumstances in which the auditor's judgments and management's judgments differ.
  - Drawing conclusions based on the audit evidence obtained, for example assessing the reasonableness of valuations prepared by management's experts and evaluating whether disclosures in the financial statements achieve fair presentation.

### **Planning Considerations<sup>12</sup>**

73. The auditor's focus in planning the audit is particularly on:
  - Understanding the accounting and disclosure requirements;
  - Understanding the financial instruments to which the entity is exposed, and their purpose and risks;

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<sup>11</sup> ISA 200, paragraph 15

<sup>12</sup> ISA 300, *Planning an Audit of Financial Statements*, deals with the auditor's responsibility to plan an audit of financial statements.

- Determining whether specialized skills and knowledge are needed in the audit;
- Understanding and evaluating the system of internal control in light of the entity's financial instrument transactions and the information systems that fall within the scope of the audit;
- Understanding the nature, role and activities of the internal audit function;
- Understanding management's process for valuing financial instruments, including whether management has used an expert or a service organization; and
- Assessing and responding to the risk of material misstatement.

#### *Understanding the Accounting and Disclosure Requirements*

74. ISA 540 requires the auditor to obtain an understanding of the requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures and any regulatory requirements.<sup>13</sup> The requirements of the applicable financial reporting framework regarding financial instruments may themselves be complex and require extensive disclosures. Reading this IAPN is not a substitute for a full understanding of all the requirements of the applicable financial reporting framework. Certain financial reporting frameworks require consideration of areas such as:

- Hedge accounting;
- Accounting for "Day 1" profits or losses;
- Recognition and derecognition of financial instrument transactions;
- Own credit risk; and
- Risk transfer and derecognition, in particular where the entity has been involved in the origination and structuring of complex financial instruments.

#### *Understanding the Financial Instruments*

75. The characteristics of financial instruments may obscure certain elements of risk and exposure. Obtaining an understanding of the instruments in which the entity has invested or to which it is exposed, including the characteristics of the instruments, helps the auditor to identify whether:

- Important aspects of a transaction are missing or inaccurately recorded;
- A valuation appears appropriate;

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<sup>13</sup> ISA 540, paragraph 8(a)

- The risks inherent in them are fully understood and managed by the entity; and
  - The financial instruments are appropriately classified into current and non-current assets and liabilities.
76. Examples of matters that the auditor may consider when obtaining an understanding of the entity’s financial instruments include:
- To which types of financial instruments the entity is exposed.
  - The use to which they are put.
  - Management’s and, where appropriate, those charged with governance’s understanding of the financial instruments, their use and the accounting requirements.
  - Their exact terms and characteristics so that their implications can be fully understood and, in particular where transactions are linked, the overall impact of the financial instrument transactions.
  - How they fit into the entity’s overall risk management strategy.

Inquiries of the internal audit function, the risk management function, if such functions exist, and discussions with those charged with governance may inform the auditor’s understanding.

77. In some cases, a contract, including a contract for a non-financial instrument may contain a derivative. Some financial reporting frameworks permit or require such “embedded” derivatives to be separated from the host contract in some circumstances. Understanding management’s process for identifying, and accounting for, embedded derivatives will assist the auditor in understanding the risks to which the entity is exposed.

#### *Using Those with Specialized Skills and Knowledge in the Audit<sup>14</sup>*

78. A key consideration in audits involving financial instruments, particularly complex financial instruments, is the competence of the auditor. ISA 220<sup>15</sup> requires the engagement partner to be satisfied that the engagement team, and any auditor’s experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit

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<sup>14</sup> When such a person’s expertise is in auditing and accounting, regardless of whether the person is from within or external to the firm, this person is considered to be part of the engagement team and is subject to the requirements of ISA 220, *Quality Control for an Audit of Financial Statements*. When such a person’s expertise is in a field other than accounting or auditing, such person is considered to be an auditor’s expert, and the provisions of ISA 620, *Using the Work of an Auditor’s Expert*, apply. ISA 620 explains that distinguishing between specialized areas of accounting or auditing, and expertise in another field, will be a matter of professional judgment, but notes the distinction may be made between expertise in methods of accounting for financial instruments (accounting and auditing expertise) and expertise in complex valuation techniques for financial instruments (expertise in a field other than accounting or auditing).

<sup>15</sup> ISA 220, paragraph 14

engagement in accordance with professional standards and applicable legal and regulatory requirements and to enable an auditor's report that is appropriate in the circumstances to be issued. Further, relevant ethical requirements<sup>16</sup> require the auditor to determine whether acceptance of the engagement would create any threats to compliance with the fundamental principles, including the professional competence and due care. Paragraph 79 below provides examples of the types of matters that may be relevant to the auditor's considerations in the context of financial instruments.

79. Accordingly, auditing financial instruments may require the involvement of one or more experts or specialists, for example, in the areas of:

- Understanding the financial instruments used by the entity and their characteristics, including their level of complexity. Using specialized skills and knowledge may be needed in checking whether all aspects of the financial instrument and related considerations have been captured in the financial statements, and evaluating whether adequate disclosure in accordance with the applicable financial reporting framework has been made where disclosure of risks is required.
- Understanding the applicable financial reporting framework, especially when there are areas known to be subject to differing interpretations, or practice is inconsistent or developing.
- Understanding the legal, regulatory, and tax implications resulting from the financial instruments, including whether the contracts are enforceable by the entity (for example, reviewing the underlying contracts), may require specialized skills and knowledge.
- Assessing the risks inherent in a financial instrument.
- Assisting the engagement team gather evidence to support management's valuations or to develop a point estimate or range, especially when fair value is determined by a complex model; when markets are inactive and data and assumptions are difficult to obtain; when unobservable inputs are used; or when management has used an expert.
- Evaluating information technology controls, especially in entities with a high volume of financial instruments. In such entities information technology may be highly complex, for example when significant information about those financial instruments is transmitted, processed, maintained or accessed electronically. In addition, it may include relevant services provided by a service organization.

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<sup>16</sup> International Ethics Standards Board of Accountants' (IESBA) *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) paragraphs 320.1-320.10 A1

80. The nature and use of particular types of financial instruments, the complexities associated with accounting requirements, and market conditions may lead to a need for the engagement team to consult<sup>17</sup> with other accounting and audit professionals, from within or outside the firm, with relevant technical accounting or auditing expertise and experience, taking into account factors such as:
- The capabilities and competence of the engagement team, including the experience of the members of the engagement team.
  - The attributes of the financial instruments used by the entity.
  - The identification of unusual circumstances or risks in the engagement, as well as the need for professional judgment, particularly with respect to materiality and significant risks.
  - Market conditions.

#### *Understanding Internal Control*

81. ISA 315 (Revised) establishes requirements for the auditor to understand the entity and its environment, including its internal control. Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding obtained enables the auditor to identify and assess the risks of material misstatement at the financial statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. The volume and variety of the financial instrument transactions of an entity typically determines the nature and extent of controls that may exist at an entity. An understanding of how financial instruments are monitored and controlled assists the auditor in determining the nature, timing and extent of audit procedures. The Appendix describes controls that may exist in an entity that deals in a high volume of financial instrument transactions.

#### *Understanding the Nature, Role and Activities of the Internal Audit Function*

82. In many large entities, the internal audit function may perform work that enables senior management and those charged with governance to review and evaluate the entity's controls relating to the use of financial instruments. The internal audit function may assist in identifying the risks of material misstatement due to fraud or error. However, the knowledge and skills required of an internal audit function to understand and perform procedures to provide assurance to management or those charged with governance on the entity's use of financial instruments are generally quite different from those needed for other parts of

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<sup>17</sup> ISA 220, paragraph 18(b), requires the engagement partner to be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm.

the business. The extent to which the internal audit function has the knowledge and skill to cover, and has in fact covered, the entity's financial instrument activities, as well as the competence and objectivity of the internal audit function, is a relevant consideration in the external auditor's determination of whether the internal audit function is likely to be relevant to the overall audit strategy and audit plan.

83. Areas where the work of the internal audit function may be particularly relevant are:<sup>18</sup>

- Developing a general overview of the extent of use of financial instruments;
- Evaluating the appropriateness of policies and procedures and management's compliance with them;
- Evaluating the operating effectiveness of financial instrument control activities;
- Evaluating systems relevant to financial instrument activities; and
- Assessing whether new risks relating to financial instruments are identified, assessed and managed.

#### *Understanding Management's Methodology for Valuing Financial Instruments*

84. Management's responsibility for the preparation of the financial statements includes applying the requirements of the applicable financial reporting framework to the valuation of financial instruments. ISA 540 requires the auditor to obtain an understanding of how management makes accounting estimates and the data on which accounting estimates are based.<sup>19</sup> Management's approach to valuation also takes into account the selection of an appropriate valuation methodology and the level of the evidence expected to be available. To meet the objective of a fair value measurement, an entity develops a valuation methodology to measure the fair value of financial instruments that considers all relevant market information that is available. A thorough understanding of the financial instrument being valued allows an entity to identify and evaluate the relevant market information available about identical or similar instruments that should be incorporated into the valuation methodology.

### **Assessing and Responding to the Risks of Material Misstatement**

#### *Overall Considerations Relating to Financial Instruments*

85. ISA 540<sup>20</sup> explains that the degree of estimation uncertainty affects the risk of material misstatement of accounting estimates. The use of more complex

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<sup>18</sup> Work performed by functions such as the risk management function, model review functions, and product control, may also be relevant.

<sup>19</sup> ISA 540, paragraph 8(c)

<sup>20</sup> ISA 540, paragraph 2

financial instruments, such as those that have a high level of uncertainty and variability of future cash flows, may lead to an increased risk of material misstatement, particularly regarding valuation. Other matters affecting the risk of material misstatement include:

- The volume of financial instruments to which the entity is exposed.
- The terms of the financial instrument, including whether the financial instrument itself includes other financial instruments.
- The nature of the financial instruments.

#### *Fraud Risk Factors<sup>21</sup>*

86. Incentives for fraudulent financial reporting by employees may exist where compensation schemes are dependent on returns made from the use of financial instruments. Understanding how an entity's compensation policies interact with its risk appetite, and the incentives that this may create for its management and traders, may be important in assessing the risk of fraud.
87. Difficult financial market conditions may give rise to increased incentives for management or employees to engage in fraudulent financial reporting: to protect personal bonuses, to hide employee or management fraud or error, to avoid breaching regulatory, liquidity or borrowing limits or to avoid reporting losses. For example, at times of market instability, unexpected losses may arise from extreme fluctuations in market prices, from unanticipated weakness in asset prices, through trading misjudgments, or for other reasons. In addition, financing difficulties create pressures on management concerned about the solvency of the business.
88. Misappropriation of assets and fraudulent financial reporting may often involve override of controls that otherwise may appear to be operating effectively. This may include override of controls over data, assumptions and detailed process controls that allow losses and theft to be hidden. For example, difficult market conditions may increase pressure to conceal or offset trades as they attempt to recover losses.

#### *Assessing the Risk of Material Misstatement*

89. The auditor's assessment of the identified risks at the assertion level in accordance with ISA 315 (Revised) includes evaluating the design and implementation of internal control. It provides a basis for considering the appropriate audit approach for designing and performing further audit procedures in accordance with ISA 330, including both substantive procedures and tests of controls. The approach taken is influenced by the auditor's understanding of internal control relevant to the audit, including the strength of the control environment and any

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<sup>21</sup> See ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, for requirements and guidance dealing with fraud risk factors.

risk management function, the size and complexity of the entity's operations and whether the auditor's assessment of the risks of material misstatement include an expectation that controls are operating effectively.

90. The auditor's assessment of the risk of material misstatement at the assertion level may change during the course of the audit as additional information is obtained. Remaining alert during the audit, for example, when inspecting records or documents may assist the auditor in identifying arrangements or other information that may indicate the existence of financial instruments that management has not previously identified or disclosed to the auditor. Such records and documents may include, for example:
- Minutes of meetings of those charged with governance; and
  - Specific invoices from, and correspondence with, the entity's professional advisors.

*Factors to Consider in Determining Whether, and to What Extent, to Test the Operating Effectiveness of Controls*

91. An expectation that controls are operating effectively may be more common when dealing with a financial institution with well-established controls, and therefore controls testing may be an effective means of obtaining audit evidence. When an entity has a trading function, substantive tests alone may not provide sufficient appropriate audit evidence due to the volume of contracts and the different systems used. Tests of controls, however, will not be sufficient on their own as the auditor is required by ISA 330 to design and perform substantive procedures for each material class of transactions, account balance and disclosure.<sup>22</sup>
92. Entities with a high volume of trading and use of financial instruments may have more sophisticated controls, and an effective risk management function, and therefore the auditor may be more likely to test controls in obtaining evidence about:
- The occurrence, completeness, accuracy, and cutoff of the transactions; and
  - The existence, rights and obligations, and completeness of account balances.
93. In those entities with relatively few financial instrument transactions:
- Management and those charged with governance may have only a limited understanding of financial instruments and how they affect the business;
  - The entity may only have a few different types of instruments with little or no interaction between them;

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<sup>22</sup> ISA 330, paragraph 18

- There is unlikely to be a complex control environment (for example, the controls described in the Appendix may not be in place at the entity);
  - Management may use pricing information from third-party pricing sources to value their instruments; and
  - Controls over the use of pricing information from third-party pricing sources may be less sophisticated.
94. When an entity has relatively few transactions involving financial instruments, it may be relatively easy for the auditor to obtain an understanding of the entity's objectives for using the financial instruments and the characteristics of the instruments. In such circumstances, much of the audit evidence is likely to be substantive in nature, the auditor may perform the majority of the audit work at year-end, and third-party confirmations are likely to provide evidence in relation to the completeness, accuracy, and existence of the transactions.
95. In reaching a decision on the nature, timing and extent of testing of controls, the auditor may consider factors such as:
- The nature, frequency and volume of financial instrument transactions;
  - The strength of controls, including whether controls are appropriately designed to respond to the risks associated with an entity's volume of financial instrument transactions and whether there is a governance framework over the entity's financial instrument activities;
  - The importance of particular controls to the overall control objectives and processes in place at the entity, including the sophistication of the information systems to support financial instrument transactions;
  - The monitoring of controls and identified deficiencies in control procedures;
  - The issues the controls are intended to address, for example, controls related to the exercise of judgments compared with controls over supporting data. Substantive tests are more likely to be effective than relying on controls related to the exercise of judgment;
  - The competency of those involved in the control activities, for example whether the entity has adequate capacity, including during periods of stress, and ability to establish and verify valuations for the financial instruments to which it is exposed;
  - The frequency of performance of these control activities;
  - The level of precision the controls are intended to achieve;
  - The evidence of performance of control activities; and
  - The timing of key financial instrument transactions, for example, whether they are close to the period end.

*Substantive Procedures*

96. Designing substantive procedures includes consideration of:
- The use of analytical procedures<sup>23</sup>—While analytical procedures undertaken by the auditor can be effective as risk assessment procedures to provide the auditor with information about an entity’s business, they may be less effective as substantive procedures when performed alone. This is because the complex interplay of the drivers of the valuation often mask any unusual trends that might arise.
  - Non-routine transactions—Many financial transactions are negotiated contracts between an entity and its counterparty (often known as “over the counter” or OTC.) To the extent that financial instrument 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. In instances where financial instrument transactions are not undertaken routinely, the auditor’s responses to assessed risk, including designing and performing audit procedures, have regard to the entity’s possible lack of experience in this area.
  - Availability of evidence—For example, when the entity uses a third-party pricing source, evidence concerning the relevant financial statement assertions may not be available from the entity.
  - Procedures performed in other audit areas—Procedures performed in other financial statement areas may provide evidence about the completeness of financial instrument transactions. These procedures may include tests of subsequent cash receipts and payments, and the search for unrecorded liabilities.
  - Selection of items for testing—In some cases, the financial instrument portfolio will comprise instruments with varying complexity and risk. In such cases, judgmental sampling may be useful.
97. For example, in the case of an asset-backed security, in responding to the risks of material misstatement for such a security, the auditor may consider performing some of the following audit procedures:
- Examining contractual documentation to understand the terms of the security, the underlying collateral and the rights of each class of security holder.
  - Inquiring about management’s process of estimating cash flows.

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<sup>23</sup> ISA 315 (Revised), paragraph 6(b), requires the auditor to apply analytical procedures as risk assessment procedures to assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. ISA 520, *Analytical Procedures*, paragraph 6, requires the auditor to use analytical procedures in forming an overall conclusion on the financial statements. Analytical procedures may also be applied at other stages of the audit.

- Evaluating the reasonableness of assumptions, such as prepayment rates, default rates and loss severities.
- Obtaining an understanding of the method used to determine the cash flow waterfall.
- Comparing the results of the fair value measurement with the valuations of other securities with similar underlying collateral and terms.
- Reperforming calculations.

#### *Dual-Purpose Tests*

98. Although the purpose of a test of controls is different from the purpose of a test of details, it may be efficient to perform both at the same time by, for example:
- Performing a test of controls and a test of details on the same transaction (for example, testing whether a signed contract has been maintained and whether the details of the financial instrument have been appropriately captured in a summary sheet; or
  - Testing controls when testing management's process of making valuation estimates.

#### *Timing of the Auditor's Procedures<sup>24</sup>*

99. After assessing the risks associated with financial instruments, the engagement team determines the timing of planned tests of controls and substantive audit procedures. The timing of planned audit procedures varies depending on a number of factors, including the frequency of the control operation, the significance of the activity being controlled, and the related risk of material misstatement.
100. While it is necessary to undertake most of the audit procedures in relation to valuation and presentation at the period end, audit procedures in relation to other assertions such as completeness and existence can usefully be tested at an interim period. For example tests of controls may be performed at an interim period for more routine controls, such as IT controls and authorizations for new products. Also, it may be effective to test the operating effectiveness of controls over new product approval by gathering evidence of the appropriate level of management sign-off on a new financial instrument for an interim period.
101. Auditors may perform some tests on models as of an interim date, for example, by comparing the output of the model to market transactions. Another possible interim procedure for instruments with observable inputs is to test the reasonableness of the pricing information provided by a third-party pricing source.

<sup>24</sup> Paragraphs 11–12 and 22–23 of ISA 330 establish requirements when the auditor performs procedures at an interim period and explains how such audit evidence can be used.

102. Areas of more significant judgment are often tested close to, or at, the period end as:
- Valuations can change significantly in a short period of time, making it difficult to compare and reconcile interim balances with comparable information at the balance sheet date;
  - An entity may engage in an increased volume of financial instrument transactions between an interim period and year-end;
  - Manual journal entries may only be made after the end of the accounting period; and
  - Non-routine or significant transactions may take place late in the accounting period.

*Procedures Relating to Completeness, Accuracy, Existence, Occurrence and Rights and Obligations*

103. Many of the auditor's procedures can be used to address a number of assertions. For example, procedures to address the existence of an account balance at period end will also address the occurrence of a class of transactions, and may also assist in establishing proper cut-off. This is because financial instruments arise from legal contracts and, by verifying the accuracy of the recording of the transaction, the auditor can also verify its existence, and obtain evidence to support the occurrence and rights and obligations assertions at the same time, and confirm that transactions are recorded in the correct accounting period.
104. Procedures that may provide audit evidence to support the completeness, accuracy, and existence assertions include:
- External confirmation<sup>25</sup> of bank accounts, trades, and custodian statements. This can be done by direct confirmation with the counterparty (including the use of bank confirmations), where a reply is sent to the auditor directly. Alternatively this information may be obtained from the counterparty's systems through a data feed. Where this is done, controls to prevent tampering with the computer systems through which the information is transmitted may be considered by the auditor in evaluating the reliability of the evidence from the confirmation. If confirmations are not received, the auditor may be able to obtain evidence by reviewing contracts and testing relevant controls. External confirmations, however, often do not provide adequate audit evidence with respect to the valuation assertion though they may assist in identifying any side agreements.

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<sup>25</sup> ISA 505, *External Confirmations*, deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of ISA 330 and ISA 500, *Audit Evidence*. See also the Staff Audit Practice Alert, *Emerging Practice Issues Regarding the Use of External Confirmations in an Audit of Financial Statements*, issued in November 2009.

- Reviewing reconciliations of statements or data feeds from custodians with the entity's own records. This may necessitate evaluating IT controls around and within automated reconciliation processes and to evaluate whether reconciling items are properly understood and resolved.
- Reviewing journal entries and the controls over the recording of such entries. This may assist in, for example:
  - Determining if entries have been made by employees other than those authorized to do so.
  - Identifying unusual or inappropriate end-of-period journal entries, which may be relevant to fraud risk.
- Reading individual contracts and reviewing supporting documentation of the entity's financial instrument transactions, including accounting records, thereby verifying existence and rights and obligations. For example, an auditor may read individual contracts associated with financial instruments and review supporting documentation, including the accounting entries made when the contract was initially recorded, and may also subsequently review accounting entries made for valuation purposes. Doing so allows the auditor to evaluate whether the complexities inherent in a transaction have been fully identified and reflected in the accounts. Legal arrangements and their associated risks need to be considered by those with suitable expertise to ensure that rights exist.
- Testing controls, for example by reperforming controls.
- Reviewing the entity's complaints management systems. Unrecorded transactions may result in the entity's failure to make a cash payment to a counterparty, and may be detected by reviewing complaints received.
- Reviewing master netting arrangements to identify unrecorded instruments.

105. These procedures are particularly important for some financial instruments, such as derivatives or guarantees. This is because they may not have a large initial investment, meaning it may be hard to identify their existence. For example, embedded derivatives are often contained in contracts for non-financial instruments which may not be included in confirmation procedures.

## Valuation of Financial Instruments

### *Financial Reporting Requirements*

106. Fair presentation financial reporting frameworks often use fair value hierarchies, for example those used in IFRS and U.S. GAAP. This usually means that

the volume and detail of the required disclosures increases as the level of measurement uncertainty increases. The distinction between the levels in the hierarchy may require judgment.

107. The auditor may find it useful to obtain an understanding of how the financial instruments relate to the fair value hierarchy. Ordinarily, the risk of material misstatement, and the level of audit procedures to be applied, increases as the level of measurement uncertainty increases. The use of level 3, and some level 2, inputs from the fair value hierarchy may be a useful guide to the level of measurement uncertainty. Level 2 inputs vary from those which are easily obtained to those which are closer to level 3 inputs. The auditor evaluates available evidence and understands both the fair value hierarchy and the risk of management bias in management's categorization of financial instruments in the fair value hierarchy.
108. In accordance with ISA 540,<sup>26</sup> the auditor considers the entity's valuation policies and methodology for data and assumptions used in the valuation methodology. In many cases, the applicable financial reporting framework does not prescribe the valuation methodology. When this is the case, matters that may be relevant to the auditor's understanding of how management values financial instruments include, for example:
- Whether management has a formal valuation policy and, if so, whether the valuation technique used for a financial instrument is appropriately documented in accordance with that policy;
  - Which models may give rise to the greatest risk of material misstatement;
  - How management considered the complexity of the valuation of the financial instrument when selecting a particular valuation technique;
  - Whether there is a greater risk of material misstatement because management has internally developed a model to be used to value financial instruments or is departing from a valuation technique commonly used to value the particular financial instrument;
  - Whether management made use of a third-party pricing source;
  - Whether those involved in developing and applying the valuation technique have the appropriate skills and expertise to do so, including whether a management's expert has been used; and
  - Whether there are indicators of management bias in selecting the valuation technique to be used.

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<sup>26</sup> ISA 540, paragraph 8(c)

*Assessing the Risk of Material Misstatement Related to Valuation*

109. When evaluating whether the valuation techniques used by an entity are appropriate in the circumstances, and whether controls over valuation techniques are in place, the factors considered by the auditor may include:

- Whether the valuation techniques are commonly used by other market participants and have been previously demonstrated to provide a reliable estimate of prices obtained from market transactions;
- Whether the valuation techniques operate as intended and there are no flaws in their design, particularly under extreme conditions, and whether they have been objectively validated. Indicators of flaws include inconsistent movements relative to benchmarks;
- Whether the valuation techniques take account of the risks inherent in the financial instrument being valued, including counterparty creditworthiness, and own credit risk in the case of valuation techniques used to measure financial liabilities;
- How the valuation techniques are calibrated to the market, including the sensitivity of the valuation techniques to changes in variables;
- Whether market variables and assumptions are used consistently and whether new conditions justify a change in the valuation techniques, market variables or assumptions used;
- Whether sensitivity analyses indicate that valuations would change significantly with only small or moderate changes in assumptions;
- The organizational structure, such as the existence of an internal department responsible for developing models to value certain instruments, particularly where level 3 inputs are involved. For example, a model development function that is involved in assisting in pricing deals is less objective than one which is functionally and organizationally segregated from the front office; and
- The competence and objectivity of those responsible for the development and application of the valuation techniques, including management's relative experience with particular models that may be newly developed.
- The auditor (or auditor's expert) may also independently develop one or more valuation techniques to compare its output with that of the valuation techniques used by management.

**Significant Risks**

110. The auditor's risk assessment process may lead the auditor to identify one or more significant risks relating to the valuation of financial instruments, when any of the following circumstances exist:

- High measurement uncertainty related to the valuation of financial instruments (for example, those with unobservable inputs).<sup>27</sup>
  - Lack of sufficient evidence to support management's valuation of its financial instruments.
  - Lack of management understanding of its financial instruments or expertise necessary to value such instruments properly, including the ability to determine whether valuation adjustments are needed.
  - Lack of management understanding of complex requirements in the applicable financial reporting framework relating to measurement and disclosure of financial instruments, and inability of management to make the judgments required to properly apply those requirements.
  - The significance of valuation adjustments made to valuation technique outputs when the applicable financial reporting framework requires or permits such adjustments.
111. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA 330, ISA 540<sup>28</sup> requires the auditor to evaluate the following:
- (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed measurement uncertainty in making the accounting estimate;
  - (b) Whether the significant assumptions used by management are reasonable; and
  - (c) Where relevant to the reasonableness of the significant assumptions used by management, or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.
112. As markets become inactive, the change in circumstances may lead to a move from valuation by market price to valuation by model, or may result in a change from one particular model to another. Reacting to changes in market conditions may be difficult if management does not have policies in place prior to their occurrence. Management may also not possess the expertise necessary to develop a model on an urgent basis, or select the valuation technique that may be appropriate in the circumstances. Even where valuation techniques have been consistently used, there is a need for management to examine the continuing appropriateness of the valuation techniques and assumptions used

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<sup>27</sup> Where the auditor determines that the high estimation uncertainty related to the valuation of complex financial instruments gives rise to a significant risk, ISA 540 requires the auditor to perform substantive procedures and evaluate the adequacy of the disclosure of their estimation uncertainty. See ISA 540, paragraphs 11, 15 and 20.

<sup>28</sup> ISA 540, paragraph 15(a)-(b)

for determining valuation of financial instruments. Further, valuation techniques may have been selected in times where reasonable market information was available, but may not provide reasonable valuations in times of unanticipated stress.

113. The susceptibility to management bias, whether intentional or unintentional, increases with the subjectivity of the valuation and the degree of measurement uncertainty. For example, management may tend to ignore observable marketplace assumptions or data and instead use their own internally-developed model if the model yields more favorable results. Even without fraudulent intent, there may be a natural temptation to bias judgments towards the most favorable end of what may be a wide spectrum, rather than the point in the spectrum that might be considered to be most consistent with the applicable financial reporting framework. Changing the valuation technique from period to period without a clear and appropriate reason for doing so may also be an indicator of management bias. Although some form of management bias is inherent in subjective decisions relating to the valuation of financial instruments, when there is intention to mislead, management bias is fraudulent in nature.

#### *Developing an Audit Approach*

114. In testing how management values the financial instrument and in responding to the assessed risks of material misstatement in accordance with ISA 540,<sup>29</sup> the auditor undertakes one or more of the following procedures, taking account of the nature of the accounting estimates:
- (a) Test how management made the accounting estimate and the data on which it is based (including valuation techniques used by the entity in its valuations).
  - (b) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
  - (c) Develop a point estimate or a range to evaluate management's point estimate.
  - (d) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

Many auditors find that a combination of testing how management valued the financial instrument, and the data on which it is based, and testing the operating effectiveness of controls, will be an effective and efficient audit approach. While subsequent events may provide some evidence about the valuation of financial instruments, other factors may need to be taken into account to address any changes in market conditions subsequent to the balance sheet date.<sup>30</sup> If the

<sup>29</sup> ISA 540, paragraphs 12–14

<sup>30</sup> Paragraphs A63–A66 of ISA 540 provide examples of some of the factors that may be relevant.

auditor is unable to test how management made the estimate, the auditor may choose to develop a point estimate or range.

115. As described in Section I, to estimate the fair value of financial instruments management may:

- Utilize information from third-party pricing sources;
- Gather data to develop their own estimate using various techniques including models; and
- Engage an expert to develop an estimate.

Management often may use a combination of these approaches. For example, management may have their own pricing process but use third-party pricing sources to corroborate their own values.

#### *Audit Considerations When Management Uses a Third-Party Pricing Source*

116. Management may make use of a third-party pricing source, such as a pricing service or broker, in valuing the entity's financial instruments. Understanding how management uses the information and how the pricing service operates assists the auditor in determining the nature and extent of audit procedures needed.

117. The following matters may be relevant where management uses a third-party pricing source:

- *The type of third-party pricing source* – Some third-party pricing sources make more information available about their process. For example, a pricing service often provides information about their methodology, assumptions and data in valuing financial instruments at the asset class level. By contrast, brokers often provide no, or only limited, information about the inputs and assumptions used in developing the quote.
- *The nature of inputs used and the complexity of the valuation technique* – The reliability of prices from third-party pricing sources varies depending on the observability of inputs (and accordingly, the level of inputs in the fair value hierarchy), and the complexity of the methodology for valuing a specific security or asset class. For example, the reliability of a price for an equity investment actively traded in a liquid market is higher than that of a corporate bond traded in a liquid market that has not traded on the measurement date, which, in turn, is more reliable than that of an asset-backed security that is valued using a discounted cash flow model.
- *The reputation and experience of the third-party pricing source* – For example, a third-party pricing source may be experienced in a certain type of financial instrument, and be recognized as such, but may not be similarly experienced in other types of financial instruments. The

auditor's past experience with the third-party pricing source may also be relevant in this regard.

- *The objectivity of the third-party pricing source* – For example, if a price obtained by management comes from a counterparty such as the broker who sold the financial instrument to the entity, or an entity with a close relationship with the entity being audited, the price may not be reliable.
- *The entity's controls over the use of third-party pricing sources* – The degree to which management has controls in place to assess the reliability of information from third-party pricing sources affects the reliability of the fair value measurement. For example, management may have controls in place to:
  - Review and approve the use of the third-party pricing source, including consideration of the reputation, experience and objectivity of the third-party pricing source.
  - Determine the completeness, relevance and accuracy of the prices and pricing-related data.
- *The third-party pricing source's controls* – The controls and processes over valuations for the asset classes of interest to the auditor. For example, a third-party pricing source may have strong controls around how prices are developed, including the use of a formalized process for customers, both buy and sell side, to challenge the prices received from the pricing service, when supported by appropriate evidence, which may enable the third-party pricing source to constantly correct prices to more fully reflect the information available to market participants.

118. Possible approaches to gathering evidence regarding information from third-party pricing sources may include the following:

- For level 1 inputs, comparing the information from third-party pricing sources with observable market prices.
- Reviewing disclosures provided by third-party pricing sources about their controls and processes, valuation techniques, inputs and assumptions.
- Testing the controls management has in place to assess the reliability of information from third-party pricing sources.
- Performing procedures at the third-party pricing source to understand and test the controls and processes, valuation techniques, inputs and assumptions used for asset classes or specific financial instruments of interest.
- Evaluating whether the prices obtained from third-party pricing sources are reasonable in relation to prices from other third-party pricing sources, the entity's estimate or the auditor's own estimate.

- Evaluating the reasonableness of valuation techniques, assumptions and inputs.
  - Developing a point estimate or a range for some financial instruments priced by the third-party pricing source and evaluating whether the results are within a reasonable range of each other.
  - Obtaining a service auditor's report that covers the controls over validation of the prices.<sup>31</sup>
119. Obtaining prices from multiple third-party pricing sources may also provide useful information about measurement uncertainty. A wide range of prices may indicate higher measurement uncertainty and may suggest that the financial instrument is sensitive to small changes in data and assumptions. A narrow range may indicate lower measurement uncertainty and may suggest less sensitivity to changes in data and assumptions. Although obtaining prices from multiple sources may be useful, when considering financial instruments that have inputs categorized at levels 2 or 3 of the fair value hierarchy, in particular, obtaining prices from multiple sources is unlikely to provide sufficient appropriate audit evidence on its own. This is because:
- (a) What appear to be multiple sources of pricing information may be utilizing the same underlying pricing source; and
  - (b) Understanding the inputs used by the third-party pricing source in determining the price may be necessary in order to categorize the financial instrument in the fair value hierarchy.
120. In some situations, the auditor may be unable to gain an understanding of the process used to generate the price, including any controls over the process of how reliably the price is determined, or may not have access to the model, including the assumptions and other inputs used. In such cases, the auditor may decide to undertake to develop a point estimate or a range to evaluate management's point estimate in responding to the assessed risk.

*Audit Considerations When Management Estimates Fair Values Using a Model*

121. Paragraph 13(b) of ISA 540 requires the auditor, if testing management's process of making the accounting estimate, to evaluate whether the method of measurement used is appropriate in the circumstances and the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.

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<sup>31</sup> Some pricing services may provide reports for users of its data to explain their controls over pricing data, that is, a report prepared in accordance with International Standard on Assurance Engagements (ISAE) 3402, *Assurance Reports on Controls at a Service Organization*. Management may request, and the auditor may consider obtaining, such a report to develop an understanding of how the pricing data is prepared and evaluate whether the controls at the pricing service can be relied upon.

122. Whether management has used a third-party pricing source, or is undertaking its own valuation, models are often used to value financial instruments, particularly when using inputs at levels 2 and 3 of the fair value hierarchy. In determining the nature, timing and extent of audit procedures on models, the auditor may consider the methodology, assumptions and data used in the model. When considering more complex financial instruments such as those using level 3 inputs, testing all three may be a useful source of audit evidence. However, when the model is both simple and generally accepted, such as some bond price calculations, audit evidence obtained from focusing on the assumptions and data used in the model may be a more useful source of evidence.
123. Testing a model can be accomplished by two main approaches:
- (a) The auditor can test management's model, by considering the appropriateness of the model used by management, the reasonableness of the assumptions and data used, and the mathematical accuracy; or
  - (b) The auditor can develop their own estimate, and then compare the auditor's valuation with that of the entity.
124. Where valuation of financial instruments is based on unobservable inputs (that is, level 3 inputs), matters that the auditor may consider include, for example, how management supports the following:
- The identification and characteristics of marketplace participants relevant to the financial instrument.
  - How unobservable inputs are determined on initial recognition.
  - Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
  - Whether it has incorporated the best input information available in the circumstances.
  - Where applicable, how its assumptions take account of comparable transactions.
  - Sensitivity analysis of models when unobservable inputs are used and whether adjustments have been made to address measurement uncertainty.
125. In addition, the auditor's industry knowledge, knowledge of market trends, understanding of other entities' valuations (having regard to confidentiality) and other relevant price indicators informs the auditor's testing of the valuations and the consideration of whether the valuations appear reasonable overall. If the valuations appear to be consistently overly aggressive or conservative, this may be an indicator of possible management bias.
126. Where there is a lack of observable external evidence, it is particularly important that those charged with governance have been appropriately engaged

to understand the subjectivity of management's valuations and the evidence that has been obtained to support these valuations. In such cases, it may be necessary for the auditor to evaluate whether there has been a thorough review and consideration of the issues, including any documentation, at all appropriate management levels within the entity, including with those charged with governance.

127. When markets become inactive or dislocated, or inputs are unobservable, management's valuations may be more judgmental and less verifiable and, as result, may be less reliable. In such circumstances, the auditor may test the model by a combination of testing controls operated by the entity, evaluating the design and operation of the model, testing the assumptions and data used in the model, and comparing its output to a point estimate or range developed by the auditor or to other third-party valuation techniques.<sup>32</sup>
128. It is likely that in testing the inputs used in an entity's valuation methodology,<sup>33</sup> for example, where such inputs are categorized in the fair value hierarchy, the auditor will also be obtaining evidence to support the disclosures required by the applicable financial reporting framework. For example, the auditor's substantive procedures to evaluate whether the inputs used in an entity's valuation technique (that is, level 1, level 2 and level 3 inputs) are appropriate, and tests of an entity's sensitivity analysis, will be relevant to the auditor's evaluation of whether the disclosures achieve fair presentation.

#### Evaluating Whether the Assumptions Used by Management Are Reasonable

129. An assumption used in a model may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the financial instrument.<sup>34</sup> Management may have considered alternative assumptions or outcomes by performing a sensitivity analysis. The extent of subjectivity associated with assumptions influences the degree of measurement uncertainty and may lead the auditor to conclude there is a significant risk, for example in the case of level 3 inputs.
130. Audit procedures to test the assumptions used by management, including those used as inputs to models, may include evaluating:
- Whether, and if so, how, management has incorporated market inputs into the development of assumptions, as it is generally preferable to seek to maximize the use of relevant observable inputs and minimize unobservable inputs;

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<sup>32</sup> ISA 540, paragraph 13(d) describes requirements when the auditor develops a range to evaluate management's point estimate. Valuation techniques developed by third parties and used by the auditor may, in some circumstances be considered the work of an auditor's expert and subject to the requirements in ISA 620.

<sup>33</sup> See, for example, paragraph 15 of ISA 540 for requirements relative to the auditor's evaluation of management's assumption regarding significant risks.

<sup>34</sup> See ISA 540, paragraph A107.

- Whether the assumptions are consistent with observable market conditions, and the characteristics of the financial asset or financial liability;
- Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different marketplace assumptions exist; and
- Whether sensitivity analyses indicate that valuations would change significantly with only small or moderate changes in assumptions.

See paragraphs A77 to A83 of ISA 540 for further considerations relative to evaluating the assumptions used by management.

131. The auditor's consideration of judgments about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.
132. In some cases, the discount rate in a present value calculation may be adjusted to account for the uncertainties in the valuation, rather than adjusting each assumption. In such cases, an auditor's procedures may focus on the discount rate, by looking at an observable trade on a similar security to compare the discount rates used or developing an independent model to calculate the discount rate and compare with that used by management.

*Audit Considerations When a Management's Expert Is Used by the Entity*

133. As discussed in Section I, management may engage a valuation expert to value some or all of their securities. Such experts may be brokers, investment bankers, pricing services that also provide expert valuation services, or other specialized valuation firms.
134. Paragraph 8 of ISA 500 contains requirements for the auditor when evaluating evidence from an expert engaged by management. The extent of the auditor's procedures in relation to a management's expert and that expert's work depend on the significance of the expert's work for the auditor's purposes. Evaluating the appropriateness of management's expert's work assists the auditor in assessing whether the prices or valuations supplied by a management's expert provide sufficient appropriate audit evidence to support the valuations. Examples of procedures the auditor may perform include:
  - Evaluating the competence, capabilities and objectivity of management's expert for example: their relationship with the entity; their reputation and standing in the market; their experience with the particular types of instruments; and their understanding of the relevant financial reporting framework applicable to the valuations;
  - Obtaining an understanding of the work of the management's expert, for example by assessing the appropriateness of the valuation technique(s)

used and the key market variables and assumptions used in the valuation technique(s);

- Evaluating the appropriateness of that expert's work as audit evidence. At this point, the focus is on the appropriateness of the expert's work at the level of the individual financial instrument. For a sample of the relevant instruments, it may be appropriate to develop an estimate independently (see paragraphs 136 to 137 on developing a point estimate or range), using different data and assumptions, then compare that estimate to that of the management's expert; and
- Other procedures may include:
  - Modeling different assumptions to derive assumptions in another model, then considering the reasonableness of those derived assumptions.
  - Comparing management's point estimates with the auditor's point estimates to determine if management's estimates are consistently higher or lower.

135. Assumptions may be made or identified by a management's expert to assist management in valuing its financial instruments. Such assumptions, when used by management, become management's assumptions that the auditor needs to consider in the same manner as management's other assumptions.

#### *Developing a Point Estimate or Range*

136. An auditor may develop a valuation technique and adjust the inputs and assumptions used in the valuation technique to develop a range for use in evaluating the reasonableness of management's valuation. Paragraphs 106 to 135 of this IAPN may assist the auditor in developing a point estimate or range. In accordance with ISA 540,<sup>35</sup> if the auditor uses assumptions, or methodologies that differ from management's, the auditor shall obtain an understanding of management's assumptions or methodologies sufficient to establish that the auditor's range takes into account relevant variables and to evaluate any significant differences from management's valuation. The auditor may find it useful to use the work of an auditor's expert to evaluate the reasonableness of management's valuation.
137. In some cases, the auditor may conclude that sufficient evidence cannot be obtained from the auditor's attempts to obtain an understanding of management's assumptions or methodology, for example when a third-party pricing source uses internally developed models and software and does not allow access to relevant information. In such cases, the auditor may not be able to obtain sufficient appropriate audit evidence about the valuation if the auditor is unable to perform other procedures to respond to the risks of material misstatement,

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<sup>35</sup> ISA 540, paragraph 13(c)

such as developing a point estimate or a range to evaluate management's point estimate.<sup>36</sup> ISA 705<sup>37</sup> describes the implications of the auditor's inability to obtain sufficient appropriate audit evidence.

### Presentation and Disclosure of Financial Instruments

138. Management's responsibilities include the preparation of the financial statements in accordance with the applicable financial reporting framework.<sup>38</sup> Financial reporting frameworks often require disclosures in the financial statements to enable users of the financial statements to make meaningful assessments of the effects of the entity's financial instrument activities, including the risks and uncertainties associated with these financial instruments. The importance of disclosures regarding the basis of measurement increases as the measurement uncertainty of the financial instruments increases and is also affected by the level of the fair value hierarchy.
139. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the presentation and disclosure of the various elements of financial statements and related disclosures. Assertions about presentation and disclosure encompass:
- (a) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
  - (b) Completeness—all disclosures that should have been included in the financial statements have been included.
  - (c) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
  - (d) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

The auditor's procedures around auditing disclosures are designed in consideration of these assertions.

#### *Procedures Relating to the Presentation and Disclosure of Financial Instruments*

140. In relation to the presentation and disclosures of financial instruments, areas of particular importance include:
- Financial reporting frameworks generally require additional disclosures regarding estimates, and related risks and uncertainties, to supplement and explain assets, liabilities, income, and expenses. The auditor's focus may need to be on the disclosures relating to risks and sensitivity

<sup>36</sup> ISA 540, paragraph 13(d)

<sup>37</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

<sup>38</sup> See paragraphs 4 and A2 of ISA 200.

analysis. Information obtained during the auditor's risk assessment procedures and testing of control activities may provide evidence in order for the auditor to conclude about whether the disclosures in the financial statements are in accordance with the requirements of the applicable financial reporting framework, for example about:

- The entity's objectives and strategies for using financial instruments, including the entity's stated accounting policies;
  - The entity's control framework for managing its risks associated with financial instruments; and
  - The risks and uncertainties associated with the financial instruments.
- Information may come from systems outside traditional financial reporting systems, such as risk systems. Examples of procedures that the auditor may choose to perform in responding to assessed risks relative to disclosures include testing:
    - The process used to derive the disclosed information; and
    - The operating effectiveness of the controls over the data used in the preparation of disclosures.
  - In relation to financial instruments having significant risk,<sup>39</sup> even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved and, accordingly, the financial statements may not achieve fair presentation. ISA 705 provides guidance on the implications for the auditor's opinion when the auditor believes that management's disclosures in the financial statements are inadequate or misleading.
  - Auditors may also consider whether the disclosures are complete and understandable, for example, all relevant information may be included in the financial statements (or accompanying reports) but it may be insufficiently drawn together to enable users of the financial statements to obtain an understanding of the position or there may not be enough qualitative disclosure to give context to the amounts recorded in the financial statements. For example, even when an entity has included sensitivity analysis disclosures, the disclosure may not fully describe the risks and uncertainties that may arise because of changes in valuation, possible effects on debt covenants, collateral requirements, and the

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<sup>39</sup> ISA 540, paragraph 20, requires the auditor to perform further procedures on disclosures relating to accounting estimates that give rise to significant risks to evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

entity's liquidity. ISA 260<sup>40</sup> contains requirements and guidance about communicating with those charged with governance, including the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

141. Consideration of the appropriateness of presentation, for example on short-term and long-term classification, in substantive testing of financial instruments is relevant to the auditor's evaluation of the presentation and disclosure.

## Other Relevant Audit Considerations

### *Written Representations*

142. ISA 540 requires the auditor to obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.<sup>41</sup> ISA 580<sup>42</sup> requires that if, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. Depending on the volume and degree of complexity of financial instrument activities, written representations to support other evidence obtained about financial instruments may also include:

- Management's objectives with respect to financial instruments, for example, whether they are used for hedging, asset/liability management or investment purposes;
- Representations about the appropriateness of presentation of the financial statements, for example the recording of financial instrument transactions as sales or financing transactions;
- Representations about the financial statement disclosures concerning financial instruments, for example that:
  - The records reflect all financial instrument transactions; and
  - All embedded derivative instruments have been identified;
- Whether all transactions have been conducted at arm's length and at market value;

<sup>40</sup> ISA 260, *Communication with Those Charged with Governance*

<sup>41</sup> ISA 540, paragraph 22. Paragraph 4 of ISA 580, *Written Representations*, states that written representations from management do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. If the auditor is otherwise unable to obtain sufficient appropriate audit evidence, this may constitute a limitation on the scope of the audit that may have implications for the auditor's report (see ISA 705, *Modification to the Opinion in the Independent Auditor's Report*).

<sup>42</sup> ISA 580, paragraph 13

- The terms of transactions;
- The appropriateness of the valuations of financial instruments;
- Whether there are any side agreements associated with any financial instruments;
- Whether the entity has entered into any written options;
- Management's intent and ability to carry out certain actions;<sup>43</sup> and
- Whether subsequent events require adjustment to the valuations and disclosures included in the financial statements.

### *Communication with Those Charged with Governance and Others*

143. Because of the uncertainties associated with the valuation of financial instruments, the potential effects on the financial statements of any significant risks are likely to be of governance interest. The auditor may communicate the nature and consequences of significant assumptions used in fair value measurements, the degree of subjectivity involved in the development of the assumptions, and the relative materiality of the items being measured at fair value to the financial statements as a whole. In addition, the need for appropriate controls over commitments to enter into financial instrument contracts and over the subsequent measurement processes are matters that may give rise to the need for communication with those charged with governance.
144. ISA 260 deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. With respect to financial instruments, matters to be communicated to those charged with governance may include:
- A lack of management understanding of the nature or extent of the financial instrument activities or the risks associated with such activities;
  - Significant deficiencies in the design or operation of the systems of internal control or risk management relating to the entity's financial instrument activities that the auditor has identified during the audit;<sup>44</sup>
  - Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to valuations performed by management or a management's expert, for example, where management is unable to obtain an understanding of the valuation methodology, assumptions

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<sup>43</sup> Paragraph A80 of ISA 540 provides examples of procedures that may be appropriate in the circumstances.

<sup>44</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, establishes requirements and provides guidance on communicating deficiencies in internal control to management, and communicating significant deficiencies in internal control to those charged with governance. It explains that deficiencies in internal control may be identified during the auditor's risk assessment procedures in accordance with ISA 315 (Revised) or at any other stage of the audit.

and data used by the management's experts, and such information is not made available to the auditor by management's expert;

- Significant differences in judgments between the auditor and management or a management's expert regarding valuations;
- The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the measurement uncertainty associated with financial instruments;
- The auditor's views about the appropriateness of the selection of accounting policies and presentation of financial instrument transactions in the financial statements;
- The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting for financial instruments; or
- A lack of comprehensive and clearly stated policies for the purchase, sale and holding of financial instruments, including operational controls, procedures for designating financial instruments as hedges, and monitoring exposures.

The appropriate timing for communications will vary with the circumstances of the engagement; however, it may be appropriate to communicate significant difficulties encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion.

#### Communications with Regulators and Others

145. In some cases, auditors may be required,<sup>45</sup> or may consider it appropriate, to communicate directly with regulators or prudential supervisors, in addition to those charged with governance, regarding matters relating to financial instruments. Such communication may be useful throughout the audit. For example, in some jurisdictions, banking regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, and compliance with regulations. This coordination may be helpful to the auditor in identifying risks of material misstatement.

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<sup>45</sup> For example, ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, requires auditors to determine whether there is a responsibility to report identified or suspected non-compliance with laws and regulations to parties outside the entity. In addition, requirements concerning the auditor's communication to banking supervisors and others may be established in many countries either by law, by supervisory requirement or by formal agreement or protocol.

**Appendix**

(Ref: Para. A14)

**Examples of Controls Relating to Financial Instruments**

1. The following provides background information and examples of controls that may exist in an entity that deals in a high volume of financial instrument transactions, whether for trading or investing purposes. The examples are not meant to be exhaustive and entities may establish different control environments and processes depending on their size, the industry in which they operate, and the extent of their financial instrument transactions. Further information on the use of trade confirmations and clearing houses is contained in paragraphs 25–26.
2. As in any control system, it is sometimes necessary to duplicate controls at different control levels (for example, preventative, detective and monitoring) to avoid the risk of material misstatement.

**The Entity's Control Environment***Commitment to Competent Use of Financial Instruments*

3. The degree of complexity of some financial instrument activities may mean that only a few individuals within the entity fully understand those activities or have the expertise necessary to value the instruments on an ongoing basis. Use of financial instruments without relevant expertise within the entity increases the risk of material misstatement.

*Participation by Those Charged with Governance*

4. Those charged with governance oversee and concur with management's establishment of the entity's overall risk appetite and provide oversight over the entity's financial instrument activities. An entity's policies for the purchase, sale and holding of financial instruments are aligned with its attitude toward risk and the expertise of those involved in financial instrument activities. In addition, an entity may establish governance structures and control processes aimed at:
  - (a) Communicating investment decisions and assessments of all material measurement uncertainty to those charged with governance; and
  - (b) Evaluating the entity's overall risk appetite when engaging in financial instrument transactions.

*Organizational Structure*

5. Financial instrument activities may be run on either a centralized or a decentralized basis. Such 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. The risks of material misstatement associated with financial instrument activities may increase with greater decentralization of control activities. This may especially be true where an entity is based in different locations, some perhaps in other countries.

### *Assignment of Authority and Responsibility*

#### Investment and Valuation Policies

6. Providing direction, through clearly stated policies approved by those charged with governance for the purchase, sale, and holding of financial instruments enables management to establish an effective approach to taking and managing business risks. These policies are most clear when they state the entity's objectives with regard to its risk management activities, and the investment and hedging alternatives available to meet these objectives, and reflect the:
  - (a) Level of management's expertise;
  - (b) Sophistication of the entity's internal control and monitoring systems;
  - (c) Entity's asset/liability structure;
  - (d) Entity's capacity to maintain liquidity and absorb losses of capital;
  - (e) Types of financial instruments that management believes will meet its objectives; and
  - (f) Uses of financial instruments that management believes will meet its objectives, for example, whether derivatives may be used for speculative purposes or only for hedging purposes.
7. Management may design policies aligned with its valuation capabilities and may establish controls to ensure that these policies are adhered to by those employees responsible for the entity's valuation. These may include:
  - (a) Processes for the design and validation of methodologies used to produce valuations, including how measurement uncertainty is addressed; and
  - (b) Policies regarding maximizing the use of observable inputs and the types of information to be gathered to support valuations of financial instruments.
8. In smaller entities, dealing in financial instruments may be rare and management's knowledge and experience limited. Nevertheless, establishing policies over financial instruments helps an entity to determine its risk appetite and consider whether investing in particular financial instruments achieves a stated objective.

*Human Resource Policies and Practices*

9. Entities may establish policies requiring key employees, both front office and back office, to take mandatory time off from their duties. This type of control is used as a means of preventing and detecting fraud, in particular if those engaged in trading activities are creating false trades or inaccurately recording transactions.

*Use of Service Organizations*

10. Entities may also use service organizations (for example asset managers) to initiate the purchase or sale of financial instruments, to maintain records of transactions for the entity or to value financial instruments. Some entities may be dependent on these service organizations to provide the basis of reporting for the financial instruments held. However, if management does not have an understanding about the controls in place at a service organization, the auditor may not be able to obtain sufficient appropriate audit evidence to rely on controls at that service organization. See ISA 402,<sup>1</sup> which establishes requirements for the auditor to obtain sufficient appropriate audit evidence when an entity uses the services of one or more service organizations.
11. The use of service organizations may strengthen or weaken the control environment for financial instruments. For example, a service organization's personnel may have more experience with financial instruments than the entity's management or may have more robust internal control over financial reporting. The use of the service organization also may allow for greater segregation of duties. On the other hand, the service organization may have a poor control environment.

**The Entity's Risk Assessment Process**

12. An entity's risk assessment process exists to establish how management identifies business risks that derive from its use of financial instruments, including how management estimates the significance of the risks, assesses the likelihood of their occurrence and decides upon actions to manage them.
13. The entity's risk assessment process forms the basis for how management determines the risks to be managed. Risk assessment processes exist with the objective of ensuring that management:
  - (a) Understands the risks inherent in a financial instrument before management enters into it, including the objective of entering into the transaction and its structure (for example, the economics and business purpose of the entity's financial instrument activities);
  - (b) Performs adequate due diligence commensurate with the risks associated with particular financial instruments;

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<sup>1</sup> ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

- (c) Monitors the entity's outstanding positions to understand how market conditions are affecting the entity's exposures;
  - (d) Has procedures in place to reduce or change risk exposure if necessary and for managing reputational risk; and
  - (e) Subjects these processes to rigorous supervision and review.
14. The structure implemented to monitor and manage exposure to risks should:
- (a) Be appropriate and consistent with the entity's attitude toward risk as determined by those charged with governance;
  - (b) Specify the approval levels for the authorization of different types of financial 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 financial instrument activities, demonstrating management's commitment to competence;
  - (c) Set 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;
  - (d) Provide for the objective and timely monitoring of the financial risks and control activities;
  - (e) Provide for the objective and timely reporting of exposures, risks and the results of financial instrument activities in managing risk; and
  - (f) Evaluate management's track record for assessing the risks of particular financial instruments.
15. The types and levels of risks an entity faces are directly related to the types of financial instruments with which it deals, including the complexity of these instruments and the volume of financial instruments transacted.

#### *Risk Management Function*

16. Some entities, for example large financial institutions with a high volume of financial instrument transactions, may be required by law or regulation, or may choose, to establish a formal risk management function. This function is separated from those responsible for undertaking and managing financial instrument transactions. The function is responsible for reporting on and monitoring financial instrument activities, and may include a formal risk committee established by those charged with governance. Examples of key responsibilities in this area may include:
- (a) Implementing the risk management policy set by those charged with governance (including analyses of the risks to which an entity may be exposed);

- (b) Designing risk limit structures and ensuring these risk limits are implemented in practice;
  - (c) Developing stress scenarios and subjecting open position portfolios to sensitivity analysis, including reviews of unusual movements in positions; and
  - (d) Reviewing and analyzing new financial instrument products.
17. Financial instruments may have the associated risk that a loss might exceed the amount, if any, of the value of the financial instrument recognized on the balance sheet. 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 due to collateral, or margin, requirements. In some cases, the potential losses may be enough to cast significant doubt on the entity's ability to continue as a going concern. The entity may perform sensitivity analyses or value-at-risk analyses to assess the future hypothetical effects on financial instruments subject to market risks. However, value-at-risk analysis does not fully reflect the extent of the risks that may affect the entity; sensitivity and scenario analyses also may be subject to limitations.
18. The volume and sophistication of financial instrument activity and relevant regulatory requirements will influence the entity's consideration whether to establish a formal risk management function and how the function may be structured. In entities that have not established a separate risk management function, for example entities with relatively few financial instruments or financial instruments that are less complex, reporting on and monitoring financial instrument activities may be a component of the accounting or finance function's responsibility or management's overall responsibility, and may include a formal risk committee established by those charged with governance

#### The Entity's Information Systems

19. The key objective of an entity's information system is that it is capable of capturing and recording all the transactions accurately, settling them, valuing them, and producing information to enable the financial instruments to be risk managed and for controls to be monitored. Difficulties can arise in entities that engage in a high volume of financial instruments, in particular if there is a multiplicity of systems that are poorly integrated and have manual interfaces without adequate controls.
20. Certain financial instruments may require a large number of accounting entries. As the sophistication or level of the financial instrument activities increases, it is necessary for the sophistication of the information system to also increase. Specific issues which can arise with respect to financial instruments include:
- (a) Information systems, in particular for smaller entities, not having the capability or not being appropriately configured to process financial instrument transactions, especially when the entity does not have any

prior experience in dealing with financial instruments. This may result in an increased number of manual transactions which may further increase the risk of error;

- (b) The potential diversity of systems required to process more complex transactions, and the need for regular reconciliations between them, in particular when the systems are not interfaced or may be subject to manual intervention;
- (c) The potential that more complex transactions, if they are only traded by a small number of individuals, may be valued or risk managed on spreadsheets rather than on main processing systems, and for the physical and logical password security around those spreadsheets to be more easily compromised;
- (d) A lack of review of systems exception logs, external confirmations and broker quotes, where available, to validate the entries generated by the systems;
- (e) Difficulties in controlling and evaluating the key inputs to systems for valuation of financial instruments, particularly where those systems are maintained by the group of traders known as the front office or a third-party service provider and/or the transactions in question are non-routine or thinly traded;
- (f) Failure to evaluate the design and calibration of complex models used to process these transactions initially and on a periodic basis;
- (g) The potential that management has not set up a library of models, with controls around access, change and maintenance of individual models, in order to maintain a strong audit trail of the accredited versions of models and in order to prevent unauthorized access or amendments to those models;
- (h) The disproportionate investment that may be required in risk management and control systems, where an entity only undertakes a limited number of financial instrument transactions, and the potential for misunderstanding of the output by management if they are not used to these types of transactions;
- (i) The potential requirement for third-party systems provision, for example from a service organization, to record, process, account for or risk manage appropriately financial instrument transactions, and the need to reconcile appropriately and challenge the output from those providers; and
- (j) Additional security and control considerations relevant to the use of an electronic network when an entity uses electronic commerce for financial instrument transactions.

21. Information systems relevant to financial reporting serve as an important source of information for the quantitative disclosures in the financial statements. However, entities may also develop and maintain non-financial systems used for internal reporting and to generate information included in qualitative disclosures, for example regarding risks and uncertainties or sensitivity analyses.

### **The Entity's Control Activities**

22. Control activities over financial instrument transactions are designed to prevent or detect problems that hinder an entity from achieving its objectives. These objectives may be either operational, financial reporting, or compliance in nature. Control activities over financial instruments are designed relative to the complexity and volume of transactions of financial instruments and will generally include an appropriate authorization process, adequate segregation of duties, and other policies and procedures designed to ensure that the entity's control objectives are met. Process flow charts may assist in identifying an entity's controls and lack of controls. This IAPN focuses on control activities related to completeness, accuracy and existence, valuation, and presentation and disclosure.

#### *Authorization*

23. Authorization can affect the financial statement assertions both directly and indirectly. For example, even if a transaction is executed outside an entity's policies, it nonetheless may be recorded and accounted for accurately. However, unauthorized transactions could significantly increase risk to the entity, thereby significantly increasing the risk of material misstatement since they would be undertaken outside the system of internal control. To mitigate this risk, an entity will often establish a clear policy as to what transactions can be traded by whom and adherence to this policy will then be monitored by an entity's back office. Monitoring trading activities of individuals, for example by reviewing unusually high volumes or significant gains or losses incurred, will assist management in ensuring compliance with the entity's policies, including the authorization of new types of transactions, and evaluating whether fraud has occurred.
24. The function of an entity's deal initiation records is to identify clearly the nature and purpose of individual transactions and the rights and obligations arising under each financial instrument contract, including the enforceability of the contracts. In addition to the basic financial information, such as a notional amount, complete and accurate records at a minimum typically include:
- (a) The identity of the dealer;
  - (b) The identity of the person recording the transaction (if not the dealer), when the transaction was initiated (including the date and time of the transaction), and how it was recorded in the entity's information systems; and

- (c) The nature and purpose of the transaction, including whether or not it is intended to hedge an underlying commercial exposure.

### *Segregation of Duties*

25. Segregation of duties and the assignment of personnel is an important control activity, particularly when exposed to financial instruments. Financial instrument activities may be segregated into a number of functions, including:
  - (a) Executing the transaction (dealing). In entities with a high volume of financial instrument transactions, this may be done by the front office;
  - (b) Initiating cash payments and accepting cash receipts (settlements);
  - (c) Sending out trade confirmations and reconciling the differences between the entity's records and replies from counterparties, if any;
  - (d) Recording of all transactions correctly in the accounting records;
  - (e) Monitoring risk limits. In entities with a high volume of financial instrument transactions, this may be performed by the risk management function; and
  - (f) Monitoring positions and valuing financial instruments.
26. Many organizations choose to segregate the duties of those investing in financial instruments, those valuing financial instruments, those settling financial instruments and those accounting/recording financial instruments.
27. Where an entity is too small to achieve proper segregation of duties, the role of management and those charged with governance in monitoring financial instrument activities is of particular importance.
28. A feature of some entities' internal control is an independent price verification (IPV) function. This department is responsible for separately verifying the price of some financial instruments, and may use alternative data sources, methodologies and assumptions. The IPV provides an objective look at the pricing that has been developed in another part of the entity.
29. Ordinarily, the middle or back office is responsible for establishing policies on valuation and ensuring adherence to the policy. Entities with a greater use of financial instruments may perform daily valuations of their financial instrument portfolio and examine the contribution to profit or loss of individual financial instrument valuations as a test of the reasonableness of valuations.

### *Completeness, Accuracy, and Existence*

30. Regular reconciliation of the entity's records to external banks' and custodians' records enables the entity to ensure transactions are properly recorded. Appropriate segregation of duties between those transacting the trades and

those reconciling them is important, as is a rigorous process for reviewing reconciliations and clearing reconciling items.

31. Controls may also be established that require traders to identify whether a complex financial instrument may have unique features, for example embedded derivatives. In such circumstances, there may be a separate function that evaluates complex financial instrument transactions at their initiation (which may be known as a product control group), working in connection with an accounting policy group to ensure the transaction is accurately recorded. While smaller entities may not have product control groups, an entity may have a process in place relating to the review of complex financial instrument contracts at the point of origination in order to ensure they are accounted for appropriately in accordance with the applicable financial reporting framework.

### **Monitoring of Controls**

32. The entity's ongoing monitoring activities are designed to detect and correct any deficiencies in the effectiveness of controls over transactions for financial instruments and their valuation. It is important that there is adequate supervision and review of financial instrument activity within the entity. This includes:
  - (a) All controls being subject to review, for example, the monitoring of operational statistics such as the number of reconciling items or the difference between internal pricing and external pricing sources;
  - (b) The need for robust information technology (IT) controls and monitoring and validating their application; and
  - (c) The need to ensure that information resulting from different processes and systems is adequately reconciled. For example, there is little benefit in a valuation process if the output from it is not reconciled properly into the general ledger.
33. In larger entities, sophisticated computer information systems generally keep track of financial instrument activities, and are designed to ensure that settlements occur when due. More complex computer systems may generate automatic postings to clearing accounts to monitor cash movements, and controls over processing are put in place with the objective of ensuring that financial instrument activities are correctly reflected in the entity's records. Computer systems may be designed to produce exception reports to alert management to situations where financial instruments have not been used within authorized limits or where transactions undertaken were not within the limits established for the chosen counterparties. However, even a sophisticated computer system may not ensure the completeness of the recording of financial instrument transactions. Accordingly, management frequently puts additional procedures in place to increase the likelihood that all transactions will be recorded.

**INTERNATIONAL STANDARD ON AUDITING 315  
(REVISED 2019)**

**IDENTIFYING AND ASSESSING THE RISKS OF  
MATERIAL MISSTATEMENT**

(Effective for audits of financial statements for periods beginning  
on or after December 15, 2021)

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**ISA**

Appendix 1: Considerations for Understanding the Entity and its Business Model

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International Standard on Auditing (ISA) 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements.

### Key Concepts in this ISA

2. ISA 200 deals with the overall objectives of the auditor in conducting an audit of the financial statements,<sup>1</sup> including to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.<sup>2</sup> Audit risk is a function of the risks of material misstatement and detection risk.<sup>3</sup> ISA 200 explains that the risks of material misstatement may exist at two levels:<sup>4</sup> the overall financial statement level; and the assertion level for classes of transactions, account balances and disclosures.
3. ISA 200 requires the auditor to exercise professional judgment in planning and performing an audit, and to plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.<sup>5</sup>
4. Risks at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level consist of two components, inherent and control risk:
  - Inherent risk is described as the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - Control risk is described as the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's controls.
5. ISA 200 explains that risks of material misstatement are assessed at the assertion level in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence.<sup>6</sup> For

<sup>1</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

<sup>2</sup> ISA 200, paragraph 17

<sup>3</sup> ISA 200, paragraph 13(c)

<sup>4</sup> ISA 200, paragraph A36

<sup>5</sup> ISA 200, paragraphs 15–16

<sup>6</sup> ISA 200, paragraph A43a and ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph 6

the identified risks of material misstatement at the assertion level, a separate assessment of inherent risk and control risk is required by this ISA. The degree to which inherent risk varies is referred to in this ISA as the ‘spectrum of inherent risk.’

6. Risks of material misstatement identified and assessed by the auditor include both those due to error and those due to fraud. Although both are addressed by this ISA, the significance of fraud is such that further requirements and guidance are included in ISA 240<sup>7</sup> in relation to risk assessment procedures and related activities to obtain information that is used to identify, assess and respond to the risks of material misstatement due to fraud.
7. The auditor’s risk identification and assessment process is iterative and dynamic. The auditor’s understanding of the entity and its environment, the applicable financial reporting framework, and the entity’s system of internal control are interdependent with concepts within the requirements to identify and assess the risks of material misstatement. In obtaining the understanding required by this ISA, initial expectations of risks may be developed, which may be further refined as the auditor progresses through the risk identification and assessment process. In addition, this ISA and ISA 330 require the auditor to revise the risk assessments, and modify further overall responses and further audit procedures, based on audit evidence obtained from performing further audit procedures in accordance with ISA 330, or if new information is obtained.
8. ISA 330 requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.<sup>8</sup> ISA 330 further explains that the auditor’s assessment of the risks of material misstatement at the financial statement level, and the auditor’s overall responses, is affected by the auditor’s understanding of the control environment. ISA 330 also requires the auditor to design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.<sup>9</sup>

### Scalability

9. ISA 200 states that some ISAs include scalability considerations which illustrate the application of the requirements to all entities regardless of whether their nature and circumstances are less complex or more complex.<sup>10</sup> This ISA is intended for audits of all entities, regardless of size or complexity and the application material therefore incorporates specific considerations specific to both less and more complex entities, where appropriate. While the size of an entity may be an indicator of its complexity, some smaller entities may be complex and some larger entities may be less complex.

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<sup>7</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

<sup>8</sup> ISA 330, paragraph 5

<sup>9</sup> ISA 330, paragraph 6

<sup>10</sup> ISA 200, paragraph A65a

## Effective Date

10. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2021.

## Objective

11. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

## Definitions

12. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) *Assertions* – Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement. (Ref: Para. A1)
  - (b) *Business risk* – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity’s ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
  - (c) *Controls* – Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context: (Ref: Para. A2–A5)
    - (i) Policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.
    - (ii) Procedures are actions to implement policies.
  - (d) *General information technology (IT) controls* – Controls over the entity’s IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information (i.e., the completeness, accuracy and validity of information) in the entity’s information system. Also see the definition of *IT environment*.

- (e) *Information processing controls* – Controls relating to the processing of information in IT applications or manual information processes in the entity’s information system that directly address risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information). (Ref: Para. A6)
- (f) *Inherent risk factors* – Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be qualitative or quantitative, and include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to management bias or other fraud risk factors<sup>11</sup> insofar as they affect inherent risk. (Ref: Para. A7–A8)
- (g) *IT environment* – The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies. For the purposes of this ISA:
  - (i) An IT application is a program or a set of programs that is used in the initiation, processing, recording and reporting of transactions or information. IT applications include data warehouses and report writers.
  - (ii) The IT infrastructure comprises the network, operating systems, and databases and their related hardware and software.
  - (iii) The IT processes are the entity’s processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations.
- (h) *Relevant assertions* – An assertion about a class of transactions, account balance or disclosure is relevant when it has an identified risk of material misstatement. The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (i.e., the inherent risk). (Ref: Para. A9)
- (i) *Risks arising from the use of IT* – Susceptibility of information processing controls to ineffective design or operation, or risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information) in the entity’s information system, due to ineffective design or operation of controls in the entity’s IT processes (see IT environment).

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<sup>11</sup> ISA 240, paragraphs A24–A27

- (j) *Risk assessment procedures* – The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
- (k) *Significant class of transactions, account balance or disclosure* – A class of transactions, account balance or disclosure for which there is one or more relevant assertions.
- (l) *Significant risk* – An identified risk of material misstatement: (Ref: Para. A10)
  - (i) For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or
  - (ii) That is to be treated as a significant risk in accordance with the requirements of other ISAs.<sup>12</sup>
- (m) *System of internal control* – The system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity’s objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. For the purposes of the ISAs, the system of internal control consists of five inter-related components:
  - (i) Control environment;
  - (ii) The entity’s risk assessment process;
  - (iii) The entity’s process to monitor the system of internal control;
  - (iv) The information system and communication; and
  - (v) Control activities.

## Requirements

### Risk Assessment Procedures and Related Activities

13. The auditor shall design and perform risk assessment procedures to obtain audit evidence that provides an appropriate basis for: (Ref: Para. A11–A18)
  - (a) The identification and assessment of risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels; and
  - (b) The design of further audit procedures in accordance with ISA 330.

<sup>12</sup> ISA 240, paragraph 27 and ISA 550, *Related Parties*, paragraph 18

The auditor shall design and perform risk assessment procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. (Ref: Para. A14)

14. The risk assessment procedures shall include the following: (Ref: Para. A19–A21)
- (a) Inquiries of management and of other appropriate individuals within the entity, including individuals within the internal audit function (if the function exists). (Ref: Para. A22–A26)
  - (b) Analytical procedures. (Ref: Para. A27–A31)
  - (c) Observation and inspection. (Ref: Para. A32–A36)

#### *Information from Other Sources*

15. In obtaining audit evidence in accordance with paragraph 13, the auditor shall consider information from: (Ref: Para. A37–A38)
- (a) The auditor's procedures regarding acceptance or continuance of the client relationship or the audit engagement; and
  - (b) When applicable, other engagements performed by the engagement partner for the entity.
16. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall evaluate whether such information remains relevant and reliable as audit evidence for the current audit. (Ref: Para. A39–A41)

#### *Engagement Team Discussion*

17. The engagement partner and other key engagement team members shall discuss the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement. (Ref: Para. A42–A47)
18. When there are engagement team members not involved in the engagement team discussion, the engagement partner shall determine which matters are to be communicated to those members.

#### **Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework and the Entity's System of Internal Control** (Ref: Para. A48–A49)

#### *Understanding the Entity and Its Environment, and the Applicable Financial Reporting Framework* (Ref: Para. A50–A55)

19. The auditor shall perform risk assessment procedures to obtain an understanding of:

- (a) The following aspects of the entity and its environment:
    - (i) The entity’s organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT; (Ref: Para. A56–A67)
    - (ii) Industry, regulatory and other external factors; (Ref: Para. A68–A73) and
    - (iii) The measures used, internally and externally, to assess the entity’s financial performance; (Ref: Para. A74–A81)
  - (b) The applicable financial reporting framework, and the entity’s accounting policies and the reasons for any changes thereto; (Ref: Para. A82–A84) and
  - (c) How inherent risk factors affect susceptibility of assertions to misstatement and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework, based on the understanding obtained in (a) and (b). (Ref: Para. A85–A89)
20. The auditor shall evaluate whether the entity’s accounting policies are appropriate and consistent with the applicable financial reporting framework.

*Understanding the Components of the Entity’s System of Internal Control* (Ref: Para. A90 – A95)

Control Environment, the Entity’s Risk Assessment Process and the Entity’s Process to Monitor the System of Internal Control (Ref: Para. A96–A98)

Control environment

21. The auditor shall obtain an understanding of the control environment relevant to the preparation of the financial statements, through performing risk assessment procedures, by: (Ref: Para. A99–A100)	
<ul style="list-style-type: none"> <li>(a) Understanding the set of controls, processes and structures that address: (Ref: Para. A101–A102)                             <ul style="list-style-type: none"> <li>(i) How management’s oversight responsibilities are carried out, such as the entity’s culture and management’s commitment to integrity and ethical values;</li> </ul> </li> </ul>	and <ul style="list-style-type: none"> <li>(b) Evaluating whether: (Ref: Para. A103–A108)                             <ul style="list-style-type: none"> <li>(i) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior;</li> </ul> </li> </ul>



<ul style="list-style-type: none"> <li>(ii) When those charged with governance are separate from management, the independence of, and oversight over the entity’s system of internal control by, those charged with governance;</li> <li>(iii) The entity’s assignment of authority and responsibility;</li> <li>(iv) How the entity attracts, develops, and retains competent individuals; and</li> <li>(v) How the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control;</li> </ul>	<ul style="list-style-type: none"> <li>(ii) The control environment provides an appropriate foundation for the other components of the entity’s system of internal control considering the nature and complexity of the entity; and</li> <li>(iii) Control deficiencies identified in the control environment undermine the other components of the entity’s system of internal control.</li> </ul>
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The entity’s risk assessment process

<p>22. The auditor shall obtain an understanding of the entity’s risk assessment process relevant to the preparation of the financial statements, through performing risk assessment procedures, by:</p>	
<ul style="list-style-type: none"> <li>(a) Understanding the entity’s process for: (Ref: Para. A109–A110)             <ul style="list-style-type: none"> <li>(i) Identifying business risks relevant to financial reporting objectives; (Ref: Para. A62)</li> <li>(ii) Assessing the significance of those risks, including the likelihood of their occurrence; and</li> <li>(iii) Addressing those risks;</li> </ul> </li> </ul>	<p>and</p> <ul style="list-style-type: none"> <li>(b) Evaluating whether the entity’s risk assessment process is appropriate to the entity’s circumstances considering the nature and complexity of the entity. (Ref: Para. A111–A113)</li> </ul>

23. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall:
- (a) Determine whether any such risks are of a kind that the auditor expects would have been identified by the entity’s risk assessment process and, if so, obtain an understanding of why the entity’s risk assessment process failed to identify such risks of material misstatement; and
  - (b) Consider the implications for the auditor’s evaluation in paragraph 22(b).

The entity’s process to monitor the system of internal control

<p>24. The auditor shall obtain an understanding of the entity’s process for monitoring the system of internal control relevant to the preparation of the financial statements, through performing risk assessment procedures, by: (Ref: Para. A114–A115)</p>	
<ul style="list-style-type: none"> <li>(a) Understanding those aspects of the entity’s process that address:                             <ul style="list-style-type: none"> <li>(i) Ongoing and separate evaluations for monitoring the effectiveness of controls, and the identification and remediation of control deficiencies identified; (Ref: Para. A116–A117) and</li> <li>(ii) The entity’s internal audit function, if any, including its nature, responsibilities and activities; (Ref: Para. A118)</li> </ul> </li> <li>(b) Understanding the sources of the information used in the entity’s process to monitor the system of internal control, and the basis upon which management considers the information to be sufficiently reliable for the purpose; (Ref: Para. A119–A120)</li> </ul>	<p>and</p> <ul style="list-style-type: none"> <li>(c) Evaluating whether the entity’s process for monitoring the system of internal control is appropriate to the entity’s circumstances considering the nature and complexity of the entity. (Ref: Para. A121–A122)</li> </ul>

Information System and Communication, and Control Activities (Ref: Para. A123–A130)

The information system and communication

<p>25. The auditor shall obtain an understanding of the entity’s information system and communication relevant to the preparation of the financial statements, through performing risk assessment procedures, by: (Ref: Para. A131)</p>	
<p>(a) Understanding the entity’s information processing activities, including its data and information, the resources to be used in such activities and the policies that define, for significant classes of transactions, account balances and disclosures: (Ref: Para. A132–A143)</p> <p>(i) How information flows through the entity’s information system, including how:</p> <p style="margin-left: 20px;">a. Transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated in the general ledger and reported in the financial statements; and</p> <p style="margin-left: 20px;">b. Information about events and conditions, other than transactions, is captured, processed and disclosed in the financial statements;</p>	<p>and</p> <p>(c) Evaluating whether the entity’s information system and communication appropriately support the preparation of the entity’s financial statements in accordance with the applicable financial reporting framework. (Ref: Para. A146)</p>

<ul style="list-style-type: none"> <li>(ii) The accounting records, specific accounts in the financial statements and other supporting records relating to the flows of information in the information system;</li> <li>(iii) The financial reporting process used to prepare the entity’s financial statements, including disclosures; and</li> <li>(iv) The entity’s resources, including the IT environment, relevant to (a)(i) to (a)(iii) above;</li> </ul> <p>(b) Understanding how the entity communicates significant matters that support the preparation of the financial statements and related reporting responsibilities in the information system and other components of the system of internal control: (Ref: Para. A144–A145)</p> <ul style="list-style-type: none"> <li>(i) Between people within the entity, including how financial reporting roles and responsibilities are communicated;</li> <li>(ii) Between management and those charged with governance; and</li> <li>(iii) With external parties, such as those with regulatory authorities;</li> </ul>	
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Control activities

<p>26. The auditor shall obtain an understanding of the control activities component, through performing risk assessment procedures, by: (Ref: Para. A147–A157)</p>	
<p>(a) Identifying controls that address risks of material misstatement at the assertion level in the control activities component as follows:</p> <p>(i) Controls that address a risk that is determined to be a significant risk; (Ref: Para. A158–A159)</p> <p>(ii) Controls over journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments; (Ref: Para. A160–A161)</p> <p>(iii) Controls for which the auditor plans to test operating effectiveness in determining the nature, timing and extent of substantive testing, which shall include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; and (Ref: Para. A162–A164)</p>	<p>and</p> <p>(d) For each control identified in (a) or (c) (ii): (Ref: Para. A175–A181)</p> <p>(i) Evaluating whether the control is designed effectively to address the risk of material misstatement at the assertion level, or effectively designed to support the operation of other controls; and</p> <p>(ii) Determining whether the control has been implemented by performing procedures in addition to inquiry of the entity’s personnel.</p>

<ul style="list-style-type: none"> <li>(iii) Other controls that the auditor considers are appropriate to enable the auditor to meet the objectives of paragraph 13 with respect to risks at the assertion level, based on the auditor's professional judgment; (Ref: Para. A165)</li> <li>(b) Based on controls identified in (a), identifying the IT applications and the other aspects of the entity's IT environment that are subject to risks arising from the use of IT; (Ref: Para. A166–A172)</li> <li>(c) For such IT applications and other aspects of the IT environment identified in (b), identifying: (Ref: Para. A173–A174) <ul style="list-style-type: none"> <li>(i) The related risks arising from the use of IT; and</li> <li>(ii) The entity's general IT controls that address such risks;</li> </ul> </li> </ul>	
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*Control Deficiencies Within the Entity's System of Internal Control*

27. Based on the auditor's evaluation of each of the components of the entity's system of internal control, the auditor shall determine whether one or more control deficiencies have been identified. (Ref: Para. A182–A183)

**Identifying and Assessing the Risks of Material Misstatement** (Ref: Para. A184–A185)

*Identifying Risks of Material Misstatement*

28. The auditor shall identify the risks of material misstatement and determine whether they exist at: (Ref: Para. A186–A192)

- (a) The financial statement level; (Ref: Para. A193–A200) or
- (b) The assertion level for classes of transactions, account balances and disclosures. (Ref: Para. A201)

29. The auditor shall determine the relevant assertions and the related significant classes of transactions, account balances and disclosures. (Ref: Para. A202–A204)

*Assessing Risks of Material Misstatement at the Financial Statement Level*

30. For identified risks of material misstatement at the financial statement level, the auditor shall assess the risks and: (Ref: Para. A193–A200)
- (a) Determine whether such risks affect the assessment of risks at the assertion level; and
  - (b) Evaluate the nature and extent of their pervasive effect on the financial statements.

*Assessing Risks of Material Misstatement at the Assertion Level*

*Assessing Inherent Risk (Ref: Para. A205–A217)*

31. For identified risks of material misstatement at the assertion level, the auditor shall assess inherent risk by assessing the likelihood and magnitude of misstatement. In doing so, the auditor shall take into account how, and the degree to which:
- (a) Inherent risk factors affect the susceptibility of relevant assertions to misstatement; and
  - (b) The risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level. (Ref: Para. A215–A216)

32. The auditor shall determine whether any of the assessed risks of material misstatement are significant risks. (Ref: Para. A218–A221)

33. The auditor shall determine whether substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatement at the assertion level. (Ref: Para. A222–A225)

*Assessing Control Risk*

34. If the auditor plans to test the operating effectiveness of controls, the auditor shall assess control risk. If the auditor does not plan to test the operating effectiveness of controls, the auditor’s assessment of control risk shall be such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk. (Ref: Para. A226–A229)

*Evaluating the Audit Evidence Obtained from the Risk Assessment Procedures*

35. The auditor shall evaluate whether the audit evidence obtained from the risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement. If not, the auditor shall perform additional risk assessment procedures until audit evidence has been obtained to provide such a basis. In identifying and assessing the risks of material misstatement, the auditor shall take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management. (Ref: Para. A230–A232)

*Classes of Transactions, Account Balances and Disclosures that Are Not Significant, but Which Are Material*

36. For material classes of transactions, account balances or disclosures that have not been determined to be significant classes of transactions, account balances or disclosures, the auditor shall evaluate whether the auditor's determination remains appropriate. (Ref: Para. A233–A235)

*Revision of Risk Assessment*

37. If the auditor obtains new information which is inconsistent with the audit evidence on which the auditor originally based the identification or assessments of the risks of material misstatement, the auditor shall revise the identification or assessment. (Ref: Para. A236)

**Documentation**

38. The auditor shall include in the audit documentation:<sup>13</sup> (Ref: Para. A237–A241)
- (a) The discussion among the engagement team and the significant decisions reached;
  - (b) Key elements of the auditor's understanding in accordance with paragraphs 19, 21, 22, 24 and 25; the sources of information from which the auditor's understanding was obtained; and the risk assessment procedures performed;
  - (c) The evaluation of the design of identified controls, and determination whether such controls have been implemented, in accordance with the requirements in paragraph 26; and
  - (d) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level, including significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for the significant judgments made.

<sup>13</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6–A7

## Application and Other Explanatory Material

### Definitions (Ref: Para. 12)

#### *Assertions* (Ref: Para. 12(a))

A1. Categories of assertions are used by auditors to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement. Examples of these categories of assertions are described in paragraph A190. The assertions differ from the written representations required by ISA 580,<sup>14</sup> to confirm certain matters or support other audit evidence.

#### *Controls* (Ref: Para. 12(c))

- A2. Controls are embedded within the components of the entity's system of internal control.
- A3. Policies are implemented through the actions of personnel within the entity, or through the restraint of personnel from taking actions that would conflict with such policies.
- A4. Procedures may be mandated, through formal documentation or other communication by management or those charged with governance, or may result from behaviors that are not mandated but are rather conditioned by the entity's culture. Procedures may be enforced through the actions permitted by the IT applications used by the entity or other aspects of the entity's IT environment.
- A5. Controls may be direct or indirect. Direct controls are controls that are precise enough to address risks of material misstatement at the assertion level. Indirect controls are controls that support direct controls.

#### *Information Processing Controls* (Ref: Para. 12(e))

A6. Risks to the integrity of information arise from susceptibility to ineffective implementation of the entity's information policies, which are policies that define the information flows, records and reporting processes in the entity's information system. Information processing controls are procedures that support effective implementation of the entity's information policies. Information processing controls may be automated (i.e., embedded in IT applications) or manual (e.g., input or output controls) and may rely on other controls, including other information processing controls or general IT controls.

#### *Inherent Risk Factors* (Ref: Para. 12(f))

**Appendix 2** sets out further considerations relating to understanding inherent risk factors.

<sup>14</sup> ISA 580, *Written Representations*

- A7. Inherent risk factors may be qualitative or quantitative and affect the susceptibility of assertions to misstatement. Qualitative inherent risk factors relating to the preparation of information required by the applicable financial reporting framework include:
- Complexity;
  - Subjectivity;
  - Change;
  - Uncertainty; or
  - Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.
- A8. Other inherent risk factors, that affect susceptibility to misstatement of an assertion about a class of transactions, account balance or disclosure may include:
- The quantitative or qualitative significance of the class of transactions, account balance or disclosure; or
  - The volume or a lack of uniformity in the composition of the items to be processed through the class of transactions or account balance, or to be reflected in the disclosure.

*Relevant Assertions* (Ref: Para. 12(h))

- A9. A risk of material misstatement may relate to more than one assertion, in which case all the assertions to which such a risk relates are relevant assertions. If an assertion does not have an identified risk of material misstatement, then it is not a relevant assertion.

*Significant Risk* (Ref: Para. 12(l))

- A10. Significance can be described as the relative importance of a matter, and is judged by the auditor in the context in which the matter is being considered. For inherent risk, significance may be considered in the context of how, and the degree to which, inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur.

**Risk Assessment Procedures and Related Activities** (Ref: Para. 13–18)

- A11. The risks of material misstatement to be identified and assessed include both those due to fraud and those due to error, and both are covered by this ISA. However, the significance of fraud is such that further requirements and guidance are included in ISA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify and assess the

risks of material misstatement due to fraud.<sup>15</sup> In addition, the following ISAs provide further requirements and guidance on identifying and assessing risks of material misstatement regarding specific matters or circumstances:

- ISA 540 (Revised)<sup>16</sup> in regard to accounting estimates;
- ISA 550 in regard to related party relationships and transactions;
- ISA 570 (Revised)<sup>17</sup> in regard to going concern; and
- ISA 600<sup>18</sup> in regard to group financial statements.

A12. Professional skepticism is necessary for the critical assessment of audit evidence gathered when performing the risk assessment procedures, and assists the auditor in remaining alert to audit evidence that is not biased towards corroborating the existence of risks or that may be contradictory to the existence of risks. Professional skepticism is an attitude that is applied by the auditor when making professional judgments that then provides the basis for the auditor's actions. The auditor applies professional judgment in determining when the auditor has audit evidence that provides an appropriate basis for risk assessment.

A13. The application of professional skepticism by the auditor may include:

- Questioning contradictory information and the reliability of documents;
- Considering responses to inquiries and other information obtained from management and those charged with governance;
- Being alert to conditions that may indicate possible misstatement due to fraud or error; and
- Considering whether audit evidence obtained supports the auditor's identification and assessment of the risks of material misstatement in light of the entity's nature and circumstances.

*Why Obtaining Audit Evidence in an Unbiased Manner Is Important* (Ref: Para. 13)

A14. Designing and performing risk assessment procedures to obtain audit evidence to support the identification and assessment of the risks of material misstatement in an unbiased manner may assist the auditor in identifying potentially contradictory information, which may assist the auditor in exercising professional skepticism in identifying and assessing the risks of material misstatement.

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<sup>15</sup> ISA 240, paragraphs 12–27

<sup>16</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

<sup>17</sup> ISA 570 (Revised), *Going Concern*

<sup>18</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

*Sources of Audit Evidence* (Ref: Para. 13)

A15. Designing and performing risk assessment procedures to obtain audit evidence in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence. In addition to information from other sources<sup>19</sup>, sources of information for risk assessment procedures may include:

- Interactions with management, those charged with governance, and other key entity personnel, such as internal auditors.
- Certain external parties such as regulators, whether obtained directly or indirectly.
- Publicly available information about the entity, for example entity-issued press releases, materials for analysts or investor group meetings, analysts' reports or information about trading activity.

Regardless of the source of information, the auditor considers the relevance and reliability of the information to be used as audit evidence in accordance with ISA 500.<sup>20</sup>

*Scalability* (Ref: Para. 13)

A16. The nature and extent of risk assessment procedures will vary based on the nature and circumstances of the entity (e.g., the formality of the entity's policies and procedures, and processes and systems). The auditor uses professional judgment to determine the nature and extent of the risk assessment procedures to be performed to meet the requirements of this ISA.

A17. Although the extent to which an entity's policies and procedures, and processes and systems are formalized may vary, the auditor is still required to obtain the understanding in accordance with paragraphs 19, 21, 22, 24, 25 and 26.

**Examples:**

Some entities, including less complex entities, and particularly owner-managed entities, may not have established structured processes and systems (e.g., a risk assessment process or a process to monitor the system of internal control) or may have established processes or systems with limited documentation or a lack of consistency in how they are undertaken. When such systems and processes lack formality, the auditor may still be able to perform risk assessment procedures through observation and inquiry.

Other entities, typically more complex entities, are expected to have more formalized and documented policies and procedures. The auditor may use such documentation in performing risk assessment procedures.

<sup>19</sup> See paragraphs A37 and A38.

<sup>20</sup> ISA 500, *Audit Evidence*, paragraph 7

A18. The nature and extent of risk assessment procedures to be performed the first time an engagement is undertaken may be more extensive than procedures for a recurring engagement. In subsequent periods, the auditor may focus on changes that have occurred since the preceding period.

*Types of Risk Assessment Procedures* (Ref: Para. 14)

A19. ISA 500<sup>21</sup> explains the types of audit procedures that may be performed in obtaining audit evidence from risk assessment procedures and further audit procedures. The nature, timing and extent of the audit procedures may be affected by the fact that some of the accounting data and other evidence may only be available in electronic form or only at certain points in time.<sup>22</sup> The auditor may perform substantive procedures or tests of controls, in accordance with ISA 330, concurrently with risk assessment procedures, when it is efficient to do so. Audit evidence obtained that supports the identification and assessment of risks of material misstatement may also support the detection of misstatements at the assertion level or the evaluation of the operating effectiveness of controls.

A20. Although the auditor is required to perform all the risk assessment procedures described in paragraph 14 in the course of obtaining the required understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control (see paragraphs 19–26), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed when the information to be obtained may be helpful in identifying risks of material misstatement. Examples of such procedures may include making inquiries of the entity's external legal counsel or external supervisors, or of valuation experts that the entity has used.

*Automated Tools and Techniques* (Ref: Para. 14)

A21. Using automated tools and techniques, the auditor may perform risk assessment procedures on large volumes of data (from the general ledger, sub-ledgers or other operational data) including for analysis, recalculations, reperformance or reconciliations.

*Inquiries of Management and Others within the Entity* (Ref: Para. 14(a))

*Why Inquiries Are Made of Management and Others Within the Entity*

A22. Information obtained by the auditor to support an appropriate basis for the identification and assessment of risks, and the design of further audit procedures, may be obtained through inquiries of management and those responsible for financial reporting.

A23. Inquiries of management and those responsible for financial reporting and of other appropriate individuals within the entity and other employees with

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<sup>21</sup> ISA 500, paragraphs A14–A17 and A21–A25

<sup>22</sup> ISA 500, paragraph A12

different levels of authority may offer the auditor varying perspectives when identifying and assessing risks of material misstatement.

**Examples:**

- Inquiries directed towards those charged with governance may help the auditor understand the extent of oversight by those charged with governance over the preparation of the financial statements by management. ISA 260 (Revised)<sup>23</sup> identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
- Inquiries of employees responsible for initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed towards in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contractual terms.
- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- Inquiries directed towards the risk management function (or inquiries of those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed towards IT personnel may provide information about system changes, system or control failures, or other IT-related risks.

#### Considerations Specific to Public Sector Entities

A24. When making inquiries of those who may have information that is likely to assist in identifying risks of material misstatement, auditors of public sector entities may obtain information from additional sources such as from the auditors that are involved in performance or other audits related to the entity.

#### Inquiries of the Internal Audit Function

**Appendix 4** sets out considerations for understanding an entity's internal audit function.

<sup>23</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 4(b)

Why inquiries are made of the internal audit function (if the function exists)

A25. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may assist the auditor in understanding the entity and its environment, and the entity's system of internal control, in the identification and assessment of risks.

Considerations specific to public sector entities

A26. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function may assist the auditors in identifying the risk of material non-compliance with applicable laws and regulations, and the risk of control deficiencies related to financial reporting.

*Analytical Procedures* (Ref: Para. 14(b))

Why Analytical Procedures Are Performed as a Risk Assessment Procedure

A27. Analytical procedures help identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that indicate matters that may have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

A28. Analytical procedures performed as risk assessment procedures may therefore assist in identifying and assessing the risks of material misstatement by identifying aspects of the entity of which the auditor was unaware or understanding how inherent risk factors, such as change, affect susceptibility of assertions to misstatement.

Types of Analytical Procedures

A29. Analytical procedures performed as risk assessment procedures may:

- Include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold (non-financial).
- Use data aggregated at a high level. Accordingly, the results of those analytical procedures may provide a broad initial indication about the likelihood of a material misstatement.

**Example:**

In the audit of many entities, including those with less complex business models and processes, and a less complex information system, the auditor may perform a simple comparison of information, such as the change in interim or monthly account balances from balances in prior periods, to obtain an indication of potentially higher risk areas.

A30. This ISA deals with the auditor’s use of analytical procedures as risk assessment procedures. ISA 520<sup>24</sup> deals with the auditor’s use of analytical procedures as substantive procedures (“substantive analytical procedures”) and the auditor’s responsibility to perform analytical procedures near the end of the audit. Accordingly, analytical procedures performed as risk assessment procedures are not required to be performed in accordance with the requirements of ISA 520. However, the requirements and application material in ISA 520 may provide useful guidance to the auditor when performing analytical procedures as part of the risk assessment procedures.

#### Automated tools and techniques

A31. Analytical procedures can be performed using a number of tools or techniques, which may be automated. Applying automated analytical procedures to the data may be referred to as data analytics.

#### **Example:**

The auditor may use a spreadsheet to perform a comparison of actual recorded amounts to budgeted amounts, or may perform a more advanced procedure by extracting data from the entity’s information system, and further analyzing this data using visualization techniques to identify classes of transactions, account balances or disclosures for which further specific risk assessment procedures may be warranted.

#### *Observation and Inspection* (Ref: Para. 14(c))

#### Why Observation and Inspection Are Performed as Risk Assessment Procedures

A32. Observation and inspection may support, corroborate or contradict inquiries of management and others, and may also provide information about the entity and its environment.

#### Scalability

A33. Where policies or procedures are not documented, or the entity has less formalized controls, the auditor may still be able to obtain some audit evidence to support the identification and assessment of the risks of material misstatement through observation or inspection of the performance of the control.

#### **Examples:**

- The auditor may obtain an understanding of controls over an inventory count, even if they have not been documented by the entity, through direct observation.
- The auditor may be able to observe segregation of duties.
- The auditor may be able to observe passwords being entered.

<sup>24</sup> ISA 520, *Analytical Procedures*

### Observation and Inspection as Risk Assessment Procedures

A34. Risk assessment procedures may include observation or inspection of the following:

- The entity's operations.
- Internal documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- The entity's premises and plant facilities.
- Information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; regulatory or financial publications; or other external documents about the entity's financial performance (such as those referred to in paragraph A79).
- The behaviors and actions of management or those charged with governance (such as the observation of an audit committee meeting).

### Automated tools and techniques

A35. Automated tools or techniques may also be used to observe or inspect, in particular assets, for example through the use of remote observation tools (e.g., a drone).

### Considerations Specific to Public Sector Entities

A36. Risk assessment procedures performed by auditors of public sector entities may also include observation and inspection of documents prepared by management for the legislature, for example documents related to mandatory performance reporting.

### *Information from Other Sources* (Ref: Para. 15)

#### Why the Auditor Considers Information from Other Sources

A37. Information obtained from other sources may be relevant to the identification and assessment of the risks of material misstatement by providing information and insights about:

- The nature of the entity and its business risks, and what may have changed from previous periods.
- The integrity and ethical values of management and those charged with governance, which may also be relevant to the auditor's understanding of the control environment.
- The applicable financial reporting framework and its application to the nature and circumstances of the entity.

## Other Relevant Sources

A38. Other relevant sources of information include:

- The auditor's procedures regarding acceptance or continuance of the client relationship or the audit engagement in accordance with ISA 220, including the conclusions reached thereon.<sup>25</sup>
- Other engagements performed for the entity by the engagement partner. The engagement partner may have obtained knowledge relevant to the audit, including about the entity and its environment, when performing other engagements for the entity. Such engagements may include agreed-upon procedures engagements or other audit or assurance engagements, including engagements to address incremental reporting requirements in the jurisdiction.

Information from the Auditor's Previous Experience with the Entity and Previous Audits (Ref: Para. 16)

Why information from previous audits is important to the current audit

A39. The auditor's previous experience with the entity and from audit procedures performed in previous audits may provide the auditor with information that is relevant to the auditor's determination of the nature and extent of risk assessment procedures, and the identification and assessment of risks of material misstatement.

Nature of the Information from Previous Audits

A40. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.
- The nature of the entity and its environment, and the entity's system of internal control (including control deficiencies).
- Significant changes that the entity or its operations may have undergone since the prior financial period.
- Those particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example, due to their complexity.

A41. The auditor is required to determine whether information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits remains relevant and reliable, if the auditor intends

<sup>25</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 12

to use that information for the purposes of the current audit. If the nature or circumstances of the entity have changed, or new information has been obtained, the information from prior periods may no longer be relevant or reliable for the current audit. To determine whether changes have occurred that may affect the relevance or reliability of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems. If the information is not reliable, the auditor may consider performing additional procedures that are appropriate in the circumstances.

*Engagement Team Discussion* (Ref: Para. 17–18)

Why the Engagement Team Is Required to Discuss the Application of the Applicable Financial Reporting Framework and the Susceptibility of the Entity's Financial Statements to Material Misstatement

A42. The discussion among the engagement team about the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement:

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity. Sharing information contributes to an enhanced understanding by all engagement team members.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject, how inherent risk factors may affect the susceptibility to misstatement of classes of transactions, account balances and disclosures, and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit, including the decisions about the nature, timing and extent of further audit procedures. In particular, the discussion assists engagement team members in further considering contradictory information based on each member's own understanding of the nature and circumstances of the entity.
- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

ISA 240 requires the engagement team discussion to place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud may occur.<sup>26</sup>

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<sup>26</sup> ISA 240, paragraph 16

- A43. Professional skepticism is necessary for the critical assessment of audit evidence, and a robust and open engagement team discussion, including for recurring audits, may lead to improved identification and assessment of the risks of material misstatement. Another outcome from the discussion may be that the auditor identifies specific areas of the audit for which exercising professional skepticism may be particularly important, and may lead to the involvement of more experienced members of the engagement team who are appropriately skilled to be involved in the performance of audit procedures related to those areas.

#### Scalability

- A44. When the engagement is carried out by a single individual, such as a sole practitioner (i.e., where an engagement team discussion would not be possible), consideration of the matters referred to in paragraphs A42 and A46 nonetheless may assist the auditor in identifying where there may be risks of material misstatement.
- A45. When an engagement is carried out by a large engagement team, such as for an audit of group financial statements, it is not always necessary or practical for the discussion to include all members in a single discussion (for example, in a multi-location audit), nor is it necessary for all the members of the engagement team to be informed of all the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking into account the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

#### Discussion of Disclosures in the Applicable Financial Reporting Framework

- A46. As part of the discussion among the engagement team, consideration of the disclosure requirements of the applicable financial reporting framework assists in identifying early in the audit where there may be risks of material misstatement in relation to disclosures, even in circumstances where the applicable financial reporting framework only requires simplified disclosures. Matters the engagement team may discuss include:

- Changes in financial reporting requirements that may result in significant new or revised disclosures;
- Changes in the entity's environment, financial condition or activities that may result in significant new or revised disclosures, for example, a significant business combination in the period under audit;
- Disclosures for which obtaining sufficient appropriate audit evidence may have been difficult in the past; and
- Disclosures about complex matters, including those involving significant management judgment as to what information to disclose.

### Considerations Specific to Public Sector Entities

A47. As part of the discussion among the engagement team by auditors of public sector entities, consideration may also be given to any additional broader objectives, and related risks, arising from the audit mandate or obligations for public sector entities.

### **Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework and the Entity’s System of Internal Control** (Ref: Para. 19–27)

**Appendices 1 through 6** set out further considerations relating to obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity’s system of internal control.

#### *Obtaining the Required Understanding* (Ref: Para. 19–27)

A48. Obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity’s system of internal control is a dynamic and iterative process of gathering, updating and analyzing information and continues throughout the audit. Therefore, the auditor’s expectations may change as new information is obtained.

A49. The auditor’s understanding of the entity and its environment and the applicable financial reporting framework may also assist the auditor in developing initial expectations about the classes of transactions, account balances and disclosures that may be significant classes of transactions, account balances and disclosures. These expected significant classes of transactions, account balances and disclosures form the basis for the scope of the auditor’s understanding of the entity’s information system.

#### *Why an Understanding of the Entity and Its Environment, and the Applicable Financial Reporting Framework Is Required* (Ref: Para. 19–20)

A50. The auditor’s understanding of the entity and its environment, and the applicable financial reporting framework, assists the auditor in understanding the events and conditions that are relevant to the entity, and in identifying how inherent risk factors affect the susceptibility of assertions to misstatement in the preparation of the financial statements, in accordance with the applicable financial reporting framework, and the degree to which they do so. Such information establishes a frame of reference within which the auditor identifies and assesses risks of material misstatement. This frame of reference also assists the auditor in planning the audit and exercising professional judgment and professional skepticism throughout the audit, for example, when:

- Identifying and assessing risks of material misstatement of the financial statements in accordance with ISA 315 (Revised 2019) or other relevant standards (e.g., relating to risks of fraud in accordance with ISA 240 or

when identifying or assessing risks related to accounting estimates in accordance with ISA 540 (Revised));

- Performing procedures to help identify instances of non-compliance with laws and regulations that may have a material effect on the financial statements in accordance with ISA 250;<sup>27</sup>
- Evaluating whether the financial statements provide adequate disclosures in accordance with ISA 700 (Revised);<sup>28</sup>
- Determining materiality or performance materiality in accordance with ISA 320;<sup>29</sup> or
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures.

A51. The auditor's understanding of the entity and its environment, and the applicable financial reporting framework, also informs how the auditor plans and performs further audit procedures, for example, when:

- Developing expectations for use when performing analytical procedures in accordance with ISA 520;<sup>30</sup>
- Designing and performing further audit procedures to obtain sufficient appropriate audit evidence in accordance with ISA 330; and
- Evaluating the sufficiency and appropriateness of audit evidence obtained (e.g., relating to assumptions or management's oral and written representations).

### Scalability

A52. The nature and extent of the required understanding is a matter of the auditor's professional judgment and varies from entity to entity based on the nature and circumstances of the entity, including:

- The size and complexity of the entity, including its IT environment;
- The auditor's previous experience with the entity;
- The nature of the entity's systems and processes, including whether they are formalized or not; and
- The nature and form of the entity's documentation.

A53. The auditor's risk assessment procedures to obtain the required understanding may be less extensive in audits of less complex entities and more extensive for

<sup>27</sup> ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 14

<sup>28</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 13(e)

<sup>29</sup> ISA 320, *Materiality in Planning and Performing an Audit*, paragraphs 10–11

<sup>30</sup> ISA 520, paragraph 5

entities that are more complex. The depth of the understanding that is required by the auditor is expected to be less than that possessed by management in managing the entity.

- A54. Some financial reporting frameworks allow smaller entities to provide simpler and less detailed disclosures in the financial statements. However, this does not relieve the auditor of the responsibility to obtain an understanding of the entity and its environment and the applicable financial reporting framework as it applies to the entity.
- A55. The entity's use of IT and the nature and extent of changes in the IT environment may also affect the specialized skills that are needed to assist with obtaining the required understanding.

*The Entity and Its Environment* (Ref: Para. 19(a))

The Entity's Organizational Structure, Ownership and Governance, and Business Model (Ref: Para. 19(a)(i))

The entity's organizational structure and ownership

- A56. An understanding of the entity's organizational structure and ownership may enable the auditor to understand such matters as:

- The complexity of the entity's structure.

**Example:**

The entity may be a single entity or the entity's structure may include subsidiaries, divisions or other components in multiple locations. Further, the legal structure may be different from the operating structure. Complex structures often introduce factors that may give rise to increased susceptibility to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately and whether adequate disclosure of such issues in the financial statements has been made.

- The ownership, and relationships between owners and other people or entities, including related parties. This understanding may assist in determining whether related party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial statements.<sup>31</sup>
- The distinction between the owners, those charged with governance and management.

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<sup>31</sup> ISA 550 establishes requirements and provide guidance on the auditor's considerations relevant to related parties.

**Example:**

In less complex entities, owners of the entity may be involved in managing the entity, therefore there is little or no distinction. In contrast, such as in some listed entities, there may be a clear distinction between management, the owners of the entity, and those charged with governance.<sup>32</sup>

- The structure and complexity of the entity's IT environment.

**Examples:**

An entity may:

- Have multiple legacy IT systems in diverse businesses that are not well integrated resulting in a complex IT environment.
- Be using external or internal service providers for aspects of its IT environment (e.g., outsourcing the hosting of its IT environment to a third party or using a shared service centre for central management of IT processes in a group).

## Automated tools and techniques

- A57. The auditor may use automated tools and techniques to understand flows of transactions and processing as part of the auditor's procedures to understand the information system. An outcome of these procedures may be that the auditor obtains information about the entity's organizational structure or those with whom the entity conducts business (e.g., vendors, customers, related parties).

## Considerations specific to public sector entities

- A58. Ownership of a public sector entity may not have the same relevance as in the private sector because decisions related to the entity may be made outside of the entity as a result of political processes. Therefore, management may not have control over certain decisions that are made. Matters that may be relevant include understanding the ability of the entity to make unilateral decisions, and the ability of other public sector entities to control or influence the entity's mandate and strategic direction.

**Example:**

A public sector entity may be subject to laws or other directives from authorities that require it to obtain approval from parties external to the entity of its strategy and objectives prior to it implementing them. Therefore, matters related to understanding the legal structure of the entity may include applicable laws and regulations, and the classification of the entity (i.e., whether the entity is a ministry, department, agency or other type of entity).

<sup>32</sup> ISA 260 (Revised), paragraphs A1 and A2, provide guidance on the identification of those charged with governance and explains that in some cases, some or all of those charged with governance may be involved in managing the entity.

## Governance

Why the auditor obtains an understanding of governance

A59. Understanding the entity's governance may assist the auditor with understanding the entity's ability to provide appropriate oversight of its system of internal control. However, this understanding may also provide evidence of deficiencies, which may indicate an increase in the susceptibility of the entity's financial statements to risks of material misstatement.

Understanding the entity's governance

A60. Matters that may be relevant for the auditor to consider in obtaining an understanding of the governance of the entity include:

- Whether any or all of those charged with governance are involved in managing the entity.
- The existence (and separation) of a non-executive Board, if any, from executive management.
- Whether those charged with governance hold positions that are an integral part of the entity's legal structure, for example as directors.
- The existence of sub-groups of those charged with governance, such as an audit committee, and the responsibilities of such a group.
- The responsibilities of those charged with governance for oversight of financial reporting, including approval of the financial statements.

The Entity's Business Model

**Appendix 1** sets out additional considerations for obtaining an understanding of the entity and its business model, as well as additional considerations for auditing special purpose entities.

Why the auditor obtains an understanding of the entity's business model

A61. Understanding the entity's objectives, strategy and business model helps the auditor to understand the entity at a strategic level, and to understand the business risks the entity takes and faces. An understanding of the business risks that have an effect on the financial statements assists the auditor in identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements.

**Examples:**

An entity's business model may rely on the use of IT in different ways:

- The entity sells shoes from a physical store, and uses an advanced stock and point of sale system to record the selling of shoes; or
- The entity sells shoes online so that all sales transactions are processed in an IT environment, including initiation of the transactions through a website.

For both of these entities the business risks arising from a significantly different business model would be substantially different, notwithstanding both entities sell shoes.

Understanding the entity's business model

- A62. Not all aspects of the business model are relevant to the auditor's understanding. Business risks are broader than the risks of material misstatement of the financial statements, although business risks include the latter. The auditor does not have a responsibility to understand or identify all business risks because not all business risks give rise to risks of material misstatement.
- A63. Business risks increasing the susceptibility to risks of material misstatement may arise from:
- Inappropriate objectives or strategies, ineffective execution of strategies, or change or complexity.
  - A failure to recognize the need for change may also give rise to business risk, for example, from:
    - The development of new products or services that may fail;
    - A market which, even if successfully developed, is inadequate to support a product or service; or
    - Flaws in a product or service that may result in legal liability and reputational risk.
  - Incentives and pressures on management, which may result in intentional or unintentional management bias, and therefore affect the reasonableness of significant assumptions and the expectations of management or those charged with governance.
- A64. Examples of matters that the auditor may consider when obtaining an understanding of the entity's business model, objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:
- Industry developments, such as the lack of personnel or expertise to deal with the changes in the industry;

- New products and services that may lead to increased product liability;
- Expansion of the entity’s business, and demand has not been accurately estimated;
- New accounting requirements where there has been incomplete or improper implementation;
- Regulatory requirements resulting in increased legal exposure;
- Current and prospective financing requirements, such as loss of financing due to the entity’s inability to meet requirements;
- Use of IT, such as the implementation of a new IT system that will affect both operations and financial reporting; or
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements.

A65. Ordinarily, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of the entity’s system of internal control and is discussed in paragraph 22, and paragraphs A109–A113.

#### Considerations specific to public sector entities

A66. Entities operating in the public sector may create and deliver value in different ways to those creating wealth for owners but will still have a ‘business model’ with a specific objective. Matters public sector auditors may obtain an understanding of that are relevant to the business model of the entity, include:

- Knowledge of relevant government activities, including related programs.
- Program objectives and strategies, including public policy elements.

A67. For the audits of public sector entities, “management objectives” may be influenced by requirements to demonstrate public accountability and may include objectives which have their source in law, regulation or other authority.

#### Industry, Regulatory and Other External Factors (Ref: Para. 19(a)(ii))

##### Industry factors

A68. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Matters the auditor may consider include:

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

- A69. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation.

**Example:**

In the construction industry, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience.<sup>33</sup>

Regulatory factors

- A70. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment and any changes thereto. Matters the auditor may consider include:
- Regulatory framework for a regulated industry, for example, prudential requirements, including related disclosures.
  - Legislation and regulation that significantly affect the entity's operations, for example, labor laws and regulations.
  - Taxation legislation and regulations.
  - Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restriction policies.
  - Environmental requirements affecting the industry and the entity's business.
- A71. ISA 250 (Revised) includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.<sup>34</sup>

Considerations specific to public sector entities

- A72. For the audits of public sector entities, there may be particular laws or regulations that affect the entity's operations. Such elements may be an essential consideration when obtaining an understanding of the entity and its environment.

Other external factors

- A73. Other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

<sup>33</sup> ISA 220, paragraph 14

<sup>34</sup> ISA 250 (Revised), paragraph 13

Measures Used by Management to Assess the Entity's Financial Performance (Ref: Para. 19(a)(iii))

Why the auditor understands measures used by management

A74. An understanding of the entity's measures assists the auditor in considering whether such measures, whether used externally or internally, create pressures on the entity to achieve performance targets. These pressures may motivate management to take actions that increase the susceptibility to misstatement due to management bias or fraud (e.g., to improve the business performance or to intentionally misstate the financial statements) (see ISA 240 for requirements and guidance in relation to the risks of fraud).

A75. Measures may also indicate to the auditor the likelihood of risks of material misstatement of related financial statement information. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry.

Measures used by management

A76. Management and others ordinarily measure and review those matters they regard as important. Inquiries of management may reveal that it relies on certain key indicators, whether publicly available or not, for evaluating financial performance and taking action. In such cases, the auditor may identify relevant performance measures, whether internal or external, by considering the information that the entity uses to manage its business. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

A77. Key indicators used for evaluating financial performance may include:

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- Period-on-period financial performance analyses.
- Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.
- Employee performance measures and incentive compensation policies.
- Comparisons of an entity's performance with that of competitors.

Scalability (Ref: Para. 19(a)(iii))

A78. The procedures undertaken to understand the entity's measures may vary depending on the size or complexity of the entity, as well as the involvement of owners or those charged with governance in the management of the entity.

**Examples:**

- For some less complex entities, the terms of the entity's bank borrowings (i.e., bank covenants) may be linked to specific performance measures related to the entity's performance or financial position (e.g., a maximum working capital amount). The auditor's understanding of the performance measures used by the bank may help identify areas where there is increased susceptibility to the risk of material misstatement.
- For some entities whose nature and circumstances are more complex, such as those operating in the insurance or banking industries, performance or financial position may be measured against regulatory requirements (e.g., regulatory ratio requirements such as capital adequacy and liquidity ratios performance hurdles). The auditor's understanding of these performance measures may help identify areas where there is increased susceptibility to the risk of material misstatement.

## Other considerations

A79. External parties may also review and analyze the entity's financial performance, in particular for entities where financial information is publicly available. The auditor may also consider publicly available information to help the auditor further understand the business or identify contradictory information such as information from:

- Analysts or credit agencies.
- News and other media, including social media.
- Taxation authorities.
- Regulators.
- Trade unions.
- Providers of finance.

Such financial information can often be obtained from the entity being audited.

A80. The measurement and review of financial performance is not the same as the monitoring of the system of internal control (discussed as a component of the system of internal control in paragraphs A114–A122), though their purposes may overlap:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- In contrast, monitoring of the system of internal control is concerned with monitoring the effectiveness of controls including those related to management's measurement and review of financial performance.

In some cases, however, performance indicators also provide information that enables management to identify control deficiencies.

#### Considerations specific to public sector entities

A81. In addition to considering relevant measures used by a public sector entity to assess the entity's financial performance, auditors of public sector entities may also consider non-financial information such as achievement of public benefit outcomes (for example, the number of people assisted by a specific program).

#### *The Applicable Financial Reporting Framework* (Ref: Para. 19(b))

#### Understanding the Applicable Financial Reporting Framework and the Entity's Accounting Policies

A82. Matters that the auditor may consider when obtaining an understanding of the entity's applicable financial reporting framework, and how it applies in the context of the nature and circumstances of the entity and its environment include:

- The entity's financial reporting practices in terms of the applicable financial reporting framework, such as:
  - Accounting principles and industry-specific practices, including for industry-specific significant classes of transactions, account balances and related disclosures in the financial statements (for example, loans and investments for banks, or research and development for pharmaceuticals).
  - Revenue recognition.
  - Accounting for financial instruments, including related credit losses.
  - Foreign currency assets, liabilities and transactions.
  - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for cryptocurrency).
- An understanding of the entity's selection and application of accounting policies, including any changes thereto as well as the reasons therefore, may encompass such matters as:
  - The methods the entity uses to recognize, measure, present and disclose significant and unusual transactions.
  - The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

- Changes in the environment, such as changes in the applicable financial reporting framework or tax reforms that may necessitate a change in the entity's accounting policies.
  - Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt, or comply with, such requirements.
- A83. Obtaining an understanding of the entity and its environment may assist the auditor in considering where changes in the entity's financial reporting (e.g., from prior periods) may be expected.

**Example:**

If the entity has had a significant business combination during the period, the auditor would likely expect changes in classes of transactions, account balances and disclosures associated with that business combination. Alternatively, if there were no significant changes in the financial reporting framework during the period, the auditor's understanding may help confirm that the understanding obtained in the prior period remains applicable.

## Considerations specific to public sector entities

- A84. The applicable financial reporting framework in a public sector entity is determined by the legislative and regulatory frameworks relevant to each jurisdiction or within each geographical area. Matters that may be considered in the entity's application of the applicable financial reporting requirements, and how it applies in the context of the nature and circumstances of the entity and its environment, include whether the entity applies a full accrual basis of accounting or a cash basis of accounting in accordance with the International Public Sector Accounting Standards, or a hybrid.

## How Inherent Risk Factors Affect Susceptibility of Assertions to Misstatement (Ref: Para. 19(c))

**Appendix 2** provides examples of events and conditions that may give rise to the existence of risks of material misstatement, categorized by inherent risk factor.

## Why the auditor understands inherent risk factors when understanding the entity and its environment and the applicable financial reporting framework

- A85. Understanding the entity and its environment, and the applicable financial reporting framework, assists the auditor in identifying events or conditions, the characteristics of which may affect the susceptibility of assertions about classes of transactions, account balances or disclosures to misstatement. These characteristics are inherent risk factors. Inherent risk factors may affect susceptibility of assertions to misstatement by influencing the likelihood of

occurrence of a misstatement or the magnitude of the misstatement if it were to occur. Understanding how inherent risk factors affect the susceptibility of assertions to misstatement may assist the auditor with a preliminary understanding of the likelihood or magnitude of misstatements, which assists the auditor in identifying risks of material misstatement at the assertion level in accordance with paragraph 28(b). Understanding the degree to which inherent risk factors affect susceptibility of assertions to misstatement also assists the auditor in assessing the likelihood and magnitude of a possible misstatement when assessing inherent risk in accordance with paragraph 31(a). Accordingly, understanding the inherent risk factors may also assist the auditor in designing and performing further audit procedures in accordance with ISA 330.

- A86. The auditor's identification of risks of material misstatement at the assertion level and assessment of inherent risk may also be influenced by audit evidence obtained by the auditor in performing other risk assessment procedures, further audit procedures or in fulfilling other requirements in the ISAs (see paragraphs A95, A103, A111, A121, A124 and A151).

The effect of inherent risk factors on a class of transactions, account balance or disclosure

- A87. The extent of susceptibility to misstatement of a class of transactions, account balance or disclosure arising from complexity or subjectivity is often closely related to the extent to which it is subject to change or uncertainty.

**Example:**

If the entity has an accounting estimate that is based on assumptions, the selection of which are subject to significant judgment, the measurement of the accounting estimate is likely to be affected by both subjectivity and uncertainty.

- A88. The greater the extent to which a class of transactions, account balance or disclosure is susceptible to misstatement because of complexity or subjectivity, the greater the need for the auditor to apply professional skepticism. Further, when a class of transactions, account balance or disclosure is susceptible to misstatement because of complexity, subjectivity, change or uncertainty, these inherent risk factors may create opportunity for management bias, whether unintentional or intentional, and affect susceptibility to misstatement due to management bias. The auditor's identification of risks of material misstatement, and assessment of inherent risk at the assertion level, are also affected by the interrelationships among inherent risk factors.
- A89. Events or conditions that may affect susceptibility to misstatement due to management bias may also affect susceptibility to misstatement due to other fraud risk factors. Accordingly, this may be relevant information for use in accordance with paragraph 24 of ISA 240, which requires the auditor to evaluate whether the information obtained from the other risk assessment procedures and related activities indicates that one or more fraud risk factors are present.

*Understanding the Components of the Entity's System of Internal Control* (Ref: Para. 21–27)

**Appendix 3** further describes the nature of the entity's system of internal control and inherent limitations of internal control, respectively. Appendix 3 also provides further explanation of the components of a system of internal control for the purposes of the ISAs.

- A90. The auditor's understanding of the entity's system of internal control is obtained through risk assessment procedures performed to understand and evaluate each of the components of the system of internal control as set out in paragraphs 21 to 27.
- A91. The components of the entity's system of internal control for the purpose of this ISA may not necessarily reflect how an entity designs, implements and maintains its system of internal control, or how it may classify any particular component. Entities may use different terminology or frameworks to describe the various aspects of the system of internal control. For the purpose of an audit, auditors may also use different terminology or frameworks provided all the components described in this ISA are addressed.

#### Scalability

- A92. The way in which the entity's system of internal control is designed, implemented and maintained varies with an entity's size and complexity. For example, less complex entities may use less structured or simpler controls (i.e., policies and procedures) to achieve their objectives.

#### Considerations Specific to Public Sector Entities

- A93. Auditors of public sector entities often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice or reporting on spending against budget. Auditors of public sector entities may also have responsibilities to report on compliance with law, regulation or other authority. As a result, their considerations about the system of internal control may be broader and more detailed.

#### Information Technology in the Components of the Entity's System of Internal Control

**Appendix 5** provides further guidance on understanding the entity's use of IT in the components of the system of internal control.

- A94. The overall objective and scope of an audit does not differ whether an entity operates in a mainly manual environment, a completely automated environment, or an environment involving some combination of manual and automated elements (i.e., manual and automated controls and other resources used in the entity's system of internal control).

## Understanding the Nature of the Components of the Entity's System of Internal Control

A95. In evaluating the effectiveness of the design of controls and whether they have been implemented (see paragraphs A175 to A181) the auditor's understanding of each of the components of the entity's system of internal control provides a preliminary understanding of how the entity identifies business risks and how it responds to them. It may also influence the auditor's identification and assessment of the risks of material misstatement in different ways (see paragraph A86). This assists the auditor in designing and performing further audit procedures, including any plans to test the operating effectiveness of controls. For example:

- The auditor's understanding of the entity's control environment, the entity's risk assessment process, and the entity's process to monitor controls components are more likely to affect the identification and assessment of risks of material misstatement at the financial statement level.
- The auditor's understanding of the entity's information system and communication, and the entity's control activities component, are more likely to affect the identification and assessment of risks of material misstatement at the assertion level.

## Control Environment, The Entity's Risk Assessment Process and the Entity's Process to Monitor the System of Internal Control (Ref: Para. 21–24)

A96. The controls in the control environment, the entity's risk assessment process and the entity's process to monitor the system of internal control are primarily indirect controls (i.e., controls that are not sufficiently precise to prevent, detect or correct misstatements at the assertion level but which support other controls and may therefore have an indirect effect on the likelihood that a misstatement will be detected or prevented on a timely basis). However, some controls within these components may also be direct controls.

Why the auditor is required to understand the control environment, the entity's risk assessment process and the entity's process to monitor the system of internal control

A97. The control environment provides an overall foundation for the operation of the other components of the system of internal control. The control environment does not directly prevent, or detect and correct, misstatements. It may, however, influence the effectiveness of controls in the other components of the system of internal control. Similarly, the entity's risk assessment process and its process for monitoring the system of internal control are designed to operate in a manner that also supports the entire system of internal control.

A98. Because these components are foundational to the entity's system of internal control, any deficiencies in their operation could have pervasive effects on the preparation of the financial statements. Therefore, the auditor's understanding and

evaluations of these components affect the auditor's identification and assessment of risks of material misstatement at the financial statement level, and may also affect the identification and assessment of risks of material misstatement at the assertion level. Risks of material misstatement at the financial statement level affect the auditor's design of overall responses, including, as explained in ISA 330, an influence on the nature, timing and extent of the auditor's further procedures.<sup>35</sup>

Obtaining an understanding of the control environment (Ref: Para. 21)

#### Scalability

- A99. The nature of the control environment in a less complex entity is likely to be different from the control environment in a more complex entity. For example, those charged with governance in less complex entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. Accordingly, some considerations about the entity's control environment may be less relevant or may not be applicable.
- A100. In addition, audit evidence about elements of the control environment in less complex entities may not be available in documentary form, in particular where communication between management and other personnel is informal, but the evidence may still be appropriately relevant and reliable in the circumstances.

#### Examples:

- The organizational structure in a less complex entity will likely be simpler and may include a small number of employees involved in roles related to financial reporting.
- If the role of governance is undertaken directly by the owner-manager, the auditor may determine that the independence of those charged with governance is not relevant.
- Less complex entities may not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behaviour through oral communication and by management example. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a less complex entity's control environment.

Understanding the control environment (Ref: Para. 21(a))

- A101. Audit evidence for the auditor's understanding of the control environment may be obtained through a combination of inquiries and other risk assessment procedures (i.e., corroborating inquiries through observation or inspection of documents).

<sup>35</sup> ISA 330, paragraphs A1–A3

A102. In considering the extent to which management demonstrates a commitment to integrity and ethical values, the auditor may obtain an understanding through inquiries of management and employees, and through considering information from external sources, about:

- How management communicates to employees its views on business practices and ethical behavior; and
- Inspecting management's written code of conduct and observing whether management acts in a manner that supports that code.

Evaluating the control environment (Ref: Para. 21(b))

Why the auditor evaluates the control environment

A103. The auditor's evaluation of how the entity demonstrates behavior consistent with the entity's commitment to integrity and ethical values; whether the control environment provides an appropriate foundation for the other components of the entity's system of internal control; and whether any identified control deficiencies undermine the other components of the system of internal control, assists the auditor in identifying potential issues in the other components of the system of internal control. This is because the control environment is foundational to the other components of the entity's system of internal control. This evaluation may also assist the auditor in understanding risks faced by the entity and therefore in identifying and assessing the risks of material misstatement at the financial statement and assertion levels (see paragraph A86).

The auditor's evaluation of the control environment

A104. The auditor's evaluation of the control environment is based on the understanding obtained in accordance with paragraph 21(a).

A105. Some entities may be dominated by a single individual who may exercise a great deal of discretion. The actions and attitudes of that individual may have a pervasive effect on the culture of the entity, which in turn may have a pervasive effect on the control environment. Such an effect may be positive or negative.

**Example:**

Direct involvement by a single individual may be key to enabling the entity to meet its growth and other objectives, and can also contribute significantly to an effective system of internal control. On the other hand, such concentration of knowledge and authority can also lead to an increased susceptibility to misstatement through management override of controls.

A106. The auditor may consider how the different elements of the control environment may be influenced by the philosophy and operating style of senior management taking into account the involvement of independent members of those charged with governance.

A107. Although the control environment may provide an appropriate foundation for the system of internal control and may help reduce the risk of fraud, an appropriate control environment is not necessarily an effective deterrent to fraud.

**Example:**

Human resource policies and procedures directed toward hiring competent financial, accounting, and IT personnel may mitigate the risk of errors in processing and recording financial information. However, such policies and procedures may not mitigate the override of controls by senior management (e.g., to overstate earnings).

A108. The auditor's evaluation of the control environment as it relates to the entity's use of IT may include such matters as:

- Whether governance over IT is commensurate with the nature and complexity of the entity and its business operations enabled by IT, including the complexity or maturity of the entity's technology platform or architecture and the extent to which the entity relies on IT applications to support its financial reporting.
- The management organizational structure regarding IT and the resources allocated (for example, whether the entity has invested in an appropriate IT environment and necessary enhancements, or whether a sufficient number of appropriately skilled individuals have been employed including when the entity uses commercial software (with no or limited modifications)).

Obtaining an understanding of the entity's risk assessment process (Ref: Para. 22–23)

Understanding the entity's risk assessment process (Ref: Para. 22(a))

A109. As explained in paragraph A62, not all business risks give rise to risks of material misstatement. In understanding how management and those charged with governance have identified business risks relevant to the preparation of the financial statements, and decided about actions to address those risks, matters the auditor may consider include how management or, as appropriate, those charged with governance, has:

- Specified the entity's objectives with sufficient precision and clarity to enable the identification and assessment of the risks relating to the objectives;
- Identified the risks to achieving the entity's objectives and analyzed the risks as a basis for determining how the risks should be managed; and
- Considered the potential for fraud when considering the risks to achieving the entity's objectives.<sup>36</sup>

<sup>36</sup> ISA 240, paragraph 19

A110. The auditor may consider the implications of such business risks for the preparation of the entity's financial statements and other aspects of its system of internal control.

Evaluating the entity's risk assessment process (Ref: Para. 22(b))

Why the auditor evaluates whether the entity's risk assessment process is appropriate

A111. The auditor's evaluation of the entity's risk assessment process may assist the auditor in understanding where the entity has identified risks that may occur, and how the entity has responded to those risks. The auditor's evaluation of how the entity identifies its business risks, and how it assesses and addresses those risks assists the auditor in understanding whether the risks faced by the entity have been identified, assessed and addressed as appropriate to the nature and complexity of the entity. This evaluation may also assist the auditor with identifying and assessing financial statement level and assertion level risks of material misstatement (see paragraph A86).

Evaluating whether the entity's risk assessment process is appropriate (Ref: Para. 22(b))

A112. The auditor's evaluation of the appropriateness of the entity's risk assessment process is based on the understanding obtained in accordance with paragraph 22(a).

Scalability

A113. Whether the entity's risk assessment process is appropriate to the entity's circumstances considering the nature and complexity of the entity is a matter of the auditor's professional judgment.

**Example:**

In some less complex entities, and particularly owner-managed entities, an appropriate risk assessment may be performed through the direct involvement of management or the owner-manager (e.g., the manager or owner-manager may routinely devote time to monitoring the activities of competitors and other developments in the market place to identify emerging business risks). The evidence of this risk assessment occurring in these types of entities is often not formally documented, but it may be evident from the discussions the auditor has with management that management are in fact performing risk assessment procedures.

Obtaining an understanding of the entity's process to monitor the entity's system of internal control (Ref: Para. 24)

Scalability

A114. In less complex entities, and in particular owner-manager entities, the auditor's understanding of the entity's process to monitor the system of internal control

is often focused on how management or the owner-manager is directly involved in operations, as there may not be any other monitoring activities.

**Example:**

Management may receive complaints from customers about inaccuracies in their monthly statement that alerts the owner-manager to issues with the timing of when customer payments are being recognized in the accounting records.

A115. For entities where there is no formal process for monitoring the system of internal control, understanding the process to monitor the system of internal control may include understanding periodic reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

Understanding the entity's process to monitor the system of internal control (Ref: Para. 24(a))

A116. Matters that may be relevant for the auditor to consider when understanding how the entity monitors its system of internal control include:

- The design of the monitoring activities, for example whether it is periodic or ongoing monitoring;
- The performance and frequency of the monitoring activities;
- The evaluation of the results of the monitoring activities, on a timely basis, to determine whether the controls have been effective; and
- How identified deficiencies have been addressed through appropriate remedial actions, including timely communication of such deficiencies to those responsible for taking remedial action.

A117. The auditor may also consider how the entity's process to monitor the system of internal control addresses monitoring information processing controls that involve the use of IT. This may include, for example:

- Controls to monitor complex IT environments that:
  - Evaluate the continuing design effectiveness of information processing controls and modify them, as appropriate, for changes in conditions; or
  - Evaluate the operating effectiveness of information processing controls.
- Controls that monitor the permissions applied in automated information processing controls that enforce the segregation of duties.
- Controls that monitor how errors or control deficiencies related to the automation of financial reporting are identified and addressed.

Understanding the entity's internal audit function (Ref: Para. 24(a)(ii))

**Appendix 4** sets out further considerations for understanding the entity's internal audit function.

A118. The auditor's inquiries of appropriate individuals within the internal audit function help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function. This understanding, together with the information obtained from the auditor's inquiries, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, ISA 610 (Revised 2013)<sup>37</sup> applies.

Other sources of information used in the entity's process to monitor the system of internal control

Understanding the sources of information (Ref: Para. 24(b))

A119. Management's monitoring activities may use information in communications from external parties such as customer complaints or regulator comments that may indicate problems or highlight areas in need of improvement.

Why the auditor is required to understand the sources of information used for the entity's monitoring of the system of internal control

A120. The auditor's understanding of the sources of information used by the entity in monitoring the entity's system of internal control, including whether the information used is relevant and reliable, assists the auditor in evaluating whether the entity's process to monitor the entity's system of internal control is appropriate. If management assumes that information used for monitoring is relevant and reliable without having a basis for that assumption, errors that may exist in the information could potentially lead management to draw incorrect conclusions from its monitoring activities.

Evaluating the entity's process to monitor the system of internal control (Ref: Para 24(c))

Why the auditor evaluates whether the entity's process to monitor the system of internal control is appropriate

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<sup>37</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

A121. The auditor's evaluation about how the entity undertakes ongoing and separate evaluations for monitoring the effectiveness of controls assists the auditor in understanding whether the other components of the entity's system of internal control are present and functioning, and therefore assists with understanding the other components of the entity's system of internal control. This evaluation may also assist the auditor with identifying and assessing financial statement level and assertion level risks of material misstatement (see paragraph A86).

Evaluating whether the entity's process to monitor the system of internal control is appropriate (Ref: Para. 24(c))

A122. The auditor's evaluation of the appropriateness of the entity's process to monitor the system of internal control is based on the auditor's understanding of the entity's process to monitor the system of internal control.

Information System and Communication, and Control Activities (Ref: Para. 25–26)

A123. The controls in the information system and communication, and control activities components are primarily direct controls (i.e., controls that are sufficiently precise to prevent, detect or correct misstatements at the assertion level).

Why the auditor is required to understand the information system and communication and controls in the control activities component

A124. The auditor is required to understand the entity's information system and communication because understanding the entity's policies that define the flows of transactions and other aspects of the entity's information processing activities relevant to the preparation of the financial statements, and evaluating whether the component appropriately supports the preparation of the entity's financial statements, supports the auditor's identification and assessment of risks of material misstatement at the assertion level. This understanding and evaluation may also result in the identification of risks of material misstatement at the financial statement level when the results of the auditor's procedures are inconsistent with expectations about the entity's system of internal control that may have been set based on information obtained during the engagement acceptance or continuance process (see paragraph A86).

A125. The auditor is required to identify specific controls in the control activities component, and evaluate the design and determine whether the controls have been implemented, as it assists the auditor's understanding about management's approach to addressing certain risks and therefore provides a basis for the design and performance of further audit procedures responsive to these risks as required by ISA 330. The higher on the spectrum of inherent risk a risk is assessed, the more persuasive the audit evidence needs to be. Even when the auditor does not plan to test the operating effectiveness of identified controls, the auditor's understanding may still affect the design of the nature, timing and extent of substantive audit procedures that are responsive to the related risks of material misstatement.

The iterative nature of the auditor's understanding and evaluation of the information system and communication, and control activities

A126. As explained in paragraph A49, the auditor's understanding of the entity and its environment, and the applicable financial reporting framework, may assist the auditor in developing initial expectations about the classes of transactions, account balances and disclosures that may be significant classes of transactions, account balances and disclosures. In obtaining an understanding of the information system and communication component in accordance with paragraph 25(a), the auditor may use these initial expectations for the purpose of determining the extent of understanding of the entity's information processing activities to be obtained.

A127. The auditor's understanding of the information system includes understanding the policies that define flows of information relating to the entity's significant classes of transactions, account balances, and disclosures, and other related aspects of the entity's information processing activities. This information, and the information obtained from the auditor's evaluation of the information system may confirm or further influence the auditor's expectations about the significant classes of transactions, account balances and disclosures initially identified (see paragraph A126).

A128. In obtaining an understanding of how information relating to significant classes of transactions, account balances and disclosures flows into, through, and out of the entity's information system, the auditor may also identify controls in the control activities component that are required to be identified in accordance with paragraph 26(a). The auditor's identification and evaluation of controls in the control activities component may first focus on controls over journal entries and controls that the auditor plans to test the operating effectiveness of in designing the nature, timing and extent of substantive procedures.

A129. The auditor's assessment of inherent risk may also influence the identification of controls in the control activities component. For example, the auditor's identification of controls relating to significant risks may only be identifiable when the auditor has assessed inherent risk at the assertion level in accordance with paragraph 31. Furthermore, controls addressing risks for which the auditor has determined that substantive procedures alone do not provide sufficient appropriate audit evidence (in accordance with paragraph 33) may also only be identifiable once the auditor's inherent risk assessments have been undertaken.

A130. The auditor's identification and assessment of risks of material misstatement at the assertion level is influenced by both the auditor's:

- Understanding of the entity's policies for its information processing activities in the information system and communication component, and
- Identification and evaluation of controls in the control activities component.

Obtaining an understanding of the information system and communication (Ref: Para. 25)

**Appendix 3**, Paragraphs 15–19, sets out further considerations relating to the information system and communication.

### Scalability

A131. The information system, and related business processes, in less complex entities are likely to be less sophisticated than in larger entities, and are likely to involve a less complex IT environment; however, the role of the information system is just as important. Less complex entities with direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the relevant aspects of the entity’s information system may therefore require less effort in an audit of a less complex entity, and may involve a greater amount of inquiry than observation or inspection of documentation. The need to obtain an understanding, however, remains important to provide a basis for the design of further audit procedures in accordance with ISA 330 and may further assist the auditor in identifying or assessing risks of material misstatement (see paragraph A86).

Obtaining an understanding of the information system (Ref: Para. 25(a))

A132. Included within the entity’s system of internal control are aspects that relate to the entity’s reporting objectives, including its financial reporting objectives, but may also include aspects that relate to its operations or compliance objectives, when such aspects are relevant to financial reporting. Understanding how the entity initiates transactions and captures information as part of the auditor’s understanding of the information system may include information about the entity’s systems (its policies) designed to address compliance and operations objectives because such information is relevant to the preparation of the financial statements. Further, some entities may have information systems that are highly integrated such that controls may be designed in a manner to simultaneously achieve financial reporting, compliance and operational objectives, and combinations thereof.

A133. Understanding the entity’s information system also includes an understanding of the resources to be used in the entity’s information processing activities. Information about the human resources involved that may be relevant to understanding risks to the integrity of the information system include:

- The competence of the individuals undertaking the work;
- Whether there are adequate resources; and
- Whether there is appropriate segregation of duties.

A134. Matters the auditor may consider when understanding the policies that define the flows of information relating to the entity's significant classes of transactions, account balances, and disclosures in the information system and communication component include the nature of:

- (a) The data or information relating to transactions, other events and conditions to be processed;
- (b) The information processing to maintain the integrity of that data or information; and
- (c) The information processes, personnel and other resources used in the information processing process.

A135. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor in obtaining an understanding of the entity's information system in a manner that is appropriate to the entity's circumstances.

A136. The auditor's understanding of the information system may be obtained in various ways and may include:

- Inquiries of relevant personnel about the procedures used to initiate, record, process and report transactions or about the entity's financial reporting process;
- Inspection of policy or process manuals or other documentation of the entity's information system;
- Observation of the performance of the policies or procedures by entity's personnel; or
- Selecting transactions and tracing them through the applicable process in the information system (i.e., performing a walk-through).

#### Automated tools and techniques

A137. The auditor may also use automated techniques to obtain direct access to, or a digital download from, the databases in the entity's information system that store accounting records of transactions. By applying automated tools or techniques to this information, the auditor may confirm the understanding obtained about how transactions flow through the information system by tracing journal entries, or other digital records related to a particular transaction, or an entire population of transactions, from initiation in the accounting records through to recording in the general ledger. Analysis of complete or large sets of transactions may also result in the identification of variations from the normal, or expected, processing procedures for these transactions, which may result in the identification of risks of material misstatement.

Information obtained from outside of the general and subsidiary ledgers

A138. Financial statements may contain information that is obtained from outside of the general and subsidiary ledgers. Examples of such information that the auditor may consider include:

- Information obtained from lease agreements relevant to disclosures in the financial statements.
- Information disclosed in the financial statements that is produced by an entity's risk management system.
- Fair value information produced by management's experts and disclosed in the financial statements.
- Information disclosed in the financial statements that has been obtained from models, or from other calculations used to develop accounting estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
  - Assumptions developed internally that may affect an asset's useful life; or
  - Data such as interest rates that are affected by factors outside the control of the entity.
- Information disclosed in the financial statements about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.
- Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records.
- Information disclosed in the financial statements that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern.<sup>38</sup>

A139. Certain amounts or disclosures in the entity's financial statements (such as disclosures about credit risk, liquidity risk, and market risk) may be based on information obtained from the entity's risk management system. However, the auditor is not required to understand all aspects of the risk management system, and uses professional judgment in determining the necessary understanding.

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<sup>38</sup> ISA 570 (Revised), paragraphs 19–20

The entity's use of information technology in the information system

Why does the auditor understand the IT environment relevant to the information system

A140. The auditor's understanding of the information system includes the IT environment relevant to the flows of transactions and processing of information in the entity's information system because the entity's use of IT applications or other aspects in the IT environment may give rise to risks arising from the use of IT.

A141. The understanding of the entity's business model and how it integrates the use of IT may also provide useful context to the nature and extent of IT expected in the information system.

Understanding the entity's use of IT

A142. The auditor's understanding of the IT environment may focus on identifying, and understanding the nature and number of, the specific IT applications and other aspects of the IT environment that are relevant to the flows of transactions and processing of information in the information system. Changes in the flow of transactions, or information within the information system may result from program changes to IT applications, or direct changes to data in databases involved in processing, or storing those transactions or information.

A143. The auditor may identify the IT applications and supporting IT infrastructure concurrently with the auditor's understanding of how information relating to significant classes of transactions, account balances and disclosures flows into, through and out the entity's information system.

Obtaining an understanding of the entity's communication (Ref: Para. 25(b))

Scalability

A144. In larger, more complex entities, information the auditor may consider when understanding the entity's communication may come from policy manuals and financial reporting manuals.

A145. In less complex entities, communication may be less structured (e.g., formal manuals may not be used) due to fewer levels of responsibility and management's greater visibility and availability. Regardless of the size of the entity, open communication channels facilitate the reporting of exceptions and acting on them.

Evaluating whether the relevant aspects of the information system support the preparation of the entity's financial statements (Ref: Para. 25(c))

A146. The auditor's evaluation of whether the entity's information system and communication appropriately supports the preparation of the financial statements is based on the understanding obtained in paragraphs 25(a)–(b).

## Control Activities (Ref: Para. 26)

## Controls in the control activities component

**Appendix 3**, Paragraphs 20 and 21 set out further considerations relating to control activities.

A147. The control activities component includes controls that are designed to ensure the proper application of policies (which are also controls) in all the other components of the entity's system of internal control, and includes both direct and indirect controls.

**Example:**

The controls that an entity has established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the risks of material misstatement relevant to the existence and completeness assertions for the inventory account balance.

A148. The auditor's identification and evaluation of controls in the control activities component is focused on information processing controls, which are controls applied during the processing of information in the entity's information system that directly address risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information). However, the auditor is not required to identify and evaluate all information processing controls related to the entity's policies that define the flows of transactions and other aspects of the entity's information processing activities for the significant classes of transactions, account balances and disclosures.

A149. There may also be direct controls that exist in the control environment, the entity's risk assessment process or the entity's process to monitor the system of internal control, which may be identified in accordance with paragraph 26. However, the more indirect the relationship between controls that support other controls and the control that is being considered, the less effective that control may be in preventing, or detecting and correcting, related misstatements.

**Example:**

A sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the risks of material misstatement relevant to the completeness assertion for sales revenue. Accordingly, it may be less effective in addressing those risks than controls more directly related thereto, such as matching shipping documents with billing documents.

A150. Paragraph 26 also requires the auditor to identify and evaluate general IT controls for IT applications and other aspects of the IT environment that the auditor has determined to be subject to risks arising from the use of IT, because general IT controls support the continued effective functioning of information

processing controls. A general IT control alone is typically not sufficient to address a risk of material misstatement at the assertion level.

A151. The controls that the auditor is required to identify and evaluate the design, and determine the implementation of, in accordance with paragraph 26 are those:

- Controls which the auditor plans to test the operating effectiveness of in determining the nature, timing and extent of substantive procedures. The evaluation of such controls provides the basis for the auditor's design of test of control procedures in accordance with ISA 330. These controls also include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.
- Controls include controls that address significant risks and controls over journal entries. The auditor's identification and evaluation of such controls may also influence the auditor's understanding of the risks of material misstatement, including the identification of additional risks of material misstatement (see paragraph A95). This understanding also provides the basis for the auditor's design of the nature, timing and extent of substantive audit procedures that are responsive to the related assessed risks of material misstatement.
- Other controls that the auditor considers are appropriate to enable the auditor to meet the objectives of paragraph 13 with respect to risks at the assertion level, based on the auditor's professional judgment.

A152. Controls in the control activities component are required to be identified when such controls meet one or more of the criteria included in paragraph 26(a). However, when multiple controls each achieve the same objective, it is unnecessary to identify each of the controls related to such objective.

Types of controls in the control activities component (Ref: Para. 26)

A153. Examples of controls in the control activities component include authorizations and approvals, reconciliations, verifications (such as edit and validation checks or automated calculations), segregation of duties, and physical or logical controls, including those addressing safeguarding of assets.

A154. Controls in the control activities component may also include controls established by management that address risks of material misstatement related to disclosures not being prepared in accordance with the applicable financial reporting framework. Such controls may relate to information included in the financial statements that is obtained from outside of the general and subsidiary ledgers.

A155. Regardless of whether controls are within the IT environment or manual systems, controls may have various objectives and may be applied at various organizational and functional levels.

## Scalability (Ref: Para. 26)

A156. Controls in the control activities component for less complex entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, in less complex entities, more controls may be directly applied by management.

**Example:**

Management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions.

A157. It may be less practicable to establish segregation of duties in less complex entities that have fewer employees. However, in an owner-managed entity, the owner-manager may be able to exercise more effective oversight through direct involvement than in a larger entity, which may compensate for the generally more limited opportunities for segregation of duties. Although, as also explained in ISA 240, domination of management by a single individual can be a potential control deficiency since there is an opportunity for management override of controls.<sup>39</sup>

Controls that address risks of material misstatement at the assertion level (Ref: Para. 26(a))

Controls that address risks that are determined to be a significant risk (Ref: Para. 26(a) (i))

A158. Regardless of whether the auditor plans to test the operating effectiveness of controls that address significant risks, the understanding obtained about management's approach to addressing those risks may provide a basis for the design and performance of substantive procedures responsive to significant risks as required by ISA 330.<sup>40</sup> Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters may include whether and how management responds to the risks. Such responses may include:

- Controls, such as a review of assumptions by senior management or experts.
- Documented processes for accounting estimations.
- Approval by those charged with governance.

<sup>39</sup> ISA 240, paragraph A28

<sup>40</sup> ISA 330, paragraph 21

**Example:**

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

A159. ISA 240<sup>41</sup> requires the auditor to understand controls related to assessed risks of material misstatement due to fraud (which are treated as significant risks), and further explains that it is important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud.

Controls over journal entries (Ref: Para. 26(a)(ii))

A160. Controls that address risks of material misstatement at the assertion level that are expected to be identified for all audits are controls over journal entries, because the manner in which an entity incorporates information from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or non-standard, or automated or manual. The extent to which other controls are identified may vary based on the nature of the entity and the auditor's planned approach to further audit procedures.

**Example:**

In an audit of a less complex entity, the entity's information system may not be complex and the auditor may not plan to rely on the operating effectiveness of controls. Further, the auditor may not have identified any significant risks or any other risks of material misstatement for which it is necessary for the auditor to evaluate the design of controls and determine that they have been implemented. In such an audit, the auditor may determine that there are no identified controls other than the entity's controls over journal entries.

Automated tools and techniques

A161. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of automated techniques.

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<sup>41</sup> ISA 240, paragraphs 28 and A33

**Example:**

In the audit of a less complex entity, the auditor may be able to extract a total listing of all journal entries into a simple spreadsheet. It may then be possible for the auditor to sort the journal entries by applying a variety of filters such as currency amount, name of the preparer or reviewer, journal entries that gross up the balance sheet and income statement only, or to view the listing by the date the journal entry was posted to the general ledger, to assist the auditor in designing responses to the risks identified relating to journal entries.

Controls for which the auditor plans to test the operating effectiveness (Ref: Para. 26(a)(iii))

A162. The auditor determines whether there are any risks of material misstatement at the assertion level for which it is not possible to obtain sufficient appropriate audit evidence through substantive procedures alone. The auditor is required, in accordance with ISA 330,<sup>42</sup> to design and perform tests of controls that address such risks of material misstatement when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level. As a result, when such controls exist that address these risks, they are required to be identified and evaluated.

A163. In other cases, when the auditor plans to take into account the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures in accordance with ISA 330, such controls are also required to be identified because ISA 330<sup>43</sup> requires the auditor to design and perform tests of those controls.

**Examples:**

The auditor may plan to test the operating effectiveness of controls:

- Over routine classes of transactions because such testing may be more effective or efficient for large volumes of homogenous transactions.
- Over the completeness and accuracy of information produced by the entity (e.g., controls over the preparation of system-generated reports), to determine the reliability of that information, when the auditor intends to take into account the operating effectiveness of those controls in designing and performing further audit procedures.
- Relating to operations and compliance objectives when they relate to data the auditor evaluates or uses in applying audit procedures.

A164. The auditor's plans to test the operating effectiveness of controls may also be influenced by the identified risks of material misstatement at the financial

<sup>42</sup> ISA 330, paragraph 8(b)

<sup>43</sup> ISA 330, paragraph 8(a)

statement level. For example, if deficiencies are identified related to the control environment, this may affect the auditor's overall expectations about the operating effectiveness of direct controls.

Other controls that the auditor considers appropriate (Ref: Para. 26(a)(iv))

A165. Other controls that the auditor may consider are appropriate to identify, and evaluate the design and determine the implementation, may include:

- Controls that address risks assessed as higher on the spectrum of inherent risk but have not been determined to be a significant risk;
- Controls related to reconciling detailed records to the general ledger; or
- Complementary user entity controls, if using a service organization.<sup>44</sup>

Identifying IT applications and other aspects of the IT environment, risks arising from the use of IT and general IT controls (Ref: Para. 26(b)–(c))

**Appendix 5** includes example characteristics of IT applications and other aspects of the IT environment, and guidance related to those characteristics, that may be relevant in identifying IT applications and other aspects of the IT environment subject to risks arising from the use of IT.

Identifying IT applications and other aspects of the IT environment (Ref: Para. 26(b))

Why the auditor identifies risks arising from the use of IT and general IT controls related to identified IT applications and other aspects of the IT environment

A166. Understanding the risks arising from the use of IT and the general IT controls implemented by the entity to address those risks may affect:

- The auditor's decision about whether to test the operating effectiveness of controls to address risks of material misstatement at the assertion level;

**Example:**

When general IT controls are not designed effectively or appropriately implemented to address risks arising from the use of IT (e.g., controls do not appropriately prevent or detect unauthorized program changes or unauthorized access to IT applications), this may affect the auditor's decision to rely on automated controls within the affected IT applications.

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<sup>44</sup> ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

- The auditor's assessment of control risk at the assertion level;

**Example:**

The ongoing operating effectiveness of an information processing control may depend on certain general IT controls that prevent or detect unauthorized program changes to the IT information processing control (i.e., program change controls over the related IT application). In such circumstances, the expected operating effectiveness (or lack thereof) of the general IT control may affect the auditor's assessment of control risk (e.g., control risk may be higher when such general IT controls are expected to be ineffective or if the auditor does not plan to test the general IT controls).

- The auditor's strategy for testing information produced by the entity that is produced by or involves information from the entity's IT applications;

**Example:**

When information produced by the entity to be used as audit evidence is produced by IT applications, the auditor may determine to test controls over system-generated reports, including identification and testing of the general IT controls that address risks of inappropriate or unauthorized program changes or direct data changes to the reports.

- The auditor's assessment of inherent risk at the assertion level; or

**Example:**

When there are significant or extensive programming changes to an IT application to address new or revised reporting requirements of the applicable financial reporting framework, this may be an indicator of the complexity of the new requirements and their effect on the entity's financial statements. When such extensive programming or data changes occur, the IT application is also likely to be subject to risks arising from the use of IT.

- The design of further audit procedures.

**Example:**

If information processing controls depend on general IT controls, the auditor may determine to test the operating effectiveness of the general IT controls, which will then require the design of tests of controls for such general IT controls. If, in the same circumstances, the auditor determines not to test the operating effectiveness of the general IT controls, or the general IT controls are expected to be ineffective, the related risks arising from the use of IT may need to be addressed through the design of substantive procedures. However, the risks arising from the use of IT may not be able to be addressed when such risks relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. In such circumstances, the auditor may need to consider the implications for the audit opinion.

## Identifying IT applications that are subject to risks arising from the use of IT

- A167. For the IT applications relevant to the information system, understanding the nature and complexity of the specific IT processes and general IT controls that the entity has in place may assist the auditor in determining which IT applications the entity is relying upon to accurately process and maintain the integrity of information in the entity's information system. Such IT applications may be subject to risks arising from the use of IT.
- A168. Identifying the IT applications that are subject to risks arising from the use of IT involves taking into account controls identified by the auditor because such controls may involve the use of IT or rely on IT. The auditor may focus on whether an IT application includes automated controls that management is relying on and that the auditor has identified, including controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. The auditor may also consider how information is stored and processed in the information system relating to significant classes of transactions, account balances and disclosures and whether management is relying on general IT controls to maintain the integrity of that information.
- A169. The controls identified by the auditor may depend on system-generated reports, in which case the IT applications that produce those reports may be subject to risks arising from the use of IT. In other cases, the auditor may not plan to rely on controls over the system-generated reports and plan to directly test the inputs and outputs of such reports, in which case the auditor may not identify the related IT applications as being subject to risks arising from IT.

## Scalability

- A170. The extent of the auditor's understanding of the IT processes, including the extent to which the entity has general IT controls in place, will vary with the nature and the circumstances of the entity and its IT environment, as well as based on the nature and extent of controls identified by the auditor. The number of IT applications that are subject to risks arising from the use of IT also will vary based on these factors.

**Examples:**

- An entity that uses commercial software and does not have access to the source code to make any program changes is unlikely to have a process for program changes, but may have a process or procedures to configure the software (e.g., the chart of accounts, reporting parameters or thresholds). In addition, the entity may have a process or procedures to manage access to the application (e.g., a designated individual with administrative access to the commercial software). In such circumstances, the entity is unlikely to have or need formalized general IT controls.

- In contrast, a larger entity may rely on IT to a great extent and the IT environment may involve multiple IT applications and the IT processes to manage the IT environment may be complex (e.g., a dedicated IT department exists that develops and implements program changes and manages access rights), including that the entity has implemented formalized general IT controls over its IT processes.
- When management is not relying on automated controls or general IT controls to process transactions or maintain the data, and the auditor has not identified any automated controls or other information processing controls (or any that depend on general IT controls), the auditor may plan to directly test any information produced by the entity involving IT and may not identify any IT applications that are subject to risks arising from the use of IT.
- When management relies on an IT application to process or maintain data and the volume of data is significant, and management relies upon the IT application to perform automated controls that the auditor has also identified, the IT application is likely to be subject to risks arising from the use of IT.

A171. When an entity has greater complexity in its IT environment, identifying the IT applications and other aspects of the IT environment, determining the related risks arising from the use of IT, and identifying general IT controls is likely to require the involvement of team members with specialized skills in IT. Such involvement is likely to be essential, and may need to be extensive, for complex IT environments.

Identifying other aspects of the IT environment that are subject to risks arising from the use of IT

A172. The other aspects of the IT environment that may be subject to risks arising from the use of IT include the network, operating system and databases, and, in certain circumstances, interfaces between IT applications. Other aspects of the IT environment are generally not identified when the auditor does not identify IT applications that are subject to risks arising from the use of IT. When the auditor has identified IT applications that are subject to risks arising from IT, other aspects of the IT environment (e.g., database, operating system, network) are likely to be identified because such aspects support and interact with the identified IT applications.

Identifying risks arising from the use of IT and general IT controls (Ref: Para. 26(c))

**Appendix 6** sets out considerations for understanding general IT controls.

- A173. In identifying the risks arising from the use of IT, the auditor may consider the nature of the identified IT application or other aspect of the IT environment and the reasons for it being subject to risks arising from the use of IT. For some identified IT applications or other aspects of the IT environment, the auditor may identify applicable risks arising from the use of IT that relate primarily to unauthorized access or unauthorized program changes, as well as that address risks related to inappropriate data changes (e.g., the risk of inappropriate changes to the data through direct database access or the ability to directly manipulate information).
- A174. The extent and nature of the applicable risks arising from the use of IT vary depending on the nature and characteristics of the identified IT applications and other aspects of the IT environment. Applicable IT risks may result when the entity uses external or internal service providers for identified aspects of its IT environment (e.g., outsourcing the hosting of its IT environment to a third party or using a shared service center for central management of IT processes in a group). Applicable risks arising from the use of IT may also be identified related to cybersecurity. It is more likely that there will be more risks arising from the use of IT when the volume or complexity of automated application controls is higher and management is placing greater reliance on those controls for effective processing of transactions or the effective maintenance of the integrity of underlying information.

Evaluating the design, and determining implementation, of identified controls in the control activities component (Ref: Para 26(d))

- A175. Evaluating the design of an identified control involves the auditor's consideration of whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements (i.e., the control objective).
- A176. The auditor determines the implementation of an identified control by establishing that the control exists and that the entity is using it. There is little point in the auditor assessing the implementation of a control that is not designed effectively. Therefore, the auditor evaluates the design of a control first. An improperly designed control may represent a control deficiency.
- A177. Risk assessment procedures to obtain audit evidence about the design and implementation of identified controls in the control activities component may include:
- Inquiring of entity personnel.
  - Observing the application of specific controls.
  - Inspecting documents and reports.
- Inquiry alone, however, is not sufficient for such purposes.

- A178. The auditor may expect, based on experience from the previous audit or based on current period risk assessment procedures, that management does not have effectively designed or implemented controls to address a significant risk. In such instances, the procedures performed to address the requirement in paragraph 26(d) may consist of determining that such controls have not been effectively designed or implemented. If the results of the procedures indicate that controls have been newly designed or implemented, the auditor is required to perform the procedures in paragraph 26(b)–(d) on the newly designed or implemented controls.
- A179. The auditor may conclude that a control, which is effectively designed and implemented, may be appropriate to test in order to take its operating effectiveness into account in designing substantive procedures. However, when a control is not designed or implemented effectively, there is no benefit in testing it. When the auditor plans to test a control, the information obtained about the extent to which the control addresses the risk(s) of material misstatement is an input to the auditor’s control risk assessment at the assertion level.
- A180. Evaluating the design and determining the implementation of identified controls in the control activities component is not sufficient to test their operating effectiveness. However, for automated controls, the auditor may plan to test the operating effectiveness of automated controls by identifying and testing general IT controls that provide for the consistent operation of an automated control instead of performing tests of operating effectiveness on the automated controls directly. Obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. Tests of the operating effectiveness of controls, including tests of indirect controls, are further described in ISA 330.<sup>45</sup>
- A181. When the auditor does not plan to test the operating effectiveness of identified controls, the auditor’s understanding may still assist in the design of the nature, timing and extent of substantive audit procedures that are responsive to the related risks of material misstatement.

**Example:**

The results of these risk assessment procedures may provide a basis for the auditor’s consideration of possible deviations in a population when designing audit samples.

*Control Deficiencies Within the Entity’s System of Internal Control* (Ref: Para. 27)

- A182. In performing the evaluations of each of the components of the entity’s system of internal control,<sup>46</sup> the auditor may determine that certain of the entity’s

<sup>45</sup> ISA 330, paragraphs 8–11

<sup>46</sup> Paragraphs 21(b), 22(b), 24(c), 25(c) and 26(d)

policies in a component are not appropriate to the nature and circumstances of the entity. Such a determination may be an indicator that assists the auditor in identifying control deficiencies. If the auditor has identified one or more control deficiencies, the auditor may consider the effect of those control deficiencies on the design of further audit procedures in accordance with ISA 330.

A183. If the auditor has identified one or more control deficiencies, ISA 265<sup>47</sup> requires the auditor to determine whether, individually or in combination, the deficiencies constitute a significant deficiency. The auditor uses professional judgment in determining whether a deficiency represents a significant control deficiency.<sup>48</sup>

**Examples:**

Circumstances that may indicate a significant control deficiency exists include matters such as:

- The identification of fraud of any magnitude that involves senior management;
- Identified internal processes that are inadequate relating to the reporting and communication of deficiencies noted by internal audit;
- Previously communicated deficiencies that are not corrected by management in a timely manner;
- Failure by management to respond to significant risks, for example, by not implementing controls over significant risks; and
- The restatement of previously issued financial statements.

**Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 28–37)**

*Why the Auditor Identifies and Assesses the Risks of Material Misstatement*

A184. Risks of material misstatement are identified and assessed by the auditor in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

A185. Information gathered by performing risk assessment procedures is used as audit evidence to provide the basis for the identification and assessment of the risks of material misstatement. For example, the audit evidence obtained when

<sup>47</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph 8

<sup>48</sup> ISA 265, paragraphs A6–A7 set out indicators of significant deficiencies, and matters to be considered in determining whether a deficiency, or a combination of deficiencies, in internal control constitute a significant deficiency.

evaluating the design of identified controls and determining whether those controls have been implemented in the control activities component, is used as audit evidence to support the risk assessment. Such evidence also provides a basis for the auditor to design overall responses to address the assessed risks of material misstatement at the financial statement level, as well as designing and performing further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement at the assertion level, in accordance with ISA 330.

### *Identifying Risks of Material Misstatement* (Ref: Para. 28)

- A186. The identification of risks of material misstatement is performed before consideration of any related controls (i.e., the inherent risk), and is based on the auditor's preliminary consideration of misstatements that have a reasonable possibility of both occurring, and being material if they were to occur.<sup>49</sup>
- A187. Identifying the risks of material misstatement also provides the basis for the auditor's determination of relevant assertions, which assists the auditor's determination of the significant classes of transactions, account balances and disclosures.

### *Assertions*

#### Why the Auditor Uses Assertions

- A188. In identifying and assessing the risks of material misstatement, the auditor uses assertions to consider the different types of potential misstatements that may occur. Assertions for which the auditor has identified related risks of material misstatement are relevant assertions.

#### The Use of Assertions

- A189. In identifying and assessing the risks of material misstatement, the auditor may use the categories of assertions as described in paragraph A190(a)–(b) below or may express them differently provided all aspects described below have been covered. The auditor may choose to combine the assertions about classes of transactions and events, and related disclosures, with the assertions about account balances, and related disclosures.
- A190. Assertions used by the auditor in considering the different types of potential misstatements that may occur may fall into the following categories:
- (a) Assertions about classes of transactions and events, and related disclosures, for the period under audit:

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<sup>49</sup> ISA 200, paragraph A15a

- (i) Occurrence—transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.
  - (ii) Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
  - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
  - (iv) Cutoff—transactions and events have been recorded in the correct accounting period.
  - (v) Classification—transactions and events have been recorded in the proper accounts.
  - (vi) Presentation—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
- (b) Assertions about account balances, and related disclosures, at the period end:
- (i) Existence—assets, liabilities and equity interests exist.
  - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
  - (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
  - (iv) Accuracy, valuation and allocation—assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
  - (v) Classification—assets, liabilities and equity interests have been recorded in the proper accounts.
  - (vi) Presentation—assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

A191. The assertions described in paragraph A190(a)–(b) above, adapted as appropriate, may also be used by the auditor in considering the different types of misstatements that may occur in disclosures not directly related to recorded classes of transactions, events or account balances.

**Example:**

An example of such a disclosure includes where the entity may be required by the applicable financial reporting framework to describe its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks.

### Considerations Specific to Public Sector Entities

A192. When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A190(a)–(b), management may often assert that transactions and events have been carried out in accordance with law, regulation or other authority. Such assertions may fall within the scope of the financial statement audit.

*Risks of Material Misstatement at the Financial Statement Level* (Ref: Para. 28(a) and 30)

#### Why the Auditor Identifies and Assesses Risks of Material Misstatement at the Financial Statement Level

A193. The auditor identifies risks of material misstatement at the financial statement level to determine whether the risks have a pervasive effect on the financial statements, and would therefore require an overall response in accordance with ISA 330.<sup>50</sup>

A194. In addition, risks of material misstatement at the financial statement level may also affect individual assertions, and identifying these risks may assist the auditor in assessing risks of material misstatement at the assertion level, and in designing further audit procedures to address the identified risks.

#### Identifying and Assessing Risks of Material Misstatement at the Financial Statement Level

A195. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance or disclosure level (e.g., risk of management override of controls). Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level. The auditor's evaluation of whether risks identified relate

<sup>50</sup> ISA 330, paragraph 5

pervasively to the financial statements supports the auditor's assessment of the risks of material misstatement at the financial statement level. In other cases, a number of assertions may also be identified as susceptible to the risk, and may therefore affect the auditor's risk identification and assessment of risks of material misstatement at the assertion level.

**Example:**

The entity faces operating losses and liquidity issues and is reliant on funding that has not yet been secured. In such a circumstance, the auditor may determine that the going concern basis of accounting gives rise to a risk of material misstatement at the financial statement level. In this situation, the accounting framework may need to be applied using a liquidation basis, which would likely affect all assertions pervasively.

A196. The auditor's identification and assessment of risks of material misstatement at the financial statement level is influenced by the auditor's understanding of the entity's system of internal control, in particular the auditor's understanding of the control environment, the entity's risk assessment process and the entity's process to monitor the system of internal control, and:

- The outcome of the related evaluations required by paragraphs 21(b), 22(b), 24(c) and 25(c); and
- Any control deficiencies identified in accordance with paragraph 27.

In particular, risks at the financial statement level may arise from deficiencies in the control environment or from external events or conditions such as declining economic conditions.

A197. Risks of material misstatement due to fraud may be particularly relevant to the auditor's consideration of the risks of material misstatement at the financial statement level.

**Example:**

The auditor understands from inquiries of management that the entity's financial statements are to be used in discussions with lenders in order to secure further financing to maintain working capital. The auditor may therefore determine that there is a greater susceptibility to misstatement due to fraud risk factors that affect inherent risk (i.e., the susceptibility of the financial statements to material misstatement because of the risk of fraudulent financial reporting, such as overstatement of assets and revenue and understatement of liabilities and expenses to ensure that financing will be obtained).

A198. The auditor's understanding, including the related evaluations, of the control environment and other components of the system of internal control may raise doubts about the auditor's ability to obtain audit evidence on which to base the audit opinion or be cause for withdrawal from the engagement where withdrawal is possible under applicable law or regulation.

**Examples:**

- As a result of evaluating the entity's control environment, the auditor has concerns about the integrity of the entity's management, which may be so serious as to cause the auditor to conclude that the risk of intentional misrepresentation by management in the financial statements is such that an audit cannot be conducted.
- As a result of evaluating the entity's information system and communication, the auditor determines that significant changes in the IT environment have been poorly managed, with little oversight from management and those charged with governance. The auditor concludes that there are significant concerns about the condition and reliability of the entity's accounting records. In such circumstances, the auditor may determine that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

A199. ISA 705 (Revised)<sup>51</sup> establishes requirements and provides guidance in determining whether there is a need for the auditor to express a qualified opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement where withdrawal is possible under applicable law or regulation.

Considerations Specific to Public Sector Entities

A200. For public sector entities, the identification of risks at the financial statement level may include consideration of matters related to the political climate, public interest and program sensitivity.

*Risks of Material Misstatement at the Assertion Level* v(Ref: Para. 28(b))

**Appendix 2** sets out examples, in the context of inherent risk factors, of events or conditions that may indicate susceptibility to misstatement that may be material.

A201. Risks of material misstatements that do not relate pervasively to the financial statements are risks of material misstatement at the assertion level.

<sup>51</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

*Relevant Assertions and Significant Classes of Transactions, Account Balances and Disclosures* (Ref: Para. 29)

## Why Relevant Assertions and Significant Classes of Transactions, Account Balances and Disclosures Are Determined

A202. Determining relevant assertions and the significant classes of transactions, account balances and disclosures provides the basis for the scope of the auditor's understanding of the entity's information system required to be obtained in accordance with paragraph 25(a). This understanding may further assist the auditor in identifying and assessing risks of material misstatement (see A86).

## Automated Tools and Techniques

A203. The auditor may use automated techniques to assist in the identification of significant classes of transactions, account balances and disclosures.

**Examples:**

- An entire population of transactions may be analyzed using automated tools and techniques to understand their nature, source, size and volume. By applying automated techniques, the auditor may, for example, identify that an account with a zero balance at period end was comprised of numerous offsetting transactions and journal entries occurring during the period, indicating that the account balance or class of transactions may be significant (e.g., a payroll clearing account). This same payroll clearing account may also identify expense reimbursements to management (and other employees), which could be a significant disclosure due to these payments being made to related parties.
- By analyzing the flows of an entire population of revenue transactions, the auditor may more easily identify a significant class of transactions that had not previously been identified.

## Disclosures that May Be Significant

A204. Significant disclosures include both quantitative and qualitative disclosures for which there is one or more relevant assertions. Examples of disclosures that have qualitative aspects and that may have relevant assertions and may therefore be considered significant by the auditor include disclosures about:

- Liquidity and debt covenants of an entity in financial distress.
- Events or circumstances that have led to the recognition of an impairment loss.
- Key sources of estimation uncertainty, including assumptions about the future.
- The nature of a change in accounting policy, and other relevant disclosures required by the applicable financial reporting framework,

where, for example, new financial reporting requirements are expected to have a significant impact on the financial position and financial performance of the entity.

- Share-based payment arrangements, including information about how any amounts recognized were determined, and other relevant disclosures.
- Related parties, and related party transactions.
- Sensitivity analysis, including the effects of changes in assumptions used in the entity's valuation techniques intended to enable users to understand the underlying measurement uncertainty of a recorded or disclosed amount.

### *Assessing Risks of Material Misstatement at the Assertion Level*

Assessing Inherent Risk (Ref: Para. 31–33)

Assessing the likelihood and magnitude of misstatement (Ref: Para: 31)

Why the auditor assesses likelihood and magnitude of misstatement

A205. The auditor assesses the likelihood and magnitude of misstatement for identified risks of material misstatement because the significance of the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement were the misstatement to occur determines where on the spectrum of inherent risk the identified risk is assessed, which informs the auditor's design of further audit procedures to address the risk.

A206. Assessing the inherent risk of identified risks of material misstatement also assists the auditor in determining significant risks. The auditor determines significant risks because specific responses to significant risks are required in accordance with ISA 330 and other ISAs.

A207. Inherent risk factors influence the auditor's assessment of the likelihood and magnitude of misstatement for the identified risks of material misstatement at the assertion level. The greater the degree to which a class of transactions, account balance or disclosure is susceptible to material misstatement, the higher the inherent risk assessment is likely to be. Considering the degree to which inherent risk factors affect the susceptibility of an assertion to misstatement assists the auditor in appropriately assessing inherent risk for risks of material misstatement at the assertion level and in designing a more precise response to such a risk.

Spectrum of inherent risk

A208. In assessing inherent risk, the auditor uses professional judgment in determining the significance of the combination of the likelihood and magnitude of a misstatement.

A209. The assessed inherent risk relating to a particular risk of material misstatement at the assertion level represents a judgment within a range, from lower to higher, on the spectrum of inherent risk. The judgment about where in the range

inherent risk is assessed may vary based on the nature, size and complexity of the entity, and takes into account the assessed likelihood and magnitude of the misstatement and inherent risk factors.

- A210. In considering the likelihood of a misstatement, the auditor considers the possibility that a misstatement may occur, based on consideration of the inherent risk factors.
- A211. In considering the magnitude of a misstatement, the auditor considers the qualitative and quantitative aspects of the possible misstatement (i.e., misstatements in assertions about classes of transactions, account balances or disclosures may be judged to be material due to size, nature or circumstances).
- A212. The auditor uses the significance of the combination of the likelihood and magnitude of a possible misstatement in determining where on the spectrum of inherent risk (i.e., the range) inherent risk is assessed. The higher the combination of likelihood and magnitude, the higher the assessment of inherent risk; the lower the combination of likelihood and magnitude, the lower the assessment of inherent risk.
- A213. For a risk to be assessed as higher on the spectrum of inherent risk, it does not mean that both the magnitude and likelihood need to be assessed as high. Rather, it is the intersection of the magnitude and likelihood of the material misstatement on the spectrum of inherent risk that will determine whether the assessed inherent risk is higher or lower on the spectrum of inherent risk. A higher inherent risk assessment may also arise from different combinations of likelihood and magnitude, for example a higher inherent risk assessment could result from a lower likelihood but a very high magnitude.
- A214. In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may designate risks of material misstatement within categories along the spectrum of inherent risk, based on their assessment of inherent risk. These categories may be described in different ways. Regardless of the method of categorization used, the auditor's assessment of inherent risk is appropriate when the design and implementation of further audit procedures to address the identified risks of material misstatement at the assertion level is appropriately responsive to the assessment of inherent risk and the reasons for that assessment.

#### Pervasive Risks of Material Misstatement at the Assertion Level (Ref: Para 31(b))

- A215. In assessing the identified risks of material misstatement at the assertion level, the auditor may conclude that some risks of material misstatement relate more pervasively to the financial statements as a whole and potentially affect many assertions, in which case the auditor may update the identification of risks of material misstatement at the financial statement level.
- A216. In circumstances in which risks of material misstatement are identified as financial statement level risks due to their pervasive effect on a number of

assertions, and are identifiable with specific assertions, the auditor is required to take into account those risks when assessing inherent risk for risks of material misstatement at the assertion level.

### Considerations Specific to Public Sector Entities

A217. In exercising professional judgment as to the assessment of the risk of material misstatement, public sector auditors may consider the complexity of the regulations and directives, and the risks of non-compliance with authorities.

### Significant Risks (Ref: Para. 32)

Why significant risks are determined and the implications for the audit

A218. The determination of significant risks allows for the auditor to focus more attention on those risks that are on the upper end of the spectrum of inherent risk, through the performance of certain required responses, including:

- Controls that address significant risks are required to be identified in accordance with paragraph 26(a)(i), with a requirement to evaluate whether the control has been designed effectively and implemented in accordance with paragraph 26(d).
- ISA 330 requires controls that address significant risks to be tested in the current period (when the auditor intends to rely on the operating effectiveness of such controls) and substantive procedures to be planned and performed that are specifically responsive to the identified significant risk.<sup>52</sup>
- ISA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk.<sup>53</sup>
- ISA 260 (Revised) requires communicating with those charged with governance about the significant risks identified by the auditor.<sup>54</sup>
- ISA 701 requires the auditor to take into account significant risks when determining those matters that required significant auditor attention, which are matters that may be key audit matters.<sup>55</sup>
- Timely review of audit documentation by the engagement partner at the appropriate stages during the audit allows significant matters, including significant risks, to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report.<sup>56</sup>

<sup>52</sup> ISA 330, paragraphs 15 and 21

<sup>53</sup> ISA 330, paragraph 7(b)

<sup>54</sup> ISA 260 (Revised), paragraph 15

<sup>55</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraph 9

<sup>56</sup> ISA 220, paragraphs 17 and A19

- ISA 600 requires more involvement by the group engagement partner if the significant risk relates to a component in a group audit and for the group engagement team to direct the work required at the component by the component auditor.<sup>57</sup>

### Determining significant risks

A219. In determining significant risks, the auditor may first identify those assessed risks of material misstatement that have been assessed higher on the spectrum of inherent risk to form the basis for considering which risks may be close to the upper end. Being close to the upper end of the spectrum of inherent risk will differ from entity to entity, and will not necessarily be the same for an entity period on period. It may depend on the nature and circumstances of the entity for which the risk is being assessed.

A220. The determination of which of the assessed risks of material misstatement are close to the upper end of the spectrum of inherent risk, and are therefore significant risks, is a matter of professional judgment, unless the risk is of a type specified to be treated as a significant risk in accordance with the requirements of another ISA. ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.<sup>58</sup>

#### **Example:**

- Cash at a supermarket retailer would ordinarily be determined to be a high likelihood of possible misstatement (due to the risk of cash being misappropriated), however the magnitude would typically be very low (due to the low levels of physical cash handled in the stores). The combination of these two factors on the spectrum of inherent risk would be unlikely to result in the existence of cash being determined to be a significant risk.
- An entity is in negotiations to sell a business segment. The auditor considers the effect on goodwill impairment, and may determine there is a higher likelihood of possible misstatement and a higher magnitude due to the impact of inherent risk factors of subjectivity, uncertainty and susceptibility to management bias or other fraud risk factors. This may result in goodwill impairment being determined to be a significant risk.

A221. The auditor also takes into the account the relative effects of inherent risk factors when assessing inherent risk. The lower the effect of inherent risk factors, the lower the assessed risk is likely to be. Risks of material misstatement that may be assessed as having higher inherent risk and may therefore be determined to be a significant risk, may arise from matters such as the following:

<sup>57</sup> ISA 600, paragraphs 30 and 31

<sup>58</sup> ISA 240, paragraphs 26–28

- Transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved.
- Accounting estimates that have high estimation uncertainty or complex models.
- Complexity in data collection and processing to support account balances.
- Account balances or quantitative disclosures that involve complex calculations.
- Accounting principles that may be subject to differing interpretation.
- Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions.

#### Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para. 33)

Why risks for which substantive procedures alone do not provide sufficient appropriate audit evidence are required to be identified

A222. Due to the nature of a risk of material misstatement, and the control activities that address that risk, in some circumstances the only way to obtain sufficient appropriate audit evidence is to test the operating effectiveness of controls. Accordingly, there is a requirement for the auditor to identify any such risks because of the implications for the design and performance of further audit procedures in accordance with ISA 330 to address risks of material misstatement at the assertion level.

A223. Paragraph 26(a)(iii) also requires the identification of controls that address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence because the auditor is required, in accordance with ISA 330,<sup>59</sup> to design and perform tests of such controls.

Determining risks for which substantive procedures alone do not provide sufficient appropriate audit evidence

A224. Where routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. This may be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an information system that involves a high degree of integration across its IT applications. In such cases:

- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.

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<sup>59</sup> ISA 330, paragraph 8

- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

**Example:**

It is typically not possible to obtain sufficient appropriate audit evidence relating to revenue for a telecommunications entity based on substantive procedures alone. This is because the evidence of call or data activity does not exist in a form that is observable. Instead, substantial controls testing is typically performed to determine that the origination and completion of calls, and data activity is correctly captured (e.g., minutes of a call or volume of a download) and recorded correctly in the entity's billing system.

A225. ISA 540 (Revised) provides further guidance related to accounting estimates about risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.<sup>60</sup> In relation to accounting estimates this may not be limited to automated processing, but may also be applicable to complex models.

*Assessing Control Risk* (Ref: Para. 34)

A226. The auditor's plans to test the operating effectiveness of controls is based on the expectation that controls are operating effectively, and this will form the basis of the auditor's assessment of control risk. The initial expectation of the operating effectiveness of controls is based on the auditor's evaluation of the design, and the determination of implementation, of the identified controls in the control activities component. Once the auditor has tested the operating effectiveness of the controls in accordance with ISA 330, the auditor will be able to confirm the initial expectation about the operating effectiveness of controls. If the controls are not operating effectively as expected, then the auditor will need to revise the control risk assessment in accordance with paragraph 37.

A227. The auditor's assessment of control risk may be performed in different ways depending on preferred audit techniques or methodologies, and may be expressed in different ways.

A228. If the auditor plans to test the operating effectiveness of controls, it may be necessary to test a combination of controls to confirm the auditor's expectation that the controls are operating effectively. The auditor may plan to test both direct and indirect controls, including general IT controls, and, if so, take into account the combined expected effect of the controls when assessing control risk. To the extent that the control to be tested does not fully address the assessed inherent risk, the auditor determines the implications on the design of further audit procedures to reduce audit risk to an acceptably low level.

A229. When the auditor plans to test the operating effectiveness of an automated control, the auditor may also plan to test the operating effectiveness of the relevant

<sup>60</sup> ISA 540 (Revised), paragraphs A87–A89

general IT controls that support the continued functioning of that automated control to address the risks arising from the use of IT, and to provide a basis for the auditor's expectation that the automated control operated effectively throughout the period. When the auditor expects related general IT controls to be ineffective, this determination may affect the auditor's assessment of control risk at the assertion level and the auditor's further audit procedures may need to include substantive procedures to address the applicable risks arising from the use of IT. Further guidance about the procedures that the auditor may perform in these circumstances is provided in ISA 330.<sup>61</sup>

*Evaluating the Audit Evidence Obtained from the Risk Assessment Procedures* (Ref: Para 35)

Why the Auditor Evaluates the Audit Evidence from the Risk Assessment Procedures

A230. Audit evidence obtained from performing risk assessment procedures provides the basis for the identification and assessment of the risks of material misstatement. This provides the basis for the auditor's design of the nature, timing and extent of further audit procedures responsive to the assessed risks of material misstatement, at the assertion level, in accordance with ISA 330. Accordingly, the audit evidence obtained from the risk assessment procedures provides a basis for the identification and assessment of risks of material misstatement whether due to fraud or error, at the financial statement and assertion levels.

The Evaluation of the Audit Evidence

A231. Audit evidence from risk assessment procedures comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.<sup>62</sup>

Professional Skepticism

A232. In evaluating the audit evidence from the risk assessment procedures, the auditor considers whether sufficient understanding about the entity and its environment, the applicable financial reporting framework and the entity's system of internal control has been obtained to be able to identify the risks of material misstatement, as well as whether there is any evidence that is contradictory that may indicate a risk of material misstatement.

*Classes of Transactions, Account Balances and Disclosures that Are Not Significant, but Which Are Material* (Ref: Para. 36)

A233. As explained in ISA 320,<sup>63</sup> materiality and audit risk are considered when identifying and assessing the risks of material misstatement in classes of transactions, account balances and disclosures. The auditor's determination

<sup>61</sup> ISA 330, paragraphs A29–A30

<sup>62</sup> ISA 500, paragraph A1

<sup>63</sup> ISA 320, paragraph A1

of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements.<sup>64</sup> For the purpose of this ISA and paragraph 18 of ISA 330, classes of transactions, account balances or disclosures are material if omitting, misstating or obscuring information about them could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole.

- A234. There may be classes of transactions, account balances or disclosures that are material but have not been determined to be significant classes of transactions, account balances or disclosures (i.e., there are no relevant assertions identified).

**Example:**

The entity may have a disclosure about executive compensation for which the auditor has not identified a risk of material misstatement. However, the auditor may determine that this disclosure is material based on the considerations in paragraph A233.

- A235. Audit procedures to address classes of transactions, account balances or disclosures that are material but are not determined to be significant are addressed in ISA 330.<sup>65</sup> When a class of transactions, account balance or disclosure is determined to be significant as required by paragraph 29, the class of transactions, account balance or disclosure is also a material class of transactions, account balance or disclosure for the purposes of paragraph 18 of ISA 330.

*Revision of Risk Assessment (Ref: Para. 37)*

- A236. During the audit, new or other information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based.

**Example:**

The entity's risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. Paragraphs 16 and 17 of ISA 330 provide further guidance about evaluating the operating effectiveness of controls.

<sup>64</sup> ISA 320, paragraph 4

<sup>65</sup> ISA 330, paragraph 18

**Documentation** (Ref: Para. 38)

A237. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

A238. ISA 230 notes that, among other considerations, although there may be no single way in which the auditor's exercise of professional skepticism is documented, the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism.<sup>66</sup> For example, when the audit evidence obtained from risk assessment procedures includes evidence that both corroborates and contradicts management's assertions, the documentation may include how the auditor evaluated that evidence, including the professional judgments made in evaluating whether the audit evidence provides an appropriate basis for the auditor's identification and assessment of the risks of material misstatement. Examples of other requirements in this ISA for which documentation may provide evidence of the exercise of professional skepticism by the auditor include:

- Paragraph 13, which requires the auditor to design and perform risk assessment procedures in a manner that is not biased towards obtaining audit evidence that may corroborate the existence of risks or towards excluding audit evidence that may contradict the existence of risks;
- Paragraph 17, which requires a discussion among key engagement team members of the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement;
- Paragraphs 19(b) and 20, which require the auditor to obtain an understanding of the reasons for any changes to the entity's accounting policies and to evaluate whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework;
- Paragraphs 21(b), 22(b), 23(b), 24(c), 25(c), 26(d) and 27, which require the auditor to evaluate, based on the required understanding obtained, whether the components of the entity's system of internal control are appropriate to the entity's circumstances considering the nature and complexity of the entity, and to determine whether one or more control deficiencies have been identified;
- Paragraph 35, which requires the auditor to take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management, and to evaluate whether the audit evidence obtained from the risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement; and

<sup>66</sup> ISA 230, paragraph A7

- Paragraph 36, which requires the auditor to evaluate, when applicable, whether the auditor’s determination that there are no risks of material misstatement for a material class of transactions, account balance or disclosure remains appropriate.

### Scalability

- A239. The manner in which the requirements of paragraph 38 are documented is for the auditor to determine using professional judgment.
- A240. More detailed documentation, that is sufficient to enable an experienced auditor, having no previous experience with the audit, to understand the nature, timing and extent of the audit procedures performed, may be required to support the rationale for difficult judgments made.
- A241. For the audits of less complex entities, the form and extent of documentation may be simple and relatively brief. The form and extent of the auditor’s documentation is influenced by the nature, size and complexity of the entity and its system of internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit. It is not necessary to document the entirety of the auditor’s understanding of the entity and matters related to it. Key elements<sup>67</sup> of understanding documented by the auditor may include those on which the auditor based the assessment of the risks of material misstatement. However, the auditor is not required to document every inherent risk factor that was taken into account in identifying and assessing the risks of material misstatement at the assertion level.

**Example:**

In audits of less complex entities audit documentation may be incorporated in the auditor’s documentation of the overall strategy and audit plan.<sup>68</sup> Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor’s documentation of further audit procedures.<sup>69</sup>

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<sup>67</sup> ISA 230, paragraph 8

<sup>68</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraphs 7, 9 and A11

<sup>69</sup> ISA 330, paragraph 28

## Appendix 1

(Ref: Para. A61–A67)

### Considerations for Understanding the Entity and its Business Model

This appendix explains the objectives and scope of the entity's business model and provides examples of matters that the auditor may consider in understanding the activities of the entity that may be included in the business model. The auditor's understanding of the entity's business model, and how it is affected by its business strategy and business objectives, may assist the auditor in identifying business risks that may have an effect on the financial statements. In addition, this may assist the auditor in identifying risks of material misstatement.

#### Objectives and Scope of an Entity's Business Model

1. An entity's business model describes how an entity considers, for example its organizational structure, operations or scope of activities, business lines (including competitors and customers thereof), processes, growth opportunities, globalization, regulatory requirements and technologies. The entity's business model describes how the entity creates, preserves and captures financial or broader value, for its stakeholders.
2. Strategies are the approaches by which management plans to achieve the entity's objectives, including how the entity plans to address the risks and opportunities that it faces. An entity's strategies are changed over time by management, to respond to changes in its objectives and in the internal and external circumstances in which it operates.
3. A description of a business model typically includes:
  - The scope of the entity's activities, and why it does them.
  - The entity's structure and scale of its operations.
  - The markets or geographical or demographic spheres, and parts of the value chain, in which it operates, how it engages with those markets or spheres (main products, customer segments and distribution methods), and the basis on which it competes.
  - The entity's business or operating processes (e.g., investment, financing and operating processes) employed in performing its activities, focusing on those parts of the business processes that are important in creating, preserving or capturing value.
  - The resources (e.g., financial, human, intellectual, environmental and technological) and other inputs and relationships (e.g., customers, competitors, suppliers and employees) that are necessary or important to its success.

- How the entity's business model integrates the use of IT in its interactions with customers, suppliers, lenders and other stakeholders through IT interfaces and other technologies.
4. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a significant fall in real estate market values may increase the risk of material misstatement associated with the valuation assertion for a lender of medium-term real estate backed loans. However, the same risk, particularly in combination with a severe economic downturn that concurrently increases the underlying risk of lifetime credit losses on its loans, may also have a longer-term consequence. The resulting net exposure to credit losses may cast significant doubt on the entity's ability to continue as a going concern. If so, this could have implications for management's, and the auditor's, conclusion as to the appropriateness of the entity's use of the going concern basis of accounting, and determination as to whether a material uncertainty exists. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of events and conditions that may give rise to the existence of risks of material misstatement are indicated in **Appendix 2**.

### **Activities of the Entity**

5. Examples of matters that the auditor may consider when obtaining an understanding of the activities of the entity (included in the entity's business model) include:
- (a) Business operations such as:
    - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
    - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
    - Alliances, joint ventures, and outsourcing activities.
    - Geographic dispersion and industry segmentation.
    - Location of production facilities, warehouses, and offices, and location and quantities of inventories.
    - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post-employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).

- Research and development activities and expenditures.
  - Transactions with related parties.
- (b) Investments and investment activities such as:
- Planned or recently executed acquisitions or divestitures.
  - Investments and dispositions of securities and loans.
  - Capital investment activities.
  - Investments in non-consolidated entities, including non-controlled partnerships, joint ventures and non-controlled special-purpose entities.
- (c) Financing and financing activities such as:
- Ownership structure of major subsidiaries and associated entities, including consolidated and non-consolidated structures.
  - Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
  - Beneficial owners (for example, local, foreign, business reputation and experience) and related parties.
  - Use of derivative financial instruments.

### Nature of Special-Purpose Entities

6. A special-purpose entity (sometimes referred to as a special-purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitization of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As ISA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.<sup>70</sup>
7. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special-purpose entity.

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<sup>70</sup> ISA 550, paragraph A7

## Appendix 2

(Ref: Para. 12(f), 19(c), A7–A8, A85–A89)

### Understanding Inherent Risk Factors

This appendix provides further explanation about the inherent risk factors, as well as matters that the auditor may consider in understanding and applying the inherent risk factors in identifying and assessing the risks of material misstatement at the assertion level.

#### The Inherent Risk Factors

1. Inherent risk factors are characteristics of events or conditions that affect susceptibility of an assertion about a class of transactions, account balance or disclosure, to misstatement, whether due to fraud or error, and before consideration of controls. Such factors may be qualitative or quantitative, and include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to management bias or other fraud risk factors<sup>71</sup> insofar as they affect inherent risk. In obtaining the understanding of the entity and its environment, and the applicable financial reporting framework and the entity's accounting policies, in accordance with paragraphs 19(a)–(b), the auditor also understands how inherent risk factors affect susceptibility of assertions to misstatement in the preparation of the financial statements.
2. Inherent risk factors relating to the preparation of information required by the applicable financial reporting framework (referred to in this paragraph as “required information”) include:
  - *Complexity*—arises either from the nature of the information or in the way that the required information is prepared, including when such preparation processes are more inherently difficult to apply. For example, complexity may arise:
    - In calculating supplier rebate provisions because it may be necessary to take into account different commercial terms with many different suppliers, or many interrelated commercial terms that are all relevant in calculating the rebates due; or
    - When there are many potential data sources, with different characteristics used in making an accounting estimate, the processing of that data involves many interrelated steps, and the data is therefore inherently more difficult to identify, capture, access, understand or process.
  - *Subjectivity*—arises from inherent limitations in the ability to prepare required information in an objective manner, due to limitations in the

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<sup>71</sup> ISA 240, paragraphs A24–A27

availability of knowledge or information, such that management may need to make an election or subjective judgment about the appropriate approach to take and about the resulting information to include in the financial statements. Because of different approaches to preparing the required information, different outcomes could result from appropriately applying the requirements of the applicable financial reporting framework. As limitations in knowledge or data increase, the subjectivity in the judgments that could be made by reasonably knowledgeable and independent individuals, and the diversity in possible outcomes of those judgments, will also increase.

- *Change*—results from events or conditions that, over time, affect the entity’s business or the economic, accounting, regulatory, industry or other aspects of the environment in which it operates, when the effects of those events or conditions are reflected in the required information. Such events or conditions may occur during, or between, financial reporting periods. For example, change may result from developments in the requirements of the applicable financial reporting framework, or in the entity and its business model, or in the environment in which the entity operates. Such change may affect management’s assumptions and judgments, including as they relate to management’s selection of accounting policies or how accounting estimates are made or related disclosures are determined.
- *Uncertainty*—arises when the required information cannot be prepared based only on sufficiently precise and comprehensive data that is verifiable through direct observation. In these circumstances, an approach may need to be taken that applies the available knowledge to prepare the information using sufficiently precise and comprehensive observable data, to the extent available, and reasonable assumptions supported by the most appropriate available data, when it is not. Constraints on the availability of knowledge or data, which are not within the control of management (subject to cost constraints where applicable) are sources of uncertainty and their effect on the preparation of the required information cannot be eliminated. For example, estimation uncertainty arises when the required monetary amount cannot be determined with precision and the outcome of the estimate is not known before the date the financial statements are finalized.
- *Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk*—susceptibility to management bias results from conditions that create susceptibility to intentional or unintentional failure by management to maintain neutrality in preparing the information. Management bias is often associated with certain conditions that have the potential to give rise to management not maintaining neutrality in exercising judgment (indicators of potential

management bias), which could lead to a material misstatement of the information that would be fraudulent if intentional. Such indicators include incentives or pressures insofar as they affect inherent risk (for example, as a result of motivation to achieve a desired result, such as a desired profit target or capital ratio), and opportunity, not to maintain neutrality. Factors relevant to the susceptibility to misstatement due to fraud in the form of fraudulent financial reporting or misappropriation of assets are described in paragraphs A1 to A5 of ISA 240.

3. When complexity is an inherent risk factor, there may be an inherent need for more complex processes in preparing the information, and such processes may be inherently more difficult to apply. As a result, applying them may require specialized skills or knowledge, and may require the use of a management's expert.
4. When management judgment is more subjective, the susceptibility to misstatement due to management bias, whether unintentional or intentional, may also increase. For example, significant management judgment may be involved in making accounting estimates that have been identified as having high estimation uncertainty, and conclusions regarding methods, data and assumptions may reflect unintentional or intentional management bias.

#### **Examples of Events or Conditions that May Give Rise to the Existence of Risks of Material Misstatement**

5. The following are examples of events (including transactions) and conditions that may indicate the existence of risks of material misstatement in the financial statements, at the financial statement level or the assertion level. The examples provided by inherent risk factor cover a broad range of events and conditions; however, not all events and conditions are relevant to every audit engagement and the list of examples is not necessarily complete. The events and conditions have been categorized by the inherent risk factor that may have the greatest effect in the circumstances. Importantly, due to the interrelationships among inherent risk factors, the example events and conditions also are likely to be subject to, or affected by, other inherent risk factors to varying degrees.

Relevant Inherent Risk Factor:	Examples of Events or Conditions That May Indicate the Existence of Risks of Material Misstatement at the Assertion Level:
Complexity	<p>Regulatory:</p> <ul style="list-style-type: none"> <li>● Operations that are subject to a high degree of complex regulation.</li> </ul> <p>Business model:</p> <ul style="list-style-type: none"> <li>● The existence of complex alliances and joint ventures.</li> </ul> <p>Applicable financial reporting framework:</p> <ul style="list-style-type: none"> <li>● Accounting measurements that involve complex processes.</li> </ul> <p>Transactions:</p> <ul style="list-style-type: none"> <li>● Use of off-balance sheet finance, special-purpose entities, and other complex financing arrangements.</li> </ul>
Subjectivity	<p>Applicable financial reporting framework:</p> <ul style="list-style-type: none"> <li>● A wide range of possible measurement criteria of an accounting estimate. For example, management's recognition of depreciation or construction income and expenses.</li> <li>● Management's selection of a valuation technique or model for a non-current asset, such as investment properties.</li> </ul>
Change	<p>Economic conditions:</p> <ul style="list-style-type: none"> <li>● Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.</li> </ul> <p>Markets:</p> <ul style="list-style-type: none"> <li>● Operations exposed to volatile markets, for example, futures trading.</li> </ul> <p>Customer loss:</p> <ul style="list-style-type: none"> <li>● Going concern and liquidity issues including loss of significant customers.</li> </ul> <p>Industry model:</p> <ul style="list-style-type: none"> <li>● Changes in the industry in which the entity operates.</li> </ul> <p>Business model:</p> <ul style="list-style-type: none"> <li>● Changes in the supply chain.</li> <li>● Developing or offering new products or services, or moving into new lines of business.</li> </ul>

Relevant Inherent Risk Factor:	Examples of Events or Conditions That May Indicate the Existence of Risks of Material Misstatement at the Assertion Level:
	<p>Geography:</p> <ul style="list-style-type: none"> <li>● Expanding into new locations.</li> </ul> <p>Entity structure:</p> <ul style="list-style-type: none"> <li>● Changes in the entity such as large acquisitions or reorganizations or other unusual events.</li> <li>● Entities or business segments likely to be sold.</li> </ul> <p>Human resources competence:</p> <ul style="list-style-type: none"> <li>● Changes in key personnel including departure of key executives.</li> </ul> <p>IT:</p> <ul style="list-style-type: none"> <li>● Changes in the IT environment.</li> <li>● Installation of significant new IT systems related to financial reporting.</li> </ul> <p>Applicable financial reporting framework:</p> <ul style="list-style-type: none"> <li>● Application of new accounting pronouncements.</li> </ul> <p>Capital:</p> <ul style="list-style-type: none"> <li>● New constraints on the availability of capital and credit.</li> </ul> <p>Regulatory:</p> <ul style="list-style-type: none"> <li>● Inception of investigations into the entity’s operations or financial results by regulatory or government bodies.</li> <li>● Impact of new legislation related to environmental protection.</li> </ul>
Uncertainty	<p>Reporting:</p> <ul style="list-style-type: none"> <li>● Events or transactions that involve significant measurement uncertainty, including accounting estimates, and related disclosures.</li> <li>● Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.</li> </ul>

<p>Relevant Inherent Risk Factor:</p>	<p>Examples of Events or Conditions That May Indicate the Existence of Risks of Material Misstatement at the Assertion Level:</p>
<p>Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk</p>	<p>Reporting:</p> <ul style="list-style-type: none"> <li>● Opportunities for management and employees to engage in fraudulent financial reporting, including omission, or obscuring, of significant information in disclosures.</li> </ul> <p>Transactions:</p> <ul style="list-style-type: none"> <li>● Significant transactions with related parties.</li> <li>● Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.</li> <li>● Transactions that are recorded based on management’s intent, for example, debt refinancing, assets to be sold and classification of marketable securities.</li> </ul>

*Other events or conditions that may indicate risks of material misstatement at the financial statement level:*

- Lack of personnel with appropriate accounting and financial reporting skills.
- Control deficiencies – particularly in the control environment, risk assessment process and process for monitoring, and especially those not addressed by management.
- Past misstatements, history of errors or a significant amount of adjustments at period end.

## Appendix 3

(Ref: Para. 12(m), 21–26, A90–A181)

### Understanding the Entity’s System of Internal Control

1. The entity’s system of internal control may be reflected in policy and procedures manuals, systems and forms, and the information embedded therein, and is effected by people. The entity’s system of internal control is implemented by management, those charged with governance, and other personnel based on the structure of the entity. The entity’s system of internal control can be applied, based on the decisions of management, those charged with governance or other personnel and in the context of legal or regulatory requirements, to the operating model of the entity, the legal entity structure, or a combination of these.
2. This appendix further explains the components of, as well as the limitations of, the entity’s system of internal control as set out in paragraphs 12(m), 21–26, and A90–A181, as they relate to a financial statement audit.
3. Included within the entity’s system of internal control are aspects that relate to the entity’s reporting objectives, including its financial reporting objectives, but it may also include aspects that relate to its operations or compliance objectives, when such aspects are relevant to financial reporting.

**Example:**

Controls over compliance with laws and regulations may be relevant to financial reporting when such controls are relevant to the entity’s preparation of disclosures of contingencies in the financial statements.

### Components of the Entity’s System of Internal Control

#### *Control Environment*

4. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity’s system of internal control, and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people, and provides the overall foundation for the operation of the other components of the entity’s system of internal control.
5. An entity’s control consciousness is influenced by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

- Their independence from management and their ability to evaluate the actions of management.
- Whether they understand the entity's business transactions.
- The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework, including whether the financial statements include adequate disclosures.

6. The control environment encompasses the following elements:

- How management's responsibilities are carried out, such as creating and maintaining the entity's culture and demonstrating management's commitment to integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards or codes of conduct, how they are communicated (e.g., through policy statements), and how they are reinforced in practice (e.g., through management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts). The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
- When those charged with governance are separate from management, how those charged with governance demonstrate independence from management and exercise oversight of the entity's system of internal control.* An entity's control consciousness is influenced by those charged with governance. Considerations may include whether there are sufficient individuals who are independent from management and objective in their evaluations and decision-making; how those charged with governance identify and accept oversight responsibilities and whether those charged with governance retain oversight responsibility for management's design, implementation and conduct of the entity's system of internal control. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures.
- How the entity assigns authority and responsibility in pursuit of its objectives.* This may include considerations about:
  - Key areas of authority and responsibility and appropriate lines of reporting;

- Policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties; and
  - Policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.
- (d) *How the entity attracts, develops, and retains competent individuals in alignment with its objectives.* This includes how the entity ensures the individuals have the knowledge and skills necessary to accomplish the tasks that define the individual's job, such as:
- Standards for recruiting the most qualified individuals – with an emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior.
  - Training policies that communicate prospective roles and responsibilities, including practices such as training schools and seminars that illustrate expected levels of performance and behavior; and
  - Periodic performance appraisals driving promotions that demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.
- (e) *How the entity holds individuals accountable for their responsibilities in pursuit of the objectives of the entity's system of internal control.* This may be accomplished through, for example:
- Mechanisms to communicate and hold individuals accountable for performance of controls responsibilities and implement corrective actions as necessary;
  - Establishing performance measures, incentives and rewards for those responsible for the entity's system of internal control, including how the measures are evaluated and maintain their relevance;
  - How pressures associated with the achievement of control objectives impact the individual's responsibilities and performance measures; and
  - How the individuals are disciplined as necessary.

The appropriateness of the above matters will be different for every entity depending on its size, the complexity of its structure and the nature of its activities.

*The Entity's Risk Assessment Process*

7. The entity's risk assessment process is an iterative process for identifying and analyzing risks to achieving the entity's objectives, and forms the basis for how management or those charged with governance determine the risks to be managed.
8. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.
9. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial information consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to assume a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:
  - *Changes in operating environment.* Changes in the regulatory, economic or operating environment can result in changes in competitive pressures and significantly different risks.
  - *New personnel.* New personnel may have a different focus on or understanding of the entity's system of internal control.
  - *New or revamped information system.* Significant and rapid changes in the information system can change the risk relating to the entity's system of internal control.
  - *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
  - *New technology.* Incorporating new technologies into production processes or the information system may change the risk associated with the entity's system of internal control.
  - *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with the entity's system of internal control.
  - *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with the entity's system of internal control.

- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.
- *Use of IT.* Risks relating to:
  - Maintaining the integrity of data and information processing;
  - Risks to the entity’s business strategy that arise if the entity’s IT strategy does not effectively support the entity’s business strategy; or
  - Changes or interruptions in the entity’s IT environment or turnover of IT personnel or when the entity does not make necessary updates to the IT environment or such updates are not timely.

*The Entity’s Process to Monitor the System of Internal Control*

10. The entity’s process to monitor the system of internal control is a continual process to evaluate the effectiveness of the entity’s system of internal control, and to take necessary remedial actions on a timely basis. The entity’s process to monitor the entity’s system of internal control may consist of ongoing activities, separate evaluations (conducted periodically), or some combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and may include regular management and supervisory activities. The entity’s process will likely vary in scope and frequency depending on the assessment of the risks by the entity.
11. The objectives and scope of internal audit functions typically include activities designed to evaluate or monitor the effectiveness of the entity’s system of internal control.<sup>72</sup> The entity’s process to monitor the entity’s system of internal control may include activities such as management’s review of whether bank reconciliations are being prepared on a timely basis, internal auditors’ evaluation of sales personnel’s compliance with the entity’s policies on terms of sales contracts, and a legal department’s oversight of compliance with the entity’s ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.
12. Controls related to the entity’s process to monitor the entity’s system of internal control, including those that monitor underlying automated controls, may be

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<sup>72</sup> ISA 610 (Revised 2013) and Appendix 4 of this ISA provide further guidance related to internal audit.

automated or manual, or a combination of both. For example, an entity may use automated monitoring controls over access to certain technology with automated reports of unusual activity to management, who manually investigate identified anomalies.

13. When distinguishing between a monitoring activity and a control related to the information system, the underlying details of the activity are considered, especially when the activity involves some level of supervisory review. Supervisory reviews are not automatically classified as monitoring activities and it may be a matter of judgment whether a review is classified as a control related to the information system or a monitoring activity. For example, the intent of a monthly completeness control would be to detect and correct errors, where a monitoring activity would ask why errors are occurring and assign management the responsibility of fixing the process to prevent future errors. In simple terms, a control related to the information system responds to a specific risk, whereas a monitoring activity assesses whether controls within each of the five components of the entity's system of internal control are operating as intended.
14. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of the entity's system of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider in performing monitoring activities any communications relating to the entity's system of internal control from external auditors.

#### *The Information System and Communication*

15. The information system relevant to the preparation of the financial statements consists of activities and policies, and accounting and supporting records, designed and established to:
  - Initiate, record and process entity transactions (as well as to capture, process and disclose information about events and conditions other than transactions) and to maintain accountability for the related assets, liabilities and equity;
  - Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
  - Process and account for system overrides or bypasses to controls;
  - Incorporate information from transaction processing in the general ledger (e.g., transferring of accumulated transactions from a subsidiary ledger);

- Capture and process information relevant to the preparation of the financial statements for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of assets; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

16. An entity's business processes include the activities designed to:

- Develop, purchase, produce, sell and distribute an entity's products and services;
- Ensure compliance with laws and regulations; and
- Record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed and reported by the information system.

17. The quality of information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
18. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to the entity's system of internal control, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.
19. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to the entity's system of internal control relevant to financial reporting. It may include such matters as the extent to which personnel understand how their activities in the information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity.

### *Control Activities*

20. Controls in the control activities component are identified in accordance with paragraph 26. Such controls include information processing controls and general IT controls, both of which may be manual or automated in nature. The greater the extent of automated controls, or controls involving automated aspects, that management uses and relies on in relation to its financial reporting, the more important it may become for the entity to implement general IT controls that address the continued functioning of the automated aspects of information processing controls. Controls in the control activities component may pertain to the following:

- *Authorization and approvals.* An authorization affirms that a transaction is valid (i.e., it represents an actual economic event or is within an entity's policy). An authorization typically takes the form of an approval by a higher level of management or of verification and a determination if the transaction is valid. For example, a supervisor approves an expense report after reviewing whether the expenses seem reasonable and within policy. An example of an automated approval is when an invoice unit cost is automatically compared with the related purchase order unit cost within a pre-established tolerance level. Invoices within the tolerance level are automatically approved for payment. Those invoices outside the tolerance level are flagged for additional investigation.
- *Reconciliations* – Reconciliations compare two or more data elements. If differences are identified, action is taken to bring the data into agreement. Reconciliations generally address the completeness or accuracy of processing transactions.
- *Verifications* – Verifications compare two or more items with each other or compare an item with a policy, and will likely involve a follow-up action when the two items do not match or the item is not consistent with policy. Verifications generally address the completeness, accuracy, or validity of processing transactions.
- *Physical or logical controls, including those that address security of assets against unauthorized access, acquisition, use or disposal.* Controls that encompass:
  - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
  - The authorization for access to computer programs and data files (i.e., logical access).
  - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

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

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

For example, a manager authorizing credit sales is not responsible for maintaining accounts receivable records or handling cash receipts. If

one person is able to perform all these activities the person could, for example, create a fictitious sale that could go undetected. Similarly, salespersons should not have the ability to modify product price files or commission rates.

Sometimes segregation is not practical, cost effective, or feasible. For example, smaller and less complex entities may lack sufficient resources to achieve ideal segregation, and the cost of hiring additional staff may be prohibitive. In these situations, management may institute alternative controls. In the example above, if the salesperson can modify product price files, a detective control activity can be put in place to have personnel unrelated to the sales function periodically review whether and under what circumstances the salesperson changed prices.

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

### **Limitations of Internal Control**

22. The entity's system of internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in the entity's system of internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of the entity's system of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
23. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of controls. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in an IT application that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
24. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

## Appendix 4

(Ref: Para 14(a), 24(a)(ii), A25–A28, A118)

### Considerations for Understanding an Entity’s Internal Audit Function

This appendix provides further considerations relating to understanding the entity’s internal audit function when such a function exists.

#### Objectives and Scope of the Internal Audit Function

1. The objectives and scope of an internal audit function, the nature of its responsibilities and its status within the organization, including the function’s authority and accountability, vary widely and depend on the size, complexity and structure of the entity and the requirements of management and, where applicable, those charged with governance. These matters may be set out in an internal audit charter or terms of reference.
2. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, the entity’s system of internal control and governance processes. If so, the internal audit function may play an important role in the entity’s process to monitor the entity’s system of internal control. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity’s financial reporting.

#### Inquiries of the Internal Audit Function

3. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity’s system of internal control, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity’s operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor’s understanding of the entity and its environment, the applicable financial reporting framework, the entity’s system of internal control, the auditor’s risk assessments or other aspects of the audit. The auditor’s inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.<sup>73</sup> Inquiries of particular relevance may be about matters the internal audit function has raised

<sup>73</sup> The relevant requirements are contained in ISA 610 (Revised 2013).

with those charged with governance and the outcomes of the function's own risk assessment process.

4. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit of the financial statements, the auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.
5. In addition, in accordance with ISA 240,<sup>74</sup> if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.
6. Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

### **Consideration of the Internal Audit Function in Understanding the Control Environment**

7. In understanding the control environment, the auditor may consider how management has responded to the findings and recommendations of the internal audit function regarding identified control deficiencies relevant to the preparation of the financial statements, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

### **Understanding the Role that the Internal Audit Function Plays in the Entity's Process to Monitor the System of Internal Control**

8. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately

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<sup>74</sup> ISA 240, paragraph 19

resourced relative to the complexity of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.

9. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, ISA 610 (Revised 2013) applies.
10. As is further discussed in ISA 610 (Revised 2013), the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.
11. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. ISA 200 discusses the importance of the auditor planning and performing the audit with professional skepticism,<sup>75</sup> including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

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<sup>75</sup> ISA 200, paragraph 7

## Appendix 5

(Ref: Para. 25(a), 26(b)–(c), A94, A166–A172)

### Considerations for Understanding Information Technology (IT)

This appendix provides further matters that the auditor may consider in understanding the entity's use of IT in its system of internal control.

#### Understanding the Entity's Use of Information Technology in the Components of the Entity's System of Internal Control

1. An entity's system of internal control contains manual elements and automated elements (i.e., manual and automated controls and other resources used in the entity's system of internal control). An entity's mix of manual and automated elements varies with the nature and complexity of the entity's use of IT. An entity's use of IT affects the manner in which the information relevant to the preparation of the financial statements in accordance with the applicable financial reporting framework is processed, stored and communicated, and therefore affects the manner in which the entity's system of internal control is designed and implemented. Each component of the entity's system of internal control may use some extent of IT.

Generally, IT benefits an entity's system of internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
  - Enhance the timeliness, availability and accuracy of information;
  - Facilitate the additional analysis of information;
  - Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
  - Reduce the risk that controls will be circumvented; and
  - Enhance the ability to achieve effective segregation of duties by implementing security controls in IT applications, databases and operating systems.
2. The characteristics of manual or automated elements are relevant to the auditor's identification and assessment of the risks of material misstatement, and further audit procedures based thereon. Automated controls may be more reliable than manual controls because they cannot be as easily bypassed, ignored, or overridden, and they are also less prone to simple errors and mistakes. Automated controls may be more effective than manual controls in the following circumstances:
    - High volume of recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, through automation.

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

*Understanding the Entity’s Use of Information Technology in the Information System*  
(Ref: Para. 25(a))

3. The entity’s information system may include the use of manual and automated elements, which also affect the manner in which transactions are initiated, recorded, processed, and reported. In particular, procedures to initiate, record, process and report transactions may be enforced through the IT applications used by the entity, and how the entity has configured those applications. In addition, records in the form of digital information may replace or supplement records in the form of paper documents.
4. In obtaining an understanding of the IT environment relevant to the flows of transactions and information processing in the information system, the auditor gathers information about the nature and characteristics of the IT applications used, as well as the supporting IT infrastructure and IT. The following table includes examples of matters that the auditor may consider in obtaining the understanding of the IT environment and includes examples of typical characteristics of IT environments based on the complexity of IT applications used in the entity’s information system. However, such characteristics are directional and may differ depending on the nature of the specific IT applications in use by an entity.

	Examples of typical characteristics of:		
	Non-complex commercial software	Mid-size and moderately complex commercial software or IT applications	Large or complex IT applications (e.g., ERP systems)
Matters related to extent of automation and use of data:			
<ul style="list-style-type: none"> <li>• The extent of automated procedures for processing, and the complexity of those procedures, including, whether there is highly automated, paperless processing.</li> </ul>	N/A	N/A	Extensive and often complex automated procedures

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	Examples of typical characteristics of:		
	Non-complex commercial software	Mid-size and moderately complex commercial software or IT applications	Large or complex IT applications (e.g., ERP systems)
<ul style="list-style-type: none"> <li>The extent of the entity’s reliance on system-generated reports in the processing of information.</li> </ul>	Simple automated report logic	Simple relevant automated report logic	Complex automated report logic; Report-writer software
<ul style="list-style-type: none"> <li>How data is input (i.e., manual input, customer or vendor input, or file load).</li> </ul>	Manual data inputs	Small number of data inputs or simple interfaces	Large number of data inputs or complex interfaces
<ul style="list-style-type: none"> <li>How IT facilitates communication between applications, databases or other aspects of the IT environment, internally and externally, as appropriate, through system interfaces.</li> </ul>	No automated interfaces (manual inputs only)	Small number of data inputs or simple interfaces	Large number of data inputs or complex interfaces
<ul style="list-style-type: none"> <li>The volume and complexity of data in digital form being processed by the information system, including whether accounting records or other information are stored in digital form and the location of stored data.</li> </ul>	Low volume of data or simple data that is able to be verified manually; Data available locally	Low volume of data or simple data	Large volume of data or complex data; Data warehouses; <sup>76</sup> Use of internal or external IT service providers (e.g., third-party storage or hosting of data)

<sup>76</sup> A data warehouse is generally described as a central repository of integrated data from one or more disparate sources (such as multiple databases) from which reports may be generated or that may be used by the entity for other data analysis activities. A report-writer is an IT application that is used to extract data from one or more sources (such as a data warehouse, a database or an IT application) and present the data in a specified format.

	Examples of typical characteristics of:		
	Non-complex commercial software	Mid-size and moderately complex commercial software or IT applications	Large or complex IT applications (e.g., ERP systems)
Matters related to the IT applications and IT infrastructure:			
<ul style="list-style-type: none"> <li>The type of application (e.g., a commercial application with little or no customization, or a highly-customized or highly-integrated application that may have been purchased and customized, or developed in-house).</li> </ul>	Purchased application with little or no customization	Purchased application or simple legacy or low-end ERP applications with little or no customization	Custom developed applications or more complex ERPs with significant customization
<ul style="list-style-type: none"> <li>The complexity of the nature of the IT applications and the underlying IT infrastructure.</li> </ul>	Small, simple laptop or client server-based solution	Mature and stable mainframe, small or simple client server, software as a service cloud	Complex mainframe, large or complex client server, web-facing, infrastructure as a service cloud
<ul style="list-style-type: none"> <li>Whether there is third-party hosting or outsourcing of IT.</li> </ul>	If outsourced, competent, mature, proven provider (e.g., cloud provider)	If outsourced, competent, mature, proven provider (e.g., cloud provider)	Competent, mature proven provider for certain applications and new or start-up provider for others
<ul style="list-style-type: none"> <li>Whether the entity is using emerging technologies that affect its financial reporting.</li> </ul>	No use of emerging technologies	Limited use of emerging technologies in some applications	Mixed use of emerging technologies across platforms

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

	Examples of typical characteristics of:		
	Non-complex commercial software	Mid-size and moderately complex commercial software or IT applications	Large or complex IT applications (e.g., ERP systems)
Matters related to IT processes:			
<ul style="list-style-type: none"> <li>The personnel involved in maintaining the IT environment (the number and skill level of the IT support resources that manage security and changes to the IT environment).</li> </ul>	Few personnel with limited IT knowledge to process vendor upgrades and manage access	Limited personnel with IT skills / dedicated to IT	Dedicated IT departments with skilled personnel, including programming skills
<ul style="list-style-type: none"> <li>The complexity of processes to manage access rights.</li> </ul>	Single individual with administrative access manages access rights	Few individuals with administrative access manage access rights	Complex processes managed by IT department for access rights
<ul style="list-style-type: none"> <li>The complexity of the security over the IT environment, including vulnerability of the IT applications, databases, and other aspects of the IT environment to cyber risks, particularly when there are web-based transactions or transactions involving external interfaces.</li> </ul>	Simple on-premise access with no external web-facing elements	Some web-based applications with primarily simple, role-based security	Multiple platforms with web-based access and complex security models

	Examples of typical characteristics of:		
	Non-complex commercial software	Mid-size and moderately complex commercial software or IT applications	Large or complex IT applications (e.g., ERP systems)
<ul style="list-style-type: none"> <li>Whether program changes have been made to the manner in which information is processed, and the extent of such changes during the period.</li> </ul>	Commercial software with no source code installed	Some commercial applications with no source code and other mature applications with a small number or simple changes; traditional systems development lifecycle	New or large number or complex changes, several development cycles each year
<ul style="list-style-type: none"> <li>The extent of change within the IT environment (e.g., new aspects of the IT environment or significant changes in the IT applications or the underlying IT infrastructure).</li> </ul>	Changes limited to version upgrades of commercial software	Changes consist of commercial software upgrades, ERP version upgrades, or legacy enhancements	New or large number or complex changes, several development cycles each year, heavy ERP customization
<ul style="list-style-type: none"> <li>Whether there was a major data conversion during the period and, if so, the nature and significance of the changes made, and how the conversion was undertaken.</li> </ul>	Software upgrades provided by vendor; No data conversion features for upgrade	Minor version upgrades for commercial software applications with limited data being converted	Major version upgrade, new release, platform change

### *Emerging Technologies*

- Entities may use emerging technologies (e.g., blockchain, robotics or artificial intelligence) because such technologies may present specific opportunities to increase operational efficiencies or enhance financial reporting. When emerging technologies are used in the entity's information system relevant to the preparation of the financial statements, the auditor may include such technologies in the identification of IT applications and other aspects of the IT environment that are subject to risks arising from the use of IT. While emerging technologies may be seen to be more sophisticated or more complex

compared to existing technologies, the auditor's responsibilities in relation to IT applications and identified general IT controls in accordance with paragraph 26(b)–(c) remain unchanged.

### *Scalability*

6. Obtaining an understanding of the entity's IT environment may be more easily accomplished for a less complex entity that uses commercial software and when the entity does not have access to the source code to make any program changes. Such entities may not have dedicated IT resources but may have a person assigned in an administrator role for the purpose of granting employee access or installing vendor-provided updates to the IT applications. Specific matters that the auditor may consider in understanding the nature of a commercial accounting software package, which may be the single IT application used by a less complex entity in its information system, may include:
  - The extent to which the software is well established and has a reputation for reliability;
  - The extent to which it is possible for the entity to modify the source code of the software to include additional modules (i.e., add-ons) to the base software, or to make direct changes to data;
  - The nature and extent of modifications that have been made to the software. Although an entity may not be able to modify the source code of the software, many software packages allow for configuration (e.g., setting or amending reporting parameters). These do not usually involve modifications to source code; however, the auditor may consider the extent to which the entity is able to configure the software when considering the completeness and accuracy of information produced by the software that is used as audit evidence; and
  - The extent to which data related to the preparation of the financial statements can be directly accessed (i.e., direct access to the database without using the IT application) and the volume of data that is processed. The greater the volume of data, the more likely the entity may need controls that address maintaining the integrity of the data, which may include general IT controls over unauthorized access and changes to the data.
7. Complex IT environments may include highly-customized or highly-integrated IT applications and may therefore require more effort to understand. Financial reporting processes or IT applications may be integrated with other IT applications. Such integration may involve IT applications that are used in the entity's business operations and that provide information to the IT applications relevant to the flows of transactions and information processing in the entity's information system. In such circumstances, certain IT applications used in the entity's business operations may also be relevant to the preparation of the

financial statements. Complex IT environments also may require dedicated IT departments that have structured IT processes supported by personnel that have software development and IT environment maintenance skills. In other cases, an entity may use internal or external service providers to manage certain aspects of, or IT processes within, its IT environment (e.g., third-party hosting).

#### Identifying IT Applications that are Subject to Risks Arising from the use of IT

8. Through understanding the nature and complexity of the entity's IT environment, including the nature and extent of information processing controls, the auditor may determine which IT applications the entity is relying upon to accurately process and maintain the integrity of financial information. The identification of IT applications on which the entity relies may affect the auditor's decision to test the automated controls within such IT applications, assuming that such automated controls address identified risks of material misstatement. Conversely, if the entity is not relying on an IT application, the automated controls within such IT application are unlikely to be appropriate or sufficiently precise for purposes of operating effectiveness tests. Automated controls that may be identified in accordance with paragraph 26(b) may include, for example, automated calculations or input, processing and output controls, such as a three-way match of a purchase order, vendor shipping document, and vendor invoice. When automated controls are identified by the auditor and the auditor determines through the understanding of the IT environment that the entity is relying on the IT application that includes those automated controls, it may be more likely for the auditor to identify the IT application as one that is subject to risks arising from the use of IT.
9. In considering whether the IT applications for which the auditor has identified automated controls are subject to risks arising from the use of IT, the auditor is likely to consider whether, and the extent to which, the entity may have access to source code that enables management to make program changes to such controls or the IT applications. The extent to which the entity makes program or configuration changes and the extent to which the IT processes over such changes are formalized may also be relevant considerations. The auditor is also likely to consider the risk of inappropriate access or changes to data.
10. System-generated reports that the auditor may intend to use as audit evidence may include, for example, a trade receivable aging report or an inventory valuation report. For such reports, the auditor may obtain audit evidence about the completeness and accuracy of the reports by substantively testing the inputs and outputs of the report. In other cases, the auditor may plan to test the operating effectiveness of the controls over the preparation and maintenance of the report, in which case the IT application from which it is produced is likely to be subject to risks arising from the use of IT. In addition to testing the completeness and accuracy of the report, the auditor may plan to test the operating effectiveness of general IT controls that address risks related to inappropriate or unauthorized program changes to, or data changes in, the report.

11. Some IT applications may include report-writing functionality within them while some entities may also utilize separate report-writing applications (i.e., report-writers). In such cases, the auditor may need to determine the sources of system-generated reports (i.e., the application that prepares the report and the data sources used by the report) to determine the IT applications subject to risks arising from the use of IT.
12. The data sources used by IT applications may be databases that, for example, can only be accessed through the IT application or by IT personnel with database administration privileges. In other cases, the data source may be a data warehouse that may itself be considered to be an IT application subject to risks arising from the use of IT.
13. The auditor may have identified a risk for which substantive procedures alone are not sufficient because of the entity's use of highly-automated and paperless processing of transactions, which may involve multiple integrated IT applications. In such circumstances, the controls identified by the auditor are likely to include automated controls. Further, the entity may be relying on general IT controls to maintain the integrity of the transactions processed and other information used in processing. In such cases, the IT applications involved in the processing and the storage of the information are likely subject to risks arising from the use of IT.

#### *End-User Computing*

14. Although audit evidence may also come in the form of system-generated output that is used in a calculation performed in an end-user computing tool (e.g., spreadsheet software or simple databases), such tools are not typically identified as IT applications in the context of paragraph 26(b). Designing and implementing controls around access and change to end-user computing tools may be challenging, and such controls are rarely equivalent to, or as effective as, general IT controls. Rather, the auditor may consider a combination of information processing controls, taking into account the purpose and complexity of the end-user computing involved, such as:
  - Information processing controls over the initiation and processing of the source data, including relevant automated or interface controls to the point from which the data is extracted (i.e., the data warehouse);
  - Controls to check that the logic is functioning as intended, for example, controls which 'prove' the extraction of data, such as reconciling the report to the data from which it was derived, comparing the individual data from the report to the source and vice versa, and controls which check the formulas or macros; or
  - Use of validation software tools, which systematically check formulas or macros, such as spreadsheet integrity tools.

## Scalability

15. The entity's ability to maintain the integrity of information stored and processed in the information system may vary based on the complexity and volume of the related transactions and other information. The greater the complexity and volume of data that supports a significant class of transactions, account balance or disclosure, the less likely it may become for the entity to maintain integrity of that information through information processing controls alone (e.g., input and output controls or review controls). It also becomes less likely that the auditor will be able to obtain audit evidence about the completeness and accuracy of such information through substantive testing alone when such information is used as audit evidence. In some circumstances, when volume and complexity of transactions are lower, management may have an information processing control that is sufficient to verify the accuracy and completeness of the data (e.g., individual sales orders processed and billed may be reconciled to the hard copy originally entered into the IT application). When the entity relies on general IT controls to maintain the integrity of certain information used by IT applications, the auditor may determine that the IT applications that maintain that information are subject to risks arising from the use of IT.

Example characteristics of an IT application that is likely not subject to risks arising from IT	Example characteristics of an IT application that is likely subject to risks arising from IT
<ul style="list-style-type: none"> <li>● Standalone applications.</li> <li>● The volume of data (transactions) is not significant.</li> <li>● The application's functionality is not complex.</li> <li>● Each transaction is supported by original hard copy documentation.</li> </ul>	<ul style="list-style-type: none"> <li>● Applications are interfaced.</li> <li>● The volume of data (transactions) is significant.</li> <li>● The application's functionality is complex as:               <ul style="list-style-type: none"> <li>○ The application automatically initiates transactions; and</li> <li>○ There are a variety of complex calculations underlying automated entries.</li> </ul> </li> </ul>
<p>IT application is likely not subject to risks arising from IT because:</p> <ul style="list-style-type: none"> <li>● The volume of data is not significant and therefore management is not relying upon general IT controls to process or maintain the data.</li> </ul>	<p>IT application is likely subject to risks arising from IT because:</p> <ul style="list-style-type: none"> <li>● Management relies on an application system to process or maintain data as the volume of data is significant.</li> </ul>

<ul style="list-style-type: none"> <li>● Management does not rely on automated controls or other automated functionality. The auditor has not identified automated controls in accordance with paragraph 26(a).</li> <li>● Although management uses system-generated reports in their controls, it does not rely on these reports. Instead, it reconciles the reports back to the hard copy documentation and verifies the calculations in the reports.</li> <li>● The auditor will directly test information produced by the entity used as audit evidence.</li> </ul>	<ul style="list-style-type: none"> <li>● Management relies upon the application system to perform certain automated controls that the auditor has also identified.</li> </ul>
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*Other Aspects of the IT Environment that Are Subject to Risks Arising from the Use of IT*

16. When the auditor identifies IT applications that are subject to risks arising from the use of IT, other aspects of the IT environment are also typically subject to risks arising from the use of IT. The IT infrastructure includes the databases, operating system, and network. Databases store the data used by IT applications and may consist of many interrelated data tables. Data in databases may also be accessed directly through database management systems by IT or other personnel with database administration privileges. The operating system is responsible for managing communications between hardware, IT applications, and other software used in the network. As such, IT applications and databases may be directly accessed through the operating system. A network is used in the IT infrastructure to transmit data and to share information, resources and services through a common communications link. The network also typically establishes a layer of logical security (enabled through the operating system) for access to the underlying resources.
17. When IT applications are identified by the auditor to be subject to risks arising from IT, the database(s) that stores the data processed by an identified IT application is typically also identified. Similarly, because an IT application's ability to operate is often dependent on the operating system and IT applications and databases may be directly accessed from the operating system, the operating system is typically subject to risks arising from the use of IT. The network may be identified when it is a central point of access to the identified IT applications and related databases or when an IT application interacts with vendors or external parties through the internet, or when web-facing IT applications are identified by the auditor.

*Identifying Risks Arising from the Use of IT and General IT Controls*

18. Examples of risks arising from the use of IT include risks related to inappropriate reliance on IT applications that are inaccurately processing data, processing inaccurate data, or both, such as
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
  - The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
  - Unauthorized changes to data in master files.
  - Unauthorized changes to IT applications or other aspects of the IT environment.
  - Failure to make necessary changes to IT applications or other aspects of the IT environment.
  - Inappropriate manual intervention.
  - Potential loss of data or inability to access data as required.
19. The auditor's consideration of unauthorized access may include risks related to unauthorized access by internal or external parties (often referred to as cybersecurity risks). Such risks may not necessarily affect financial reporting, as an entity's IT environment may also include IT applications and related data that address operational or compliance needs. It is important to note that cyber incidents usually first occur through the perimeter and internal network layers, which tend to be further removed from the IT application, database and operating systems that affect the preparation of the financial statements. Accordingly, if information about a security breach has been identified, the auditor ordinarily considers the extent to which such a breach has the potential to affect financial reporting. If financial reporting may be affected, the auditor may decide to understand, and test the related controls to determine the possible impact or scope of potential misstatements in the financial statements or may determine that the entity has provided adequate disclosures in relation to such security breach.
20. In addition, laws and regulations that may have a direct or indirect effect on the entity's financial statements may include data protection legislation. Considering an entity's compliance with such laws or regulations, in accordance with ISA 250 (Revised), may involve understanding the entity's IT processes and general IT controls that the entity has implemented to address the relevant laws or regulations.

21. General IT controls are implemented to address risks arising from the use of IT. Accordingly, the auditor uses the understanding obtained about the identified IT applications and other aspects of the IT environment and the applicable risks arising from the use of IT in determining the general IT controls to identify. In some cases, an entity may use common IT processes across its IT environment or across certain IT applications, in which case common risks arising from the use of IT and common general IT controls may be identified.
22. In general, a greater number of general IT controls related to IT applications and databases are likely to be identified than for other aspects of the IT environment. This is because these aspects are the most closely concerned with the information processing and storage of information in the entity's information system. In identifying general IT controls, the auditor may consider controls over actions of both end users and of the entity's IT personnel or IT service providers.
23. **Appendix 6** provides further explanation of the nature of the general IT controls typically implemented for different aspects of the IT environment. In addition, examples of general IT controls for different IT processes are provided.

**Appendix 6**

(Ref: Para. 25(c)(ii), A173–A174)

**Considerations for Understanding General IT Controls**

*This appendix provides further matters that the auditor may consider in understanding general IT controls.*

1. The nature of the general IT controls typically implemented for each of the aspects of the IT environment:

- (a) Applications

General IT controls at the IT application layer will correlate to the nature and extent of application functionality and the access paths allowed in the technology. For example, more controls will be relevant for highly-integrated IT applications with complex security options than a legacy IT application supporting a small number of account balances with access methods only through transactions.

- (b) Database

General IT controls at the database layer typically address risks arising from the use of IT related to unauthorized updates to financial reporting information in the database through direct database access or execution of a script or program.

- (c) Operating system

General IT controls at the operating system layer typically address risks arising from the use of IT related to administrative access, which can facilitate the override of other controls. This includes actions such as compromising other user's credentials, adding new, unauthorized users, loading malware or executing scripts or other unauthorized programs.

- (d) Network

General IT controls at the network layer typically address risks arising from the use of IT related to network segmentation, remote access, and authentication. Network controls may be relevant when an entity has web-facing applications used in financial reporting. Network controls may be relevant when the entity has significant business partner relationships or third-party outsourcing, which may increase data transmissions and the need for remote access.

2. Examples of general IT controls that may exist, organized by IT process include:
- (a) Process to manage access:
    - *Authentication*  
Controls that ensure a user accessing the IT application or other aspect of the IT environment is using the user's own log-in credentials (i.e., the user is not using another user's credentials).
    - *Authorization*  
Controls that allow users to access the information necessary for their job responsibilities and nothing further, which facilitates appropriate segregation of duties.
    - *Provisioning*  
Controls to authorize new users and modifications to existing users' access privileges.
    - *Deprovisioning*  
Controls to remove user access upon termination or transfer.
    - *Privileged access*  
Controls over administrative or powerful users' access.
    - *User access reviews*  
Controls to recertify or evaluate user access for ongoing authorization over time.
    - *Security configuration controls*  
Each technology generally has key configuration settings that help restrict access to the environment.
    - *Physical access*  
Controls over physical access to the data center and hardware, as such access may be used to override other controls.
  - (b) Process to manage program or other changes to the IT environment:
    - *Change management process*  
Controls over the process to design, program, test and migrate changes to a production (i.e., end user) environment.
    - *Segregation of duties over change migration*  
Controls that segregate access to make and migrate changes to a production environment.

- *Systems development or acquisition or implementation*  
Controls over initial IT application development or implementation (or in relation to other aspects of the IT environment).
  - *Data conversion*  
Controls over the conversion of data during development, implementation or upgrades to the IT environment.
- (c) Process to manage IT operations
- *Job scheduling*  
Controls over access to schedule and initiate jobs or programs that may affect financial reporting.
  - *Job monitoring*  
Controls to monitor financial reporting jobs or programs for successful execution.
  - *Backup and recovery*  
Controls to ensure backups of financial reporting data occur as planned and that such data is available and able to be accessed for timely recovery in the event of an outage or attack.
  - *Intrusion detection*  
Controls to monitor for vulnerabilities and or intrusions in the IT environment.

The table below illustrates examples of general IT controls to address examples of risks arising from the use of IT, including for different IT applications based on their nature.

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

Process	Risks	Controls	IT Applications		
IT Process	Example Risks Arising from the Use of IT	Example General IT Controls	Non-complex commercial software – Applicable (yes / no)	Mid-size and moderately complex commercial software or IT applications – Applicable (yes / no)	Large or complex IT applications (e.g., ERP systems) – Applicable (yes / no)
Manage Access	User-access privileges: Users have access privileges beyond those necessary to perform their assigned duties, which may create improper segregation of duties.	Management approves the nature and extent of user-access privileges for new and modified user access, including standard application profiles/roles, critical financial reporting transactions, and segregation of duties	Yes – instead of user access reviews noted below	Yes	Yes
		Access for terminated or transferred users is removed or modified in a timely manner	Yes – instead of user access reviews below	Yes	Yes
		User access is periodically reviewed	Yes – instead of provisioning/ Deprovisioning controls above	Yes – for certain applications	Yes

Process	Risks	Controls	IT Applications		
IT Process	Example Risks Arising from the Use of IT	Example General IT Controls	Non-complex commercial software – Applicable (yes / no)	Mid-size and moderately complex commercial software or IT applications – Applicable (yes / no)	Large or complex IT applications (e.g., ERP systems) – Applicable (yes / no)
		Segregation of duties is monitored and conflicting access is either removed or mapped to mitigating controls, which are documented and tested	N/A – no system enabled segregation	Yes – for certain applications	Yes
		Privileged-level access (e.g., configuration, data and security administrators) is authorized and appropriately restricted	Yes – likely at IT application layer only	Yes – at IT application and certain layers of IT environment for platform	Yes – at all layers of IT environment for platform
Manage Access	Direct data access: Inappropriate changes are made directly to financial data through means other than application transactions.	Access to application data files or database objects/tables/ data is limited to authorized personnel, based on their job responsibilities and assigned role, and such access is approved by management	N/A	Yes – for certain applications and databases	Yes

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

Process	Risks	Controls	IT Applications		
IT Process	Example Risks Arising from the Use of IT	Example General IT Controls	Non-complex commercial software – Applicable (yes / no)	Mid-size and moderately complex commercial software or IT applications – Applicable (yes / no)	Large or complex IT applications (e.g., ERP systems) – Applicable (yes / no)
Manage Access	System settings: Systems are not adequately configured or updated to restrict system access to properly authorized and appropriate users.	Access is authenticated through unique user IDs and passwords or other methods as a mechanism for validating that users are authorized to gain access to the system. Password parameters meet company or industry standards (e.g., password minimum length and complexity, expiration, account lockout)	Yes – password authentication only	Yes – mix of password and multi-factor authentication	Yes
		The key attributes of the security configuration are appropriately implemented	N/A – no technical security configurations exist	Yes – for certain applications and databases	Yes

Process	Risks	Controls	IT Applications		
IT Process	Example Risks Arising from the Use of IT	Example General IT Controls	Non-complex commercial software – Applicable (yes / no)	Mid-size and moderately complex commercial software or IT applications – Applicable (yes / no)	Large or complex IT applications (e.g., ERP systems) – Applicable (yes / no)
Manage Change	Application changes: Inappropriate changes are made to application systems or programs that contain relevant automated controls (i.e., configurable settings, automated algorithms, automated calculations, and automated data extraction) or report logic.	Application changes are appropriately tested and approved before being moved into the production environment	N/A – would verify no source code installed	Yes – for non-commercial software	Yes
		Access to implement changes into the application production environment is appropriately restricted and segregated from the development environment	N/A	Yes for non-commercial software	Yes
Manage Change	Database changes: Inappropriate changes are made to the database structure and relationships between the data.	Database changes are appropriately tested and approved before being moved into the production environment	N/A – no database changes made at entity	Yes – for non-commercial software	Yes

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

Process	Risks	Controls	IT Applications		
IT Process	Example Risks Arising from the Use of IT	Example General IT Controls	Non-complex commercial software – Applicable (yes / no)	Mid-size and moderately complex commercial software or IT applications – Applicable (yes / no)	Large or complex IT applications (e.g., ERP systems) – Applicable (yes / no)
Manage Change	System software changes: Inappropriate changes are made to system software (e.g., operating system, network, change-management software, access-control software).	System software changes are appropriately tested and approved before being moved to production	N/A – no system software changes are made at entity	Yes	Yes
Manage Change	Data conversion: Data converted from legacy systems or previous versions introduces data errors if the conversion transfers incomplete, redundant, obsolete, or inaccurate data.	Management approves the results of the conversion of data (e.g., balancing and reconciliation activities) from the old application system or data structure to the new application system or data structure and monitors that the conversion is performed in accordance with established conversion policies and procedures	N/A – Addressed through manual controls	Yes	Yes

Process	Risks	Controls	IT Applications		
IT Process	Example Risks Arising from the Use of IT	Example General IT Controls	Non-complex commercial software – Applicable (yes / no)	Mid-size and moderately complex commercial software or IT applications – Applicable (yes / no)	Large or complex IT applications (e.g., ERP systems) – Applicable (yes / no)
IT Operations	Network: The network does not adequately prevent unauthorized users from gaining inappropriate access to information systems.	Access is authenticated through unique user IDs and passwords or other methods as a mechanism for validating that users are authorized to gain access to the system. Password parameters meet company or professional policies and standards (e.g., password minimum length and complexity, expiration, account lockout)	N/A – no separate network authentication method exists	Yes	Yes
		Network is architected to segment web-facing applications from the internal network, where ICFR relevant applications are accessed	N/A – no network segmentation employed	Yes – with judgment	Yes – with judgment

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

Process	Risks	Controls	IT Applications		
IT Process	Example Risks Arising from the Use of IT	Example General IT Controls	Non-complex commercial software – Applicable (yes / no)	Mid-size and moderately complex commercial software or IT applications – Applicable (yes / no)	Large or complex IT applications (e.g., ERP systems) – Applicable (yes / no)
		On a periodic basis, vulnerability scans of the network perimeter are performed by the network management team, which also investigates potential vulnerabilities	N/A	Yes – with judgment	Yes – with judgment
		On a periodic basis, alerts are generated to provide notification of threats identified by the intrusion detection systems. These threats are investigated by the network management team	N/A	Yes – with judgment	Yes – with judgment
		Controls are implemented to restrict Virtual Private Network (VPN) access to authorized and appropriate users	N/A – no VPN	Yes – with judgment	Yes – with judgment

Process	Risks	Controls	IT Applications		
IT Process	Example Risks Arising from the Use of IT	Example General IT Controls	Non-complex commercial software – Applicable (yes / no)	Mid-size and moderately complex commercial software or IT applications – Applicable (yes / no)	Large or complex IT applications (e.g., ERP systems) – Applicable (yes / no)
IT Operations	Data backup and recovery: Financial data cannot be recovered or accessed in a timely manner when there is a loss of data.	Financial data is backed up on a regular basis according to an established schedule and frequency	N/A – relying on manual backups by finance team	Yes	Yes
IT Operations	Job scheduling: Production systems, programs, or jobs result in inaccurate, incomplete, or unauthorized processing of data.	Only authorized users have access to update the batch jobs (including interface jobs) in the job scheduling software	N/A – no batch jobs	Yes – for certain applications	Yes
		Critical systems, programs, or jobs are monitored, and processing errors are corrected to ensure successful completion.	N/A – no job monitoring	Yes – for certain applications	Yes

## CONFORMING AND CONSEQUENTIAL AMENDMENTS TO OTHER INTERNATIONAL STANDARDS ARISING FROM ISA 315 (REVISED 2019)

**Note:** The following are conforming amendments to other International Standards as a result of the approval of ISA 315 (Revised 2019). These amendments will become effective at the same time as ISA 315 (Revised 2019), and are shown with marked changes from the latest approved versions of the International Standards that are amended. The footnote numbers within these amendments do not align with the International Standards that are amended, and reference should be made to those International Standards. These conforming amendments have received the approval of the PIOB which concluded that due process was followed in the development of the conforming amendments and that proper regard was paid to the public interest.

### ***ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing***

#### **Scope of this ISA**

...

#### **An Audit of Financial Statements**

...

7. The ISAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The ISAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:
- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control.
  - Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
  - Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

...

#### **Effective Date**

...

## Overall Objectives of the Auditor

...

### Definitions

13. For purposes of the ISAs, the following terms have the meanings attributed below:

...

- (n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level: (Ref: Para. A15a)
  - (i) Inherent risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - (ii) Control risk – The risk that a misstatement that could occur in an assertion about a class of transactions, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal controls.

...

### Requirements

#### Ethical Requirements Relating to an Audit of Financial Statements

...

#### Professional Skepticism

...

#### Professional Judgment

...

#### Sufficient Appropriate Audit Evidence and Audit Risk

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A30–A54)

## **Conduct of an Audit in Accordance with ISAs**

### *Complying with ISAs Relevant to the Audit*

...

19. The auditor shall have an understanding of the entire text of an ISA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A60–A68)

...

### *Objectives Stated in Individual ISAs*

...

### *Complying with Relevant Requirements*

...

### *Failure to Achieve an Objective*

...

## **Application and Other Explanatory Material**

### **An Audit of Financial Statements**

#### *Scope of the Audit* (Ref: Para. 3)

...

#### *Preparation of the Financial Statements* (Ref: Para. 4)

...

#### Considerations Specific to Audits in the Public Sector

...

#### *Form of the Auditor's Opinion* (Ref: Para. 8)

...

### **Definitions**

#### *Financial Statements* (Ref: Para. 13(f))

...

*Risk of Material Misstatement* (Ref: Para. 13(n))

A15a. For the purposes of the ISAs, a risk of material misstatement exists when there is a reasonable possibility of:

- (a) A misstatement occurring (i.e., its likelihood); and
- (b) Being material if it were to occur (i.e., its magnitude).

**Ethical Requirements Relating to an Audit of Financial Statements** (Ref: Para. 14)

...

**Professional Skepticism** (Ref: Para. 15)

...

**Professional Judgment** (Ref: Para. 16)

...

**Sufficient Appropriate Audit Evidence and Audit Risk** (Ref: Para. 5 and 17)

*Sufficiency and Appropriateness of Audit Evidence*

A30. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit<sup>77</sup>) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

...

*Audit Risk*

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<sup>77</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 169

## Risks of Material Misstatement

...

- A40. Inherent risk is influenced by inherent risk factors, higher for some assertions and related classes of transactions, account balances, and disclosures than for others. Depending on the degree to which the inherent risk factors affect the susceptibility to misstatement of an assertion, the level of inherent risk varies on a scale that is referred to as the spectrum of inherent risk. The auditor determines significant classes of transactions, account balances and disclosures, and their relevant assertions, as part of the process of identifying and assessing the risks of material misstatement. For example, it may be higher for complex calculations or for accounts balances consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty may be identified as significant account balances, and the auditor's assessment of inherent risk for the related risks at the assertion level may be higher because of the high estimation uncertainty.
- A40a. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.
- A41. Control risk is a function of the effectiveness of the design, implementation and maintenance of ~~internal controls~~ by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of ~~internal controls~~. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The ISAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.<sup>78</sup>
- A42.<sup>79</sup> The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made. The ISAs typically do not ordinarily refer to inherent risk and control risk separately,

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<sup>78</sup> ISA 330, *The Auditor's Responses to Assessed Risks*, paragraphs 7–17

<sup>79</sup> Note that paragraph A42 of ISA 200 is marked to the updated paragraph presented separately as a conforming amendment relating to ISA 540 (Revised) and its conforming amendments.

~~but rather to a combined assessment of the “risks of material misstatement.” rather than to inherent risk and control risk separately. However, ISA 540315 (Revised 2019)<sup>80</sup> requires a separate assessment of inherent risk to be assessed separately from and control risk to provide a basis for designing and performing further audit procedures to respond to the assessed risks of material misstatement at the assertion level; including significant risks, for accounting estimates at the assertion level in accordance with ISA 330.<sup>81</sup> In identifying and assessing risks of material misstatement for significant classes of transactions, account balances or disclosures other than accounting estimates, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.~~

A43a. Risks of material misstatement are assessed at the assertion level in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence.<sup>82</sup>

Detection Risk

...

*Inherent Limitations of an Audit*

...

The Nature of Financial Reporting

...

The Nature of Audit Procedures

...

Timeliness of Financial Reporting and the Balance between Benefit and Cost

...

A52. In light of the approaches described in paragraph A51, the ISAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities;<sup>83</sup> and

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<sup>80</sup> ISA 540315 (Revised 2019), *Auditing Accounting Estimates and Disclosures*, paragraph 15 (*Identifying and Assessing the Risks of Material Misstatement*)

<sup>81</sup> ISA 330, paragraph 7(b)

<sup>82</sup> ISA 330, paragraph 6

<sup>83</sup> ISA 315 (Revised 2019), paragraphs 135-140

- Use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population.<sup>84</sup>

Other Matters that Affect the Inherent Limitations of an Audit

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## Conduct of an Audit in Accordance with ISAs

*Nature of the ISAs* (Ref: Para. 18)

...

Considerations Specific to Audits in the Public Sector

...

*Contents of the ISAs* (Ref: Para. 19)

A60. In addition to objectives and requirements (requirements are expressed in the ISAs using “shall”), an ISA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the ISA, and definitions. The entire text of an ISA, therefore, is relevant to an understanding of the objectives stated in an ISA and the proper application of the requirements of an ISA.

A61. Where necessary, the application and other explanatory material provides further explanation of the requirements of an ISA and guidance for carrying them out. In particular, it may:

- Explain more precisely what a requirement means or is intended to cover, including in some ISAs such as ISA 315 (Revised 2019), why a procedure is required.
- Include examples of procedures that may be appropriate in the circumstances. In some ISAs, such as ISA 315 (Revised 2019), examples are presented in boxes.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an ISA. The application and other explanatory material may also provide background information on matters addressed in an ISA.

## Considerations Specific to Smaller Entities Scalability Considerations

A65a Scalability considerations have been included in some ISAs (e.g., ISA 315 (Revised 2019)), illustrating the application of the requirements to all entities regardless of whether their nature and circumstances are less complex or more

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<sup>84</sup> ISA 330; ISA 500; ISA 520, *Analytical Procedures*; ISA 530, *Audit Sampling*

complex. Less complex entities are entities for which the characteristics in paragraph A66 may apply.

A65b. The “considerations specific to smaller entities” included in some the ISAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.

A66. For purposes of specifying additional considerations to audits of smaller entities, a “smaller entity” refers to an entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
  - (i) Straightforward or uncomplicated transactions;
  - (ii) Simple record-keeping;
  - (iii) Few lines of business and few products within business lines;
  - (iv) Simpler systems of~~Few~~ internal controls;
  - (v) Few levels of management with responsibility for a broad range of controls; or
  - (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

A67. [*Moved – now A65b*]

#### Considerations Specific to Automated Tools and Techniques

A67a. The considerations specific to “automated tools and techniques” included in some ISAs (for example, ISA 315 (Revised 2019)) have been developed to explain how the auditor may apply certain requirements when using automated tools and techniques in performing audit procedures.

*Objectives Stated in Individual ISAs* (Ref: Para. 21)

...

Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 21(a))

...

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has  
Been Obtained (Ref: Para. 21(b))

...

*Complying with Relevant Requirements*

Relevant Requirements (Ref: Para. 22)

...

Departure from a Requirement (Ref: Para. 23)

...

*Failure to Achieve an Objective* (Ref: Para. 24)

...

## **ISA 210, *Agreeing the Terms of Audit Engagements***

### **Application and Other Explanatory Material**

...

#### **Preconditions for an Audit**

...

*Agreement of the Responsibilities of Management*

...

Internal Control

...

A18. It is for management to determine what internal control is necessary to enable the preparation of the financial statements. The term “internal control” encompasses a wide range of activities within components of the system of internal control that may be described as the control environment; the entity’s risk assessment process; the entity’s process to monitor the system of internal control, the information system, ~~including the related business processes relevant to financial reporting~~; and communication; and control activities; and monitoring of controls. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component.<sup>85</sup> An entity’s internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.

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<sup>85</sup> ISA 315 (Revised 2019), paragraph A9159 and Appendix 3†

## **ISA 230, *Audit Documentation***

### **Application and Other Explanatory Material**

...

#### **Documentation of the Audit Procedures Performed and Audit Evidence Obtained**

...

*Identification of Specific Items or Matters Tested, and of the Preparer and Reviewer*  
(Ref: Para. 9)

...

Considerations Specific to Smaller Entities (Ref. Para 8)

...

A17. When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control, the overall audit strategy and audit plan, materiality determined in accordance with ISA 320,<sup>86</sup> assessed risks, significant matters noted during the audit, and conclusions reached.

...

## **ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements***

### **Application and Other Explanatory Material**

...

#### **Audit Procedures When Non-Compliance is Identified or Suspected**

...

*Evaluating the Implications of Identified or Suspected Non-Compliance* (Ref: Para. 22)

A23. As required by paragraph 22, the auditor evaluates the implications of identified or suspected non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular identified or suspected non-compliance will depend on the relationship of the perpetration and concealment, if any, of the act to specific controls activities and the level of management or individuals working

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<sup>86</sup> ISA 320, *Materiality in Planning and Performing an Audit*

for, or under the direction of, the entity involved, especially implications arising from the involvement of the highest authority within the entity. As noted in paragraph 9, the auditor's compliance with law, regulation or relevant ethical requirements may provide further information that is relevant to the auditor's responsibilities in accordance with paragraph 22.

...

## **ISA 260 (Revised), *Communication with Those Charged with Governance***

### **Application and Other Explanatory Material**

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#### **Matters to Be Communicated**

...

*Planned Scope and Timing of the Audit* (Ref: Para. 15)

...

A12. Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they were determined to be significant risks ~~require special audit consideration~~. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

A13. Matters communicated may include: ...

- How the auditor plans to address the significant risks of material misstatement, whether due to fraud or error.
- How the auditor plans to address areas of higher assessed risks of material misstatement.
- The auditor's approach to the entity's system of internal control, ~~relevant to the audit.~~
- The application of the concept of materiality in the context of an audit.
- ...

## **Appendix 2**

(Ref: Para. 16(a), A19–A20)

### **Qualitative Aspects of Accounting Practices**

The communication required by paragraph 16(a), and discussed in paragraphs A19–A20, may include such matters as:

...

## Accounting Estimates

- For items for which estimates are significant, issues discussed in ISA 540 (Revised),<sup>1</sup> including, for example:
  - How management identifies those transactions, events ~~and~~ or conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements.

...

## ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance*

### Introduction

#### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. This ISA does not impose additional responsibilities on the auditor regarding obtaining an understanding of the entity's system of internal control and designing and performing tests of controls over and above the requirements of ISA 315 (Revised 2019)<sup>87</sup> and ISA 330. ISA 260 (Revised) establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance in relation to the audit.
2. The auditor is required to obtain an understanding of the entity's system of internal control ~~relevant to the audit~~ when identifying and assessing the risks of material misstatement.<sup>4</sup> In making those risk assessments, the auditor considers the entity's system of internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify control deficiencies in the entity's system of internal control not only during this risk assessment process but also at any other stage of the audit. This ISA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

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### Application and Other Explanatory Material

#### Determination of Whether Deficiencies in Internal Control Have Been Identified (Ref: Para 7)

...

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<sup>87</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*, paragraphs 12(c) and (m), and paragraphs 21 to 27.

*Considerations Specific to Smaller Entities*

- A3. While the concepts underlying controls in the control activities component in smaller entities are likely to be similar to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of controls activities are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed controls activities.

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**Significant Deficiencies in Internal Control** (Ref: Para. 6(b), 8)

- A8. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements. For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account balance or disclosure, relevant assertion, or component of the entity's system of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

***ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements***

**Introduction**

**Scope of this ISA**

...

**Characteristics of Fraud**

...

**Responsibility for the Prevention and Detection of Fraud**

...

***Responsibilities of the Auditor***

...

7. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate

accounting records, present fraudulent financial information or override controls ~~procedures~~ designed to prevent similar frauds by other employees.

...

## Effective Date

...

## Objectives

...

## Definitions

...

## Requirements

### Professional Skepticism

13. In accordance with ISA 200,<sup>88</sup> the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7–A8)
14. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)
15. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

### Discussion among the Engagement Team

16. ISA 315 (Revised 2019) requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion.<sup>89</sup> This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10–A11)

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<sup>88</sup> ISA 200, paragraph 15

<sup>89</sup> ISA 315 (Revised 2019), paragraph 17–18 †0

## Risk Assessment Procedures and Related Activities

17. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, the applicable financial reporting framework and ~~including~~ the entity's system of internal control, required by ISA 315 (Revised 2019),<sup>90</sup> the auditor shall perform the procedures in paragraphs ~~2317–4324~~ to obtain information for use in identifying the risks of material misstatement due to fraud.

## *Management and Others within the Entity*

...

### *Those Charged with Governance*

21. Unless all of those charged with governance are involved in managing the entity,<sup>91</sup> the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the ~~internal controls~~ that management has established to mitigate these risks. (Ref: Para. A19–A21)

...

### *Unusual or Unexpected Relationships Identified*

...

### *Other Information*

24. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

### *Evaluation of Fraud Risk Factors*

25. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23–A27)

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

26. In accordance with ISA 315 (Revised 2019), the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.<sup>92</sup>

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<sup>90</sup> ISA 315 (Revised), paragraphs 5–24

<sup>91</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

<sup>92</sup> ISA 315 (Revised 2019), paragraph 282

27. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28–A30)
28. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall ~~obtain an understanding of the entity's related~~ identify the entity's controls, including control activities, relevant to that address such risks, and evaluate their design and determine whether they have been implemented.<sup>93</sup> (Ref: Para. A31–A32)

## Responses to the Assessed Risks of Material Misstatement Due to Fraud

### *Overall Responses*

...

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

...

### *Audit Procedures Responsive to Risks Related to Management Override of Controls*

...

33. Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:
- (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:
    - (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
    - (ii) Select journal entries and other adjustments made at the end of a reporting period; and
    - (iii) Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A41–A44)

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<sup>93</sup> ISA 315 (Revised 2019), paragraph 26(a)(i) and 26(d)

## Evaluation of Audit Evidence (Ref: Para. A49)

...

## Auditor Unable to Continue the Engagement

...

## Written Representations

...

## Communications to Management and with Those Charged with Governance

...

## Communications to Regulatory and Enforcement Authorities

...

## Documentation

45. The auditor shall include the following in the audit documentation<sup>94</sup> ~~of the auditor's understanding of the entity and its environment and of the identification~~ and the assessment of the risks of material misstatement required by ISA 315 (Revised 2019):<sup>95</sup>

- (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; ~~and~~
- (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level; ~~and~~ and
- (c) Identified controls in the control activities component that address assessed risks of material misstatement due to fraud.

...

## Application and Other Explanatory Material

Characteristics of Fraud (Ref: Para. 3)

...

### *Professional Skepticism (Ref: Para. 12–14)*

A8. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and ~~the identified controls in the~~

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<sup>94</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and paragraph A6

<sup>95</sup> ISA 315 (Revised 2019), paragraph 3832

control activities component, if any, over its preparation and maintenance, where relevant. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

...

***Discussion Among the Engagement Team*** (Ref: Para. 15)

...

**Risk Assessment Procedures and Related Activities**

*Inquiries of Management*

Management's Assessment of the Risk of Material Misstatement Due to Fraud (Ref: Para. 17(a))

...

*Inquiry of Internal Audit* (Ref: Para. 19)

A19. ISA 315 (Revised 2019) and ISA 610 (Revised 2013) establish requirements and provide guidance relevant to audits of those entities that have an internal audit function.<sup>96</sup> In carrying out the requirements of those ISAs in the context of fraud, the auditor may inquire about specific activities of the function including, for example:

- The procedures performed, if any, by the internal auditor function during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

*Obtaining an Understanding of Oversight Exercised by Those Charged with Governance* (Ref: Para. 20)

A20. Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and ~~of the relevant internal control~~ the controls that address such risks. Since the responsibilities of those charged with governance and management may vary by entity and by country, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.<sup>97</sup>

<sup>96</sup> ISA 315 (Revised 2019), paragraphs 14(a) and ~~24(a)(ii)6 and 23~~, and ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

<sup>97</sup> ISA 260 (Revised), paragraphs A1–A8, discuss with whom the auditor communicates when the entity's governance structure is not well defined.

A21. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of ~~internal controls~~ that address ~~over~~ risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

#### Considerations Specific to Smaller Entities

...

#### *Consideration of Other Information* (Ref: Para. 23)

A23. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment, the applicable financial reporting framework and the entity's system of internal control may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

#### *Evaluation of Fraud Risk Factors* (Ref: Para. 24)

...

A26. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

Fraud risk factors may relate to incentives, pressures or opportunities that arise from conditions that create susceptibility to misstatement, before consideration of controls. Fraud risk factors, which include intentional management bias, are, insofar as they affect inherent risk, inherent risk factors.<sup>98</sup> Fraud risk factors may also relate to conditions within the entity's system of internal control that provide opportunity to commit fraud or that may affect management's attitude or ability to rationalize fraudulent actions. Fraud rRisk factors reflective of an attitude that permits rationalization of the fraudulent action may not

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<sup>98</sup> ISA 315 (Revised 2019), paragraph 12(f)

be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information through, for example, the required understanding of the entity's control environment.<sup>99</sup> Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

...

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

*Risks of Fraud in Revenue Recognition* (Ref: Para. 26)

...

*Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls* (Ref: Para. 27)

A32. Management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

A33. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. ~~In doing so, In identifying the controls that address the risks of material misstatement due to fraud,~~ the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from ~~obtaining this understanding identifying these controls, and evaluating their design and determining whether they have been implemented,~~ may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

## **Responses to the Assessed Risks of Material Misstatement Due to Fraud**

*Overall Responses* (Ref: Para. 28)

...

*Assignment and Supervision of Personnel* (Ref: Para. 29(a))

...

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<sup>99</sup> [ISA 315 \(Revised 2019\), paragraph 21](#)

*Unpredictability in the Selection of Audit Procedures* (Ref: Para. 29(c))

...

*Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level* (Ref: Para. 30)

...

Audit Procedures Responsive to Risks Related to Management Override of Controls  
Journal Entries and Other Adjustments (Ref: Para. 32(a))

...

A43. Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries<sup>100</sup> is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, where IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

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

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

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<sup>100</sup> ISA 315 (Revised 2019), paragraph 26(a)(ii)

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

...

Accounting Estimates (Ref: Para. 32(b))

...

Business Rationale for Significant Transactions (Ref: Para. 32(c))

...

**Evaluation of Audit Evidence** (Ref: Para. 34–37)

...

*Analytical Procedures Performed Near the End of the Audit in Forming an Overall Conclusion* (Ref: Para. 34)

...

*Consideration of Identified Misstatements* (Ref: Para. 35–37)

...

**Auditor Unable to Continue the Engagement** (Ref: Para. 38)

...

**Written Representations** (Ref: Para. 39)

...

**Communications to Management and with Those Charged with Governance**

*Communication to Management* (Ref: Para. 40)

...

*Communication with Those Charged with Governance* (Ref: Para. 41)

...

*Other Matters Related to Fraud* (Ref: Para. 42)

...

**Communications to Regulatory and Enforcement Authorities** (Ref: Para. 43)

...

**Appendix 1**

(Ref: Para. A25)

**Examples of Fraud Risk Factors**

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

Fraud risk factors may relate to incentives or pressures, or opportunities, that arise from conditions that create susceptibility to misstatement before consideration of controls (i.e., the inherent risk). Such factors are inherent risk factors, insofar as they affect inherent risk, and may be due to management bias. Fraud risk factors related to opportunities may also arise from other identified inherent risk factors (for example, complexity or uncertainty may create opportunities that result in susceptibility to misstatement due to fraud). Fraud risk factors related to opportunities may also relate to conditions within the entity's system of internal control, such as limitations or deficiencies in the entity's internal control that create such opportunities. Fraud risk

factors related to attitudes or rationalizations may arise, in particular, from limitations or deficiencies in the entity's control environment.

### **Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting**

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

#### *Incentives/Pressures*

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

...

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

...

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

...

#### *Opportunities*

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

...

The monitoring of management is not effective as a result of the following:

...

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

...

~~Internal control components are deficient~~ Deficiencies in internal control as a result of the following:

- ~~Inadequate monitoring of controls process to monitor the entity's system of internal control~~, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of staff in accounting, information technology, or the internal audit function that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

*Attitudes/Rationalizations*

...

**Risk Factors Arising from Misstatements Arising from Misappropriation of Assets**

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

*Incentives/Pressures*

...

*Opportunities*

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

...

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

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

- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

*Attitudes/Rationalizations*

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

## Appendix 2

(Ref: Para. A40)

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

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

#### Consideration at the Assertion Level

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

The following are specific examples of responses:

...

- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of material misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.

...

### **Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting**

Examples of responses to the auditor’s assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

...

## **Appendix 3**

(Ref: Para. A49)

### **Examples of Circumstances that Indicate the Possibility of Fraud**

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

...

### ***ISA 300, Planning an Audit of Financial Statements***

#### **Application and Other Explanatory Material**

...

#### **Documentation (Ref: Para. 12)**

...

#### ***Considerations Specific to Smaller Entities***

A21. As discussed in paragraph A11, a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity. For the audit plan, standard audit programs or checklists (see paragraph A19) drawn up on the assumption of few **relevant** controls<sup>101</sup> **activities**, as is likely to be the case in a smaller entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor’s risk assessments.

...

### ***ISA 402, Audit Considerations Relating to an Entity Using a Service Organization***

#### **Introduction**

#### **Scope of this ISA**

1. This International Standard on Auditing (ISA) deals with the user auditor’s responsibility to obtain sufficient appropriate audit evidence when a user entity

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<sup>101</sup> [ISA 315 \(Revised 2019\), paragraph 26\(a\)](#)

uses the services of one or more service organizations. Specifically, it expands on how the user auditor applies ISA 315 (Revised 2019)<sup>102</sup> and ISA 330<sup>103</sup> in obtaining an understanding of the user entity, including the entity's system of internal control relevant to the preparation of the financial statements relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

...

3. Services provided by a service organization are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, ~~including related business processes, relevant to financial reporting~~ the preparation of the financial statements. ~~Although in~~ Most controls at the service organization are likely to relate to financial reporting be part of the user entity's information system relevant to the preparation of the financial statements, ~~there may be other or related controls that may also be relevant to the audit~~, such as controls over the safeguarding of assets. A service organization's services are part of a user entity's information system; ~~including related business processes, relevant to financial reporting~~ if these services affect any of the following:
- (a) How information relating to significant classes of transactions, account balances and disclosures flows through the user entity's information system, whether manually or using IT, and whether obtained from within or outside the general ledger and subsidiary ledgers. The classes of transactions in the user entity's operations that are significant to the user entity's financial statements; This includes when the service organization's services affect how:
    - (i) ~~(b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements; Transactions of the user entity are initiated, and how information about them is recorded, processed, corrected as necessary, and incorporated in the general ledger and reported in the financial statements; and~~
    - (ii) Information about events or conditions, other than transactions, is captured, processed and disclosed by the user entity in the financial statements.
  - (b) ~~(c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements and other supporting records relating to the flows of information in paragraph 3(a) that are used to initiate, record, process and report the user~~

<sup>102</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*

<sup>103</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;

- (d) ~~How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;~~
- (ce) The financial reporting process used to prepare the user entity's financial statements from the records described in paragraph 3(b), including as it relates to disclosures and to accounting estimates relating to significant classes of transactions, account balances and disclosures accounting estimates and disclosures; and
- (d) The entity's IT environment relevant to (a) to (c) above.
- (f) ~~Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.~~

...

## Objectives

7. The objectives of the user auditor, when the user entity uses the services of a service organization, are:
  - (a) To obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's system of internal control relevant to the audit, sufficient to provide an appropriate basis for the identification and assessment of identify and assess the risks of material misstatement; and
  - (b) To design and perform audit procedures responsive to those risks.

...

## Requirements

### Obtaining an Understanding of the Services Provided by a Service Organization, Including Internal Control

...

10. When obtaining an understanding of the entity's system of internal control relevant to the audit in accordance with ISA 315 (Revised 2019),<sup>104</sup> the user auditor shall identify controls in the control activities component<sup>105</sup> ~~evaluate the design and implementation of relevant controls at the user entity, from those~~ that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization, and evaluate their design and determine whether they have been implemented.<sup>106</sup> (Ref: Para. A12–A14)

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<sup>104</sup> ISA 315 (Revised), paragraph 12

<sup>105</sup> ISA 315 (Revised 2019), paragraphs 26(a)

<sup>106</sup> ISA 315 (Revised 2019), paragraph 26(d)

11. The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's system of internal control ~~relevant to the audit~~ has been obtained to provide an appropriate basis for the identification and assessment of the risks of material misstatement.
12. If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures:  
...
  - (c) Visiting the service organization and performing procedures that will provide the necessary information about the relevant controls at the service organization; or
  - (d) Using another auditor to perform procedures that will provide the necessary information about ~~the relevant~~ controls at the service organization. (Ref: Para. A15–A20)

*Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organization*

- ...
14. If the user auditor plans to use a type 1 or type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organization, the user auditor shall:  
...
    - (b) Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal controls at the service organization ~~relevant to the audit~~; and
- ...

## **Application and Other Explanatory Material**

### **Obtaining an Understanding of the Services Provided by a Service Organization, Including Internal Control**

...

*Further Procedures When a Sufficient Understanding Cannot Be Obtained from the User Entity* (Ref: Para. 12)

...

- A19. Another auditor may be used to perform procedures that will provide the necessary information about the relevant controls at the service organization related to services provided to the user entity. If a type 1 or type 2 report has been

issued, the user auditor may use the service auditor to perform these procedures as the service auditor has an existing relationship with the service organization. The user auditor using the work of another auditor may find the guidance in ISA 600<sup>107</sup> useful as it relates to understanding another auditor (including that auditor's independence and professional competence), involvement in the work of another auditor in planning the nature, timing and extent of such work, and in evaluating the sufficiency and appropriateness of the audit evidence obtained.

...

*Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organization* (Ref: Para. 13–14)

...

A22. A type 1 or type 2 report, along with information about the user entity, may assist the user auditor in obtaining an understanding of:

- (a) The aspects of controls at the service organization that may affect the processing of the user entity's transactions, including the use of subservice organizations;
- (b) The flow of significant transactions through the service organization to determine the points in the transaction flow where material misstatements in the user entity's financial statements could occur;
- (c) The control objectives at the service organization that are relevant to the user entity's financial statement assertions; and
- (d) Whether controls at the service organization are suitably designed and implemented to prevent, or detect and correct processing errors that could result in material misstatements in the user entity's financial statements.

A type 1 or type 2 report may assist the user auditor in obtaining a sufficient understanding to identify and assess the risks of material misstatement. A type 1 report, however, does not provide any evidence of the operating effectiveness of the relevant controls.

## **Responding to the Assessed Risks of Material Misstatement**

...

### *Test of Controls*

A29. The user auditor is required by ISA 330 to design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness

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<sup>107</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph 2, states: "An auditor may find this ISA, adapted as necessary in the circumstances, useful when that auditor involves other auditors in the audit of financial statements that are not group financial statements ..." See also paragraph 19 of ISA 600.

of ~~relevant~~ controls in certain circumstances. In the context of a service organization, this requirement applies when:

...

- A30. If a type 2 report is not available, a user auditor may contact the service organization, through the user entity, to request that a service auditor be engaged to provide a type 2 report that includes tests of the operating effectiveness of the ~~relevant~~ controls or the user auditor may use another auditor to perform procedures at the service organization that test the operating effectiveness of those controls. A user auditor may also visit the service organization and perform tests of ~~relevant~~ controls if the service organization agrees to it. The user auditor's risk assessments are based on the combined evidence provided by the work of another auditor and the user auditor's own procedures.

Using a Type 2 Report as Audit Evidence that Controls at the Service Organization Are Operating Effectively

...

- A33. It may also be necessary for the user auditor to obtain additional evidence about significant changes to the ~~relevant~~ controls at the service organization outside of the period covered by the type 2 report or determine additional audit procedures to be performed. Relevant factors in determining what additional audit evidence to obtain about controls at the service organization that were operating outside of the period covered by the service auditor's report may include:

...

- The effectiveness of the control environment and the user entity's process to monitor the system of internal control ~~monitoring of controls at the user entity.~~

- A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the user entity's process to monitor the system of internal control ~~monitoring of controls.~~

...

- A39. The user auditor is required to communicate in writing significant deficiencies identified during the audit to both management and those charged with governance on a timely basis.<sup>11</sup> The user auditor is also required to communicate to management at an appropriate level of responsibility on a timely basis other deficiencies in internal control identified during the audit that, in the user auditor's professional judgment, are of sufficient importance to merit management's attention.<sup>12</sup> Matters that the user auditor may identify during the audit and may communicate to management and those charged with governance of the user entity include:

- Any controls within the entity’s process to monitor the system of internal control ~~monitoring of controls~~ that could be implemented by the user entity, including those identified as a result of obtaining a type 1 or type 2 report;

...

## **ISA 330, *The Auditor’s Responses to Assessed Risks***

### **Introduction**

#### **Scope of this ISA**

1. This International Standard on Auditing (ISA) deals with the auditor’s responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with ISA 315 (Revised 2019)<sup>108</sup> in an audit of financial statements.

#### **Effective Date**

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### **Objective**

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

### **Definitions**

4. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) Substantive procedure – An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:
    - (i) Tests of details (of classes of transactions, account balances, and disclosures); and
    - (ii) Substantive analytical procedures.
  - (b) Test of controls – An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

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<sup>108</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

## Requirements

### Overall Responses

5. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1–A3)

### Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

6. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4–A8; A42–A52)
7. In designing the further audit procedures to be performed, the auditor shall:
  - (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each significant class of transactions, account balance, and disclosure, including:
    - (i) The likelihood and magnitude of ~~material~~-misstatement due to the particular characteristics of the ~~relevant-significant~~ class of transactions, account balance, or disclosure (that is, the inherent risk); and
    - (ii) Whether the risk assessment takes account of ~~relevant-controls that address the risk of material misstatement~~ (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor ~~intends to rely on~~plans to test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9–A18)
  - (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

### Tests of Controls

8. The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of ~~relevant~~ controls if:
  - (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor ~~intends~~plans to test to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
  - (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20–A24)

9. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25)

#### Nature and Extent of Tests of Controls

10. In designing and performing tests of controls, the auditor shall:
- (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
    - (i) How the controls were applied at relevant times during the period under audit;
    - (ii) The consistency with which they were applied; and
    - (iii) By whom or by what means they were applied. (Ref: Para. A26–A29a)
  - (b) To the extent not already addressed, Determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30–A31)

#### Timing of Tests of Controls

11. The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs 12 and 15 below, in order to provide an appropriate basis for the auditor's intended reliance. (Ref: Para. A32)

#### Using audit evidence obtained during an interim period

12. If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:
- (a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and
  - (b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33–A34)

#### Using audit evidence obtained in previous audits

13. In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:
- (a) The effectiveness of other ~~elements~~ components of the entity's system of internal control, including the control environment, the entity's process

- ~~to monitoring of the system of internal~~ controls, and the entity's risk assessment process;
- (b) The risks arising from the characteristics of the control, including whether it is manual or automated;
  - (c) The effectiveness of general IT controls;
  - (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
  - (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
  - (f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)
14. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance and reliability of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:
- (a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36)
  - (b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37–A39)

#### Controls over significant risks

15. If the auditor ~~plans-intends~~ to rely ~~test~~ on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

#### Evaluating the Operating Effectiveness of Controls

16. When evaluating the operating effectiveness of ~~relevant~~ controls upon which the auditor intends to rely, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive

procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A40)

17. If deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether: (Ref: Para. A41)
- (a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
  - (b) Additional tests of controls are necessary; or
  - (c) The ~~potential~~ risks of material misstatement need to be addressed using substantive procedures.

#### *Substantive Procedures*

18. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. (Ref: Para. A42–A47)
19. The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48–A51)

#### Substantive Procedures Related to the Financial Statement Closing Process

20. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:
- (a) Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers; and
  - (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)

#### Substantive Procedures Responsive to Significant Risks

21. If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)

#### Timing of Substantive Procedures

22. If substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:
- (a) substantive procedures, combined with tests of controls for the intervening period; or

- (b) if the auditor determines that it is sufficient, further substantive procedures only,

that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A54–A57)

23. If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified. (Ref: Para. A58)

### **Adequacy of Presentation of the Financial Statements**

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework. In making this evaluation, the auditor shall consider whether the financial statements are presented in a manner that reflects the appropriate:
- Classification and description of financial information and the underlying transactions, events and conditions; and
  - Presentation, structure and content of the financial statements. (Ref: Para. A59)

### **Evaluating the Sufficiency and Appropriateness of Audit Evidence**

25. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A60–A61)
26. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)
27. If the auditor has not obtained sufficient appropriate audit evidence ~~as to related to an material financial statement~~ relevant assertion about a class of transactions, account balance or disclosure, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

### **Documentation**

28. The auditor shall include in the audit documentation:<sup>109</sup>

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<sup>109</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

- (a) The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed;
  - (b) The linkage of those procedures with the assessed risks at the assertion level; and
  - (c) The results of the audit procedures, including the conclusions where these are not otherwise clear. (Ref: Para. A63)
29. If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit.
30. The auditor's documentation shall demonstrate that information in the financial statements agrees or reconciles with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers.

## Application and Other Explanatory Material

### Overall Responses (Ref: Para. 5)

- A1. Overall responses to address the assessed risks of material misstatement at the financial statement level may include:
- Emphasizing to the engagement team the need to maintain professional skepticism.
  - Assigning more experienced staff or those with special skills or using experts.
  - Providing more supervision—Changes to the nature, timing and extent of direction and supervision of members of the engagement team and the review of the work performed.
  - Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
  - Changes to the overall audit strategy as required by ISA 300, or planned audit procedures, and may include changes to:
    - The auditor's determination of performance materiality in accordance with ISA 320.
    - The auditor's plans to tests the operating effectiveness of controls, and the persuasiveness of audit evidence needed to support the planned reliance on the operating effectiveness of the controls, particularly when deficiencies in the control environment or the entity's monitoring activities are identified.

- The nature, timing and extent of substantive procedures. For example, it may be appropriate to perform substantive procedures at or near the date of the financial statements when the risk of material misstatement is assessed as higher.
  - ~~Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.~~
- A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:
- Conducting more audit procedures as of the period end rather than at an interim date.
  - Obtaining more extensive audit evidence from substantive procedures.
  - Increasing the number of locations to be included in the audit scope.
- A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

### **Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level**

#### *The Nature, Timing and Extent of Further Audit Procedures (Ref: Para. 6)*

- A4. The auditor's assessment of the identified risks of material misstatement at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that:
- (a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;
  - (b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the ~~relevant risk assessment of the risk of material misstatement~~. This may be because the ~~auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because~~ auditor has not

identified a risk for which substantive procedures alone cannot provide sufficient appropriate audit evidence and therefore is not required to test the operating effectiveness of controls. testing controls would be inefficient and ~~T~~therefore, the auditor ~~does~~ may not intend to rely on plan to test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or

- (c) A combined approach using both tests of controls and substantive procedures is an effective approach.

The auditor need not design and perform further audit procedures where the assessment of the risk of material misstatement is below the acceptably low level. However, as required by paragraph 18, irrespective of the approach selected and the assessed risk of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure.

- A5. The nature of an audit procedure refers to its purpose (that is, test of controls or substantive procedure) and its type (that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks.
- A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.
- A7. Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.
- A8. Designing and performing further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage between the auditor's further audit procedures and the risk assessment.

#### Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))

##### Nature

- A9. ISA 315 (Revised 2019) requires that the auditor's assessment of the risks of material misstatement at the assertion level is performed by assessing inherent risk and control risk. The auditor assesses inherent risk by assessing the likelihood and magnitude of a misstatement taking into account how, and the degree to which the inherent risk factors affect the susceptibility to misstatement of relevant assertions.<sup>110</sup> The auditor's assessed risks, including the reasons for those assessed risks, may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit

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<sup>110</sup> ISA 315 (Revised 2019), paragraphs 31 and 34

procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of material misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of material misstatement of the occurrence assertion.

- A10. The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of ~~internal~~ the auditor plans to test the operating effectiveness of controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

#### Timing

- A11. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from interim date to the period end would not be effective.
- A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.
- A13. In addition, certain audit procedures can be performed only at or after the period end, for example:
- Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers;
  - Examining adjustments made during the course of preparing the financial statements; and

- Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized.

A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.
- The timing of the preparation of the financial statements, particularly for those disclosures that provide further explanation about amounts recorded in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.

#### Extent

A15. The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

A16. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

#### Considerations specific to public sector entities

A17. For the audits of public sector entities, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.

Considerations specific to smaller entities

A18. In the case of very small entities, there may not be many controls ~~activities~~ that could be identified by the auditor, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of controls ~~activities~~ or of ~~other~~ components of the system of internal control may make it impossible to obtain sufficient appropriate audit evidence.

Higher Assessments of Risk (Ref: Para 7(b))

A19. When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.

*Tests of Controls*

Designing and Performing Tests of Controls (Ref: Para. 8)

A20. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in ~~an~~ relevant assertion, and the auditor plans to test those controls. If substantially different controls were used at different times during the period under audit, each is considered separately.

A21. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

A22. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:

- Inquiring about management's use of budgets.
- Observing management's comparison of monthly budgeted and actual expenses.
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts.

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

- A23. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.
- A24. In some cases, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level.<sup>111</sup> This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls that address the risk for which substantive procedures alone cannot provide sufficient appropriate audit evidence.

#### Audit Evidence and Intended Reliance (Ref: Para. 9)

- A25. A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

#### Nature and Extent of Tests of Controls

##### Other audit procedures in combination with inquiry (Ref: Para. 10(a))

- A26. Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.
- A27. The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant.

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<sup>111</sup> ISA 315 (Revised 2019), paragraph 3330

For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of controls ~~activities~~, such as automated controls ~~activities performed by a computer~~. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

#### Extent of tests of controls

A28. When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control. As well as the degree of reliance on controls, matters the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

ISA 530<sup>112</sup> contains further guidance on the extent of testing.

A29. Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated controls can be expected to function consistently unless the ~~program~~ IT application (including the tables, files, or other permanent data used by the ~~program~~ IT application) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests ~~might~~ may include testing the general IT controls related to the IT application, determining that:

- ~~Changes to the program are not made without being subject to the appropriate program change controls;~~
- ~~The authorized version of the program is used for processing transactions; and~~
- ~~Other relevant general controls are effective.~~

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<sup>112</sup> ISA 530, *Audit Sampling*

Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.

A29a. Similarly, the auditor may perform tests of controls that address risks of material misstatement related to the integrity of the entity's data, or the completeness and accuracy of the entity's system-generated reports, or to address risks of material misstatement for which substantive procedures alone cannot provide sufficient appropriate audit evidence. These tests of controls may include tests of general IT controls that address the matters in paragraph 10(a). When this is the case, the auditor may not need to perform any further testing to obtain audit evidence about the matters in paragraph 10(a).

A29b. When the auditor determines that a general IT control is deficient, the auditor may consider the nature of the related risk(s) arising from the use of IT that were identified in accordance with ISA 315 (Revised 2019)<sup>113</sup> to provide the basis for the design of the auditor's additional procedures to address the assessed risk of material misstatement. Such procedures may address determining whether:

- The related risk(s) arising from IT has occurred. For example, if users have unauthorized access to an IT application (but cannot access or modify the system logs that track access), the auditor may inspect the system logs to obtain audit evidence that those users did not access the IT application during the period.
- There are any alternate or redundant general IT controls, or any other controls, that address the related risk(s) arising from the use of IT. If so, the auditor may identify such controls (if not already identified) and therefore evaluate their design, determine that they have been implemented and perform tests of their operating effectiveness. For example, if a general IT control related to user access is deficient, the entity may have an alternate control whereby IT management reviews end user access reports on a timely basis. Circumstances when an application control may address a risk arising from the use of IT may include when the information that may be affected by the general IT control deficiency can be reconciled to external sources (e.g., a bank statement) or internal sources not affected by the general IT control deficiency (e.g., a separate IT application or data source).

Testing of indirect controls (Ref: Para. 10(b))

A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls (e.g., general IT controls). As explained in paragraphs A29 to A29b, general IT controls may have been identified in accordance with ISA 315 (Revised 2019) because of their support

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<sup>113</sup> ISA 315 (Revised 2019), paragraph 26(c)(i)

of the operating effectiveness of automated controls or due to their support in maintaining the integrity of information used in the entity's financial reporting, including system-generated reports. The requirement in paragraph 10(b) acknowledges that the auditor may have already tested certain indirect controls to address the matters in paragraph 10(a). For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, general IT controls) are described as "indirect" controls.

~~A31. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.~~

#### Timing of Tests of Controls

Intended period of reliance (Ref: Para. 11)

A32. Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of controls in the entity's process to monitoring of the system of internal controls.

Using audit evidence obtained during an interim period (Ref: Para. 12(b))

A33. Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel.
- The degree to which audit evidence about the operating effectiveness of those controls was obtained.
- The length of the remaining period.
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.
- The control environment.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the entity's monitoring of controls.

Using audit evidence obtained in previous audits (Ref: Para. 13)

A35. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance and reliability. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

Controls that have changed from previous audits (Ref: Para. 14(a))

A36. Changes may affect the relevance and reliability of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A37. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

- (a) have not changed since they were last tested; and
- (b) are not controls that mitigate a significant risk,

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year.

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A deficient control environment.
- A deficiency in the entity's process to monitoring of the system of internal controls.
- A significant manual element to ~~the relevant~~ controls.

- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT controls.

A39. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

#### Evaluating the Operating Effectiveness of Controls (Ref: Para.16–17)

- A40. A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.
- A41. The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor.

#### *Substantive Procedures* (Ref: Para. 6, 18)

A42. Paragraph 18 requires the auditor to design and perform substantive procedures for each material-class of transactions, account balance, and disclosure; ~~irrespective of the assessed risks of material misstatement.~~ For significant classes of transactions, account balances and disclosures, substantive procedures may have already been performed because paragraph 6 requires the auditor to design and perform further audit procedures that are responsive to the assessed risks of material misstatement at the assertion level. Accordingly, substantive procedures are required to be designed and performed in accordance with paragraph 18:

- When the further audit procedures for significant classes of transactions, account balances or disclosures, designed and performed in accordance with paragraph 6, did not include substantive procedures; or
- For each class of transactions, account balance or disclosure that is not a significant class of transactions, account balance or disclosure, but that has been identified as material in accordance with ISA 315 (Revised 2019).<sup>114</sup>

This requirement reflects the facts that: (a) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and (b) there are inherent limitations to ~~internal~~ controls, including management override.

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<sup>114</sup> ISA 315 (Revised 2019), paragraph 36

A42a. Not all assertions within a material class of transactions, account balance or disclosure are required to be tested. Rather, in designing the substantive procedures to be performed, the auditor's consideration of the assertion(s) in which, if a misstatement were to occur, there is a reasonable possibility of the misstatement being material, may assist in identifying the appropriate nature, timing and extent of the procedures to be performed.

#### Nature and Extent of Substantive Procedures

A43. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

A44. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. ISA 520<sup>115</sup> establishes requirements and provides guidance on the application of analytical procedures during an audit.

A45. The ~~nature assessment~~ of the risk ~~and~~ or the nature of the assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

A46. Because the assessment of the risk of material misstatement takes account of ~~internal controls~~ that the auditor plans to test, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

A47. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. See ISA 500.<sup>116</sup>

#### Considering Whether External Confirmation Procedures Are to Be Performed (Ref: Para. 19)

A48. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not

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<sup>115</sup> ISA 520, *Analytical Procedures*

<sup>116</sup> ISA 500, *Audit Evidence*, paragraph 10

be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cutoff assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms.

A49. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.

A50. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor’s decision about whether to perform external confirmation procedures.

A51. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

- The confirming party’s knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- The ability or willingness of the intended confirming party to respond – for example, the confirming party:

- May not accept responsibility for responding to a confirmation request;
- May consider responding too costly or time consuming;
- May have concerns about the potential legal liability resulting from responding;
- May account for transactions in different currencies; or
- May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

- The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

Substantive Procedures Related to the Financial Statement Closing Process (Ref: Para. 20)

A52. The nature, and also the extent, of the auditor's substantive procedures related to the financial statement closing process depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

*Substantive Procedures Responsive to Significant Risks* (Ref: Para. 21)

A53. Paragraph 21 of this ISA requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

Timing of Substantive Procedures (Ref: Para. 22–23)

A54. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. There are, however, exceptions, for example, a legal opinion obtained in a previous audit related to the structure of a securitization to which no changes have occurred, may be relevant in the current period. In such cases, it may be appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed, and audit procedures have been performed during the current period to establish its continuing relevance.

Using audit evidence obtained during an interim period (Ref: Para. 22)

A55. In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to:

- (a) Identify amounts that appear unusual;
- (b) Investigate any such amounts; and
- (c) Perform substantive analytical procedures or tests of details to test the intervening period.

A56. Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The control environment and other ~~relevant~~ controls.
- The availability at a later date of information necessary for the auditor's procedures.
- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

A57. Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period end:

- Whether the period-end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.
- Whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.
- Whether the information system ~~relevant to financial reporting~~ will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:
  - (a) Significant unusual transactions or entries (including those at or near the period end);
  - (b) Other causes of significant fluctuations, or expected fluctuations that did not occur; and
  - (c) Changes in the composition of the classes of transactions or account balances.

Misstatements detected at an interim date (Ref: Para. 23)

A58. When the auditor concludes that the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating the procedures performed at the interim date at the period end.

**Adequacy of Presentation of the Financial Statements** (Ref: Para. 24)

A59. Evaluating the appropriate presentation, arrangement and content of the financial statements includes, for example, consideration of the terminology used as required by the applicable financial reporting framework, the level of detail provided, the aggregation and disaggregation of amounts and the bases of amounts set forth.

**Evaluating the Sufficiency and Appropriateness of Audit Evidence** (Ref: Para. 25–27)

A60. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example:

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a significant deficiency in internal control.

- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement.

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks of material misstatement for all or some of and the effect on the significant classes of transactions, account balances, or disclosures and related—their relevant assertions. ISA 315 (Revised 2019) contains further guidance on revising the auditor's risk assessment.<sup>117</sup>

- A61. The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.
- A62. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:
- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
  - Effectiveness of management's responses and controls to address the risks.
  - Experience gained during previous audits with respect to similar potential misstatements.
  - Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
  - Source and reliability of the available information.
  - Persuasiveness of the audit evidence.
  - Understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control.

#### **Documentation** (Ref: Para. 28)

- A63. The form and extent of audit documentation is a matter of professional judgment, and is influenced by the nature, size and complexity of the entity and its system of internal control, availability of information from the entity and the audit methodology and technology used in the audit.

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<sup>117</sup> ISA 315 (Revised 2019), paragraph 373†

## **ISA 500, *Audit Evidence***

### **Application and Other Explanatory Material**

#### **Sufficient Appropriate Audit Evidence (Ref: Para. 6)**

- A1. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has evaluated whether such information remains relevant and reliable as audit evidence for the current audit<sup>118</sup> ~~determined whether changes have occurred since the previous audit that may affect its relevance to the current audit~~) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

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#### *Audit Procedures for Obtaining Audit Evidence*

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#### **Observation**

- A17. Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of controls ~~activities~~. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed. See ISA 501 for further guidance on observation of the counting of inventory.

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## **ISA 501, *Audit Evidence—Special Considerations for Selected Items***

### **Application and Other Explanatory Material**

#### **Inventory**

#### *Attendance at Physical Inventory Counting (Ref: Para. 4(a))*

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<sup>118</sup> ISA 315 (Revised 2019), paragraph 916

Evaluate Management's Instructions and Procedures (Ref: Para. 4(a)(i))

- A4. Matters relevant in evaluating management's instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example:
- The application of appropriate controls ~~activities~~, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.

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## **ISA 530, *Audit Sampling***

### **Application and Other Explanatory Material**

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#### **Sample Design, Size, and Selection of Items for Testing**

*Sample Design* (Ref: Para. 6)

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- A7. In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the ~~relevant~~ controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size....

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## **Appendix 2**

(Ref: Para. A11)

### **Example of Factors Influencing Sample Size for Test of Controls**

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

Factor 1 An increase in the extent to which the auditor's risk assessment takes into account relevant plans to test the operating effectiveness of controls.

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## ISA 550, *Related Parties*

### Application and Other Explanatory Material

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#### Risk Assessment Procedures and Related Activities

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#### *Understanding the Entity's Related Party Relationships and Transactions*

Discussion among the Engagement Team (Ref: Para. 12)

A9. Matters that may be addressed in the discussion among the engagement team include:

- ...
- The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of ~~relevant~~ controls.

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The Identity of the Entity's Related Parties (Ref: Para. 13(a))

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A12. However, where the framework does not establish related party requirements, the entity may not have such information systems in place. Under such circumstances, it is possible that management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by paragraph 13 still applies because management may be aware of parties that meet the related party definition set out in this ISA. In such a case, however, the auditor's inquiries regarding the identity of the entity's related parties are likely to form part of the auditor's risk assessment procedures and related activities performed in accordance with ISA 315 (Revised 2019) to obtain information regarding the entity's organizational structure, ownership, governance and business model.:

- ~~The entity's ownership and governance structures;~~
- ~~The types of investments that the entity is making and plans to make; and~~
- ~~The way the entity is structured and how it is financed.~~

In the particular case of common control relationships, as management is more likely to be aware of such relationships if they have economic significance to the

entity, the auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or shares resources to a significant degree, are related parties.

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#### Considerations specific to smaller entities

A20. Controls ~~activities~~ in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions. An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of available relevant documentation.

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#### *Sharing Related Party Information with the Engagement Team* (Ref: Para. 17)

A28. Relevant related party information that may be shared among the engagement team members includes, for example:

- The identity of the entity's related parties.
- The nature of the related party relationships and transactions.
- Significant or complex related party relationships or transactions that may be determined to be significant risks ~~require special audit consideration,~~ in particular transactions in which management or those charged with governance are financially involved.

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#### **Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions** (Ref: Para. 20)

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A34. Depending upon the results of the auditor's risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone in relation to the risks of material misstatement associated with related party relationships and transactions. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically

in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the ISA 330 requirement to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls,<sup>119</sup> the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.

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## **ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures***

### **Introduction**

#### **Scope of this ISA**

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of financial statements. Specifically, it includes requirements and guidance that refer to, or expand on, how ISA 315 (Revised 2019),<sup>120</sup> ISA 330,<sup>121</sup> ISA 450,<sup>122</sup> ISA 500<sup>123</sup> and other relevant ISAs are to be applied in relation to accounting estimates and related disclosures. It also includes requirements and guidance on the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible management bias.

#### **Nature of Accounting Estimates**

2. Accounting estimates vary widely in nature and are required to be made by management when the monetary amounts cannot be directly observed. The measurement of these monetary amounts is subject to estimation uncertainty, which reflects inherent limitations in knowledge or data. These limitations give rise to inherent subjectivity and variation in the measurement outcomes. The process of making accounting estimates involves selecting and applying a method using assumptions and data, which requires judgment by management and can give rise to complexity in measurement. The effects of complexity, subjectivity or other inherent risk factors on the measurement of these monetary amounts affects their susceptibility to misstatement. (Ref: Para. A1–A6, Appendix 1)

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<sup>119</sup> ISA 330, paragraph 8(b)

<sup>120</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>121</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>122</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*

<sup>123</sup> ISA 500, *Audit Evidence*

3. Although this ISA applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing and extent of the risk assessment and further audit procedures required by this ISA will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be very low, based on their nature, and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures required by this ISA would not be expected to be extensive. When estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive. This ISA contains guidance on how the requirements of this ISA can be scaled. (Ref: Para. A7)

### Key Concepts of This ISA

4. ~~This ISA 315 (Revised 2019) requires a separate assessment of inherent risk for identified risks of material misstatement at the assertion level.<sup>124</sup> purposes of assessing the risks of material misstatement at the assertion level for accounting estimates: In the context of ISA 540 (Revised), and depending on the nature of a particular accounting estimate, the susceptibility of an assertion to a misstatement that could be material may be subject to or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, and the interrelationship among them. As explained in ISA 200,<sup>125</sup> inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others.~~ Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale that is referred to in this ISA as the spectrum of inherent risk. (Ref: Para. A8–A9, A65–A66, Appendix 1)
5. This ISA refers to relevant requirements in ISA 315 (Revised 2019) and ISA 330, and provides related guidance, to emphasize the importance of the auditor’s decisions about controls relating to accounting estimates, including decisions about whether:
  - There are controls ~~relevant to the audit~~ required to be identified by ISA 315 (Revised 2019), for which the auditor is required to evaluate their design and determine whether they have been implemented.
  - To test the operating effectiveness of ~~relevant~~ controls.
6. ~~This ISA 315 (Revised 2019) also requires a separate assessment of control risk when assessing the risks of material misstatement at the assertion level for accounting estimates.~~ In assessing control risk, the auditor takes into account whether the auditor’s further audit procedures contemplate planned reliance

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<sup>124</sup> ISA 315 (Revised 2019), paragraph 31

<sup>125</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A40

on the operating effectiveness of controls. If the auditor does not ~~perform plan to tests the operating effectiveness of controls, or does not intend to rely on the operating effectiveness of controls,~~ the auditor's assessment of the risk of material misstatement at the assertion level control risk cannot be reduced for the effective operation of controls with respect to the particular assertion is such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.<sup>126</sup> (Ref: Para. A10)

7. This ISA emphasizes that the auditor's further audit procedures (including, where appropriate, tests of controls) need to be responsive to the reasons for the assessed risks of material misstatement at the assertion level, taking into account the effect of one or more inherent risk factors and the auditor's assessment of control risk.
8. The exercise of professional skepticism in relation to accounting estimates is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity or other inherent risk factors. Similarly, the exercise of professional skepticism is important when there is greater susceptibility to misstatement due to management bias or ~~fraud~~ other fraud risk factors insofar as they affect inherent risk. (Ref: Para. A11)

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## Objective

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## Definitions

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## Requirements

### Risk Assessment Procedures and Related Activities

13. When obtaining an understanding of the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control, as required by ISA 315 (Revised 2019),<sup>127</sup> the auditor shall obtain an understanding of the following matters related to the entity's accounting estimates. The auditor's procedures to obtain the understanding shall be performed to the extent necessary to obtain audit evidence that provides an appropriate basis for the identification and assessment of risks

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<sup>126</sup> ISA 530, *Audit Sampling*, Appendix 3

<sup>127</sup> ISA 315 (Revised 2019), paragraphs 3, 5–6, 9, 11–12, 15–17, and 20–21 19–27

of material misstatement at the financial statement and assertion levels. (Ref: Para. A19–A22)

Obtaining an Understanding of the Entity and Its Environment and the Applicable Financial Reporting Framework

- (a) The entity's transactions and other events ~~and~~ conditions that may give rise to the need for, or changes in, accounting estimates to be recognized or disclosed in the financial statements. (Ref: Para. A23)
- (b) The requirements of the applicable financial reporting framework related to accounting estimates (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements); and how they apply in the context of the nature and circumstances of the entity and its environment, including how ~~transactions and other events or conditions are subject to, or affected by,~~ the inherent risk factors affect susceptibility to misstatement of assertions. (Ref: Para. A24–A25)
- (c) Regulatory factors relevant to the entity's accounting estimates, including, when applicable, regulatory frameworks related to prudential supervision. (Ref: Para. A26)
- (d) The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements, based on the auditor's understanding of the matters in 13(a)–(c) above. (Ref: Para. A27)

Obtaining an Understanding of the Entity's System of Internal Control

- (e) The nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates. (Ref: Para. A28–A30).
- (f) How management identifies the need for, and applies, specialized skills or knowledge related to accounting estimates, including with respect to the use of a management's expert. (Ref: Para. A31)
- (g) How the entity's risk assessment process identifies and addresses risks relating to accounting estimates. (Ref: Para. A32–A33)
- (h) The entity's information system as it relates to accounting estimates, including:
  - (i) How information relating to accounting estimates and related disclosures for significant classes of transactions, account balances or disclosures flows through the entity's information system ~~The classes of transactions, events and conditions, that are significant to the financial statements and that give rise to the need for, or changes in, accounting estimates and related disclosures;~~ and (Ref: Para. A34–A35)

(ii) For such accounting estimates and related disclosures, how management:

- a. Identifies the relevant methods, assumptions or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework, including how management: (Ref: Para. A36–A37)
  - i. Selects or designs, and applies, the methods used, including the use of models; (Ref: Para. A38–A39)
  - ii. Selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions; (Ref: Para. A40–A43); and
  - iii. Selects the data to be used; (Ref: Para. A44)
- b. Understands the degree of estimation uncertainty, including through considering the range of possible measurement outcomes; and (Ref: Para. A45)
- c. Addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements. (Ref: Para. A46–A49)

- (i) Identified controls in the control activities component<sup>128</sup> ~~activities relevant to the audit~~ over management's process for making accounting estimates as described in paragraph 13(h)(ii). (Ref: Para. A50–A54)
- (j) How management reviews the outcome(s) of previous accounting estimates and responds to the results of that review.

14. The auditor shall review the outcome of previous accounting estimates, or, where applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor shall take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question judgments about previous period accounting estimates that were appropriate based on the information available at the time they were made. (Ref: Para. A55–A60)

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### **Identifying and Assessing the Risks of Material Misstatement**

16. In identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the assertion level, including separately assessing inherent risk and control risk at the assertion level, as

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<sup>128</sup> ISA 315 (Revised 2019), paragraphs 26(a)(i)–(iv)

required by ISA 315 (Revised 2019),<sup>129</sup> the auditor shall ~~separately assess inherent risk and control risk. The auditor shall~~ take the following into account in identifying the risks of material misstatement and in assessing inherent risk: (Ref: Para. A64–A71)

- (a) The degree to which the accounting estimate is subject to estimation uncertainty; and (Ref: Para. A72–A75)
- (b) The degree to which the following are affected by complexity, subjectivity, or other inherent risk factors: (Ref: Para. A76–A79)
  - (i) The selection and application of the method, assumptions and data in making the accounting estimate; or
  - (ii) The selection of management’s point estimate and related disclosures for inclusion in the financial statements.

17. The auditor shall determine whether any of the risks of material misstatement identified and assessed in accordance with paragraph 16 are, in the auditor’s judgment, a significant risk.<sup>130</sup> If the auditor has determined that a significant risk exists, the auditor shall identify controls that obtain an understanding of the entity’s controls, including control activities, relevant to address that risk,<sup>131</sup> and evaluate whether such controls have been designed effectively, and determine whether they have been implemented.<sup>132</sup> (Ref: Para. A80)

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19. As required by ISA 330,<sup>133</sup> the auditor shall design and perform tests to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls, if:

- (a) The auditor’s assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively; or
- (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In relation to accounting estimates, the auditor’s tests of such controls shall be responsive to the reasons for the assessment given to the risks of material misstatement. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.<sup>134</sup> (Ref: Para. A85–A89)

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<sup>129</sup> ISA 315 (Revised 2019), paragraph ~~25 and 26~~31 and 34

<sup>130</sup> ISA 315 (Revised 2019), paragraph ~~32~~27

<sup>131</sup> ISA 315 (Revised 2019), paragraph ~~26(a)(i)~~29

<sup>132</sup> ISA 315 (Revised 2019), paragraph 26(a)

<sup>133</sup> ISA 330, paragraph 8

<sup>134</sup> ISA 330, paragraph 9

*Other Considerations Relating to Audit Evidence*

30. In obtaining audit evidence regarding the risks of material misstatement relating to accounting estimates, irrespective of the sources of information to be used as audit evidence, the auditor shall comply with the relevant requirements in ISA 500.

When using the work of a management's expert, the requirements in paragraphs 21–29 of this ISA may assist the auditor in evaluating the appropriateness of the expert's work as audit evidence for a relevant assertion in accordance with paragraph 8(c) of ISA 500. In evaluating the work of the management's expert, the nature, timing and extent of the further audit procedures are affected by the auditor's evaluation of the expert's competence, capabilities and objectivity, the auditor's understanding of the nature of the work performed by the expert, and the auditor's familiarity with the expert's field of expertise. (Ref: Para. A126–A132)

...

**Documentation**

39. The auditor shall include in the audit documentation:<sup>135</sup> (Ref: Para. A149–A152)
- (a) Key elements of the auditor's understanding of the entity and its environment, including the entity's internal control related to the entity's accounting estimates;
  - (b) The linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level,<sup>136</sup> taking into account the reasons (whether related to inherent risk or control risk) given to the assessment of those risks;
  - (c) The auditor's response(s) when management has not taken appropriate steps to understand and address estimation uncertainty;
  - (d) Indicators of possible management bias related to accounting estimates, if any, and the auditor's evaluation of the implications for the audit, as required by paragraph 32; and
  - (e) Significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

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<sup>135</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, A6, A7 and A10

<sup>136</sup> ISA 330, paragraph 28(b)

## Application and Other Explanatory Material

### Nature of Accounting Estimates (Ref: Para. 2)

#### *Examples of Accounting Estimates*

...

#### *Methods*

- A2. A method is a measurement technique used by management to make an accounting estimate in accordance with the required measurement basis. For example, one recognized method used to make accounting estimates relating to share-based payment transactions is to determine a theoretical option call price using the Black Scholes option pricing formula. A method is applied using a computational tool or process, sometimes referred to as a model, and involves applying assumptions and data and taking into account a set of relationships between them.

#### *Assumptions and Data*

- A3. Assumptions involve judgments based on available information about matters such as the choice of an interest rate, a discount rate, or judgments about future conditions or events. An assumption may be selected by management from a range of appropriate alternatives. Assumptions that may be made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate.
- A4. For purposes of this ISA, data is information that can be obtained through direct observation or from a party external to the entity. Information obtained by applying analytical or interpretive techniques to data is referred to as derived data when such techniques have a well-established theoretical basis and therefore less need for management judgment. Otherwise, such information is an assumption.
- A5. Examples of data include:
- Prices agreed in market transactions;
  - Operating times or quantities of output from a production machine;
  - Historical prices or other terms included in contracts, such as a contracted interest rate, a payment schedule, and term included in a loan agreement;
  - Forward-looking information such as economic or earnings forecasts obtained from an external information source, or
  - A future interest rate determined using interpolation techniques from forward interest rates (derived data).

- A6. Data can come from a wide range of sources. For example, data can be:
- Generated within the organization or externally;
  - Obtained from a system that is either within or outside the general or subsidiary ledgers;
  - Observable in contracts; or
  - Observable in legislative or regulatory pronouncements.

*Scalability* (Ref: Para. 3)

- A7. Examples of paragraphs that include guidance on how the requirements of this ISA can be scaled include paragraphs A20–A22, A63, A67, and A84.

## Key Concepts of This ISA

*Inherent Risk Factors* (Ref: Para. 4)

- A8. Inherent risk factors are characteristics of ~~conditions and events~~ and conditions that ~~may~~ affect the susceptibility of ~~an assertion~~ to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosures, before consideration of controls.<sup>137</sup> Appendix 1 further explains the nature of these inherent risk factors, and their inter-relationships, in the context of making accounting estimates and their presentation in the financial statements.
- A9. ~~In addition to the inherent risk factors of estimation uncertainty, complexity or subjectivity, other inherent risk factors that the auditor may consider in identifying and~~ When assessing the risks of material misstatement at the assertion level<sup>138</sup>, in addition to estimation uncertainty, complexity, and subjectivity, the auditor also takes into account the degree ~~may include the extent to which inherent risk factors included in ISA 315 (Revised 2019); (other than estimation uncertainty, complexity, and subjectivity); affect susceptibility to misstatement of assertions to misstatement about the accounting estimate. Such additional inherent risk factors include~~ is subject to, or affected by:
- Change in the nature or circumstances of the relevant financial statement items, or requirements of the applicable financial reporting framework which may give rise to the need for changes in the method, assumptions or data used to make the accounting estimate.
  - Susceptibility to misstatement due to management bias, or other fraud risk factors insofar as they affect inherent risk, in making the accounting estimate.
  - Uncertainty, other than estimation uncertainty.

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<sup>137</sup> ISA 315 (Revised 2019), paragraph 12(f)

<sup>138</sup> ISA 315 (Revised 2019), paragraph 31

*Control Risk* (Ref: Para. 6)

A10. ~~An important consideration for the auditor is~~ In assessing control risk at the assertion level in accordance with ISA 315 (Revised 2019), the auditor takes into account ~~is the effectiveness of the design of the controls that whether the auditor intends plans to rely test on the operating effectiveness of controls, and the extent to which the controls address the assessed inherent risks at the assertion level. When the auditor is considering whether to test the operating effectiveness of controls, the auditor's evaluation that controls are effectively designed and have been implemented supports an expectation, by the auditor, about the operating effectiveness of the controls in determining whether establishing the plan to test them.~~

*Professional Skepticism* (Ref: Para. 8)

....

*Concept of "Reasonable"* (Ref: Para. 9, 35)

...

**Risk Assessment Procedures and Related Activities**

*Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control* (Ref: Para. 13)

A19. Paragraphs ~~1911–2724~~ of ISA 315 (Revised 2019) require the auditor to obtain an understanding of certain matters about the entity and its environment, the applicable financial reporting framework and including the entity's system of internal control. The requirements in paragraph 13 of this ISA relate more specifically to accounting estimates and build on the broader requirements in ISA 315 (Revised 2019).

*Scalability*

A20. The nature, timing, and extent of the auditor's procedures to obtain the understanding of the entity and its environment, including the applicable financial reporting framework, and the entity's system of internal control, related to the entity's accounting estimates, may depend, to a greater or lesser degree, on the extent to which the individual matter(s) apply in the circumstances. For example, the entity may have few transactions or other events ~~and/or~~ conditions that give rise to the need for accounting estimates, the applicable financial reporting requirements may be simple to apply, and there may be no relevant regulatory factors. Further, the accounting estimates may not require significant judgments, and the process for making the accounting estimates may be less complex. In these circumstances, the accounting estimates may be subject to, or affected by, estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree, and there may be fewer identified controls in

the control activities component relevant to the audit. If so, the auditor's risk identification and assessment procedures are likely to be less extensive and may be obtained primarily through inquiries of management with appropriate responsibilities for the financial statements, such as and simple walk-throughs of management's process for making the accounting estimate (including when evaluating whether identified controls in that process are designed effectively and when determining whether the control has been implemented).

- A21. By contrast, the accounting estimates may require significant judgments by management, and the process for making the accounting estimates may be complex and involve the use of complex models. In addition, the entity may have a more sophisticated information system, and more extensive controls over accounting estimates. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, subjectivity, complexity or other inherent risk factors to a greater degree. If so, the nature or timing of the auditor's risk assessment procedures are likely to be different, or be more extensive, than in the circumstances in paragraph A20.
- A22. The following considerations may be relevant for entities with only simple businesses, which may include many smaller entities:
- Processes relevant to accounting estimates may be uncomplicated because the business activities are simple or the required estimates may have a lesser degree of estimation uncertainty.
  - Accounting estimates may be generated outside of the general and subsidiary ledgers, controls over their development may be limited, and an owner-manager may have significant influence over their determination. The owner-manager's role in making the accounting estimates may need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering the risk of management bias.

### The Entity and Its Environment

The entity's transactions and other events ~~and~~ or conditions (Ref: Para. 13(a))

- A23. Changes in circumstances that may give rise to the need for, or changes in, accounting estimates may include, for example, whether:
- The entity has engaged in new types of transactions;
  - Terms of transactions have changed; or
  - New events or conditions have occurred.

The requirements of the applicable financial reporting framework (Ref: Para. 13(b))

- A24. Obtaining an understanding of the requirements of the applicable financial reporting framework provides the auditor with a basis for discussion with

management and, where applicable, those charged with governance about how management has applied ~~these~~ requirements of the applicable financial reporting framework relevant to the accounting estimates, and about the auditor's determination of whether they have been applied appropriately. This understanding also may assist the auditor in communicating with those charged with governance when the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework, not to be the most appropriate in the circumstances of the entity.<sup>139</sup>

A25. In obtaining this understanding, the auditor may seek to understand whether:

- The applicable financial reporting framework:
  - Prescribes certain criteria for the recognition, or methods for the measurement of accounting estimates;
  - Specifies certain criteria that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability; or
  - Specifies required or suggested disclosures, including disclosures concerning judgments, assumptions, or other sources of estimation uncertainty relating to accounting estimates; and
- Changes in the applicable financial reporting framework require changes to the entity's accounting policies relating to accounting estimates.

Regulatory factors (Ref: Para. 13(c))

...

The nature of the accounting estimates and related disclosures that the auditor expects to be included in the financial statements (Ref: Para. 13(d))

...

*The Entity's System of Internal Control Relevant to the Audit*

The nature and extent of oversight and governance (Ref: Para. 13(e))

A28. In applying ISA 315 (Revised 2019),<sup>140</sup> the auditor's understanding of the nature and extent of oversight and governance that the entity has in place over management's process for making accounting estimates may be important to the auditor's required evaluation of as it relates to whether:

- Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; ~~and~~

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<sup>139</sup> ISA 260 (Revised), paragraph 16(a)

<sup>140</sup> ISA 315 (Revised 2019), paragraph 21(a)+4

- ~~The strengths in the entity's control environment elements collectively provides an appropriate foundation for the other components of the system of internal control considering the nature and size of the entity; and whether~~
- ~~those other components are undermined by eControl deficiencies identified in the control environment undermine the other components of the system of internal control.~~

...

A30. Obtaining an understanding of the oversight by those charged with governance may be important when there are accounting estimates that:

- Require significant judgment by management to address subjectivity;
- Have high estimation uncertainty;
- Are complex to make, for example, because of the extensive use of information technology, large volumes of data or the use of multiple data sources or assumptions with complex-interrelationships;
- Had, or ought to have had, a change in the method, assumptions or data compared to previous periods; or
- Involve significant assumptions.

Management's application of specialized skills or knowledge, including the use of management's experts (Ref: Para. 13(f))

...

The entity's risk assessment process (Ref: Para. 13(g))

A32. Understanding how the entity's risk assessment process identifies and addresses risks relating to accounting estimates may assist the auditor in considering changes in:

- The requirements of the applicable financial reporting framework related to the accounting estimates;
- The availability or nature of data sources that are relevant to making the accounting estimates or that may affect the reliability of the data used;
- The entity's information systems or IT environment; and
- Key personnel.

A33. Matters that the auditor may consider in obtaining an understanding of how management identified and addresses the susceptibility to misstatement due to management bias or fraud in making accounting estimates, include whether, and if so how, management:

- Pays particular attention to selecting or applying the methods, assumptions and data used in making accounting estimates.
- Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors.
- Identifies financial or other incentives that may be a motivation for bias.
- Monitors the need for changes in the methods, significant assumptions or the data used in making accounting estimates.
- Establishes appropriate oversight and review of models used in making accounting estimates.
- Requires documentation of the rationale for, or an independent review of, significant judgments made in making accounting estimates.

The entity's information system relating to accounting estimates (Ref: Para. 13(h)(i))

A34. The significant classes of transactions, events and conditions within the scope of paragraph 13(h) are the same as the significant classes of transactions, events and conditions relating to accounting estimates and related disclosures that are subject to paragraphs ~~25(a)18(a) and (d)~~ of ISA 315 (Revised 2019). In obtaining the understanding of the entity's information system as it relates to accounting estimates, the auditor may consider:

- Whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions.
- How the information system addresses the completeness of accounting estimates and related disclosures, in particular for accounting estimates related to liabilities.

A35. During the audit, the auditor may identify classes of transactions, events ~~and~~ or conditions that give rise to the need for accounting estimates and related disclosures that management failed to identify. ISA 315 (Revised 2019) deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including ~~determining whether there is a significant deficiency in internal control with regard to~~ considering the implications for the auditor's evaluation of the entity's risk assessment process.<sup>141</sup>

Management's Identification of the Relevant Methods, Assumptions and Sources of Data (Ref: Para. 13(h)(ii)(a))

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<sup>141</sup> ISA 315 (Revised 2019), paragraph ~~22(b)17~~

Methods (Ref: Para. 13(h)(ii)(a)(i))

...

Models

A39. Management may design and implement specific controls around models used for making accounting estimates, whether management's own model or an external model. When the model itself has an increased level of complexity or subjectivity, such as an expected credit loss model or a fair value model using level 3 inputs, controls that address such complexity or subjectivity may be more likely to be identified as relevant to the audit. When complexity in relation to models is present, controls over data integrity are also more likely to be identified controls in accordance with ISA 315 (Revised 2019) relevant to the audit. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and of related identified controls activities relevant to the audit include the following:

- How management determines the relevance and accuracy of the model;
- The validation or back testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model may include evaluation of:
  - The model's theoretical soundness;
  - The model's mathematical integrity; and
  - The accuracy and completeness of the data and the appropriateness of data and assumptions used in the model.
- How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model;
- Whether adjustments, also referred to as overlays in certain industries, are made to the output of the model and whether such adjustments are appropriate in the circumstances in accordance with the requirements of the applicable financial reporting framework. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias; and
- Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, the results of any validation performed on it and the nature of, and basis for, any adjustments made to its output.

Assumptions (Ref: Para. 13(h)(ii)(a)(ii))

...

Data (Ref: Para. 13(h)(ii)(a)(iii))

A44. Matters that the auditor may consider in obtaining an understanding of how management selects the data on which the accounting estimates are based include:

- The nature and source of the data, including information obtained from an external information source.
- How management evaluates whether the data is appropriate.
- The accuracy and completeness of the data.
- The consistency of the data used with data used in previous periods.
- The complexity of IT applications or other aspects of the entity's IT environment ~~the information technology systems~~ used to obtain and process the data, including when this involves handling large volumes of data.
- How the data is obtained, transmitted and processed and how its integrity is maintained.

How management understands and addresses estimation uncertainty (Ref: Para. 13(h)(ii)(b)–13(h)(ii)(c))

...

Identified Controls Activities Relevant to the Audit ~~Over Management's Process for Making Accounting Estimates~~ (Ref: Para 13(i))

A50. The auditor's judgment in identifying controls ~~relevant to the audit~~ the controls activities component, and therefore the need to evaluate the design of those controls and determine whether they have been implemented, relates to management's process described in paragraph 13(h)(ii). The auditor may not identify ~~relevant controls activities~~ in relation to all the ~~elements~~ aspects of paragraph 13(h)(ii); ~~depending on the complexity associated with the accounting estimate.~~

A51. As part of ~~obtaining an understanding of~~ identifying the controls activities relevant to the audit, and evaluating their design and determining whether they have been implemented, the auditor may consider:

- How management determines the appropriateness of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers.
- The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.

- The segregation of duties between those responsible for making the accounting estimates and those committing the entity to the related transactions, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity's financial products staffed by individuals whose remuneration is not tied to such products.
- The effectiveness of the design of the controls, ~~activities~~. Generally, it may be more difficult for management to design controls that address subjectivity and estimation uncertainty in a manner that effectively prevents, or detects and corrects, material misstatements, than it is to design controls that address complexity. Controls that address subjectivity and estimation uncertainty may need to include more manual elements, which may be less reliable than automated controls as they can be more easily bypassed, ignored or overridden by management. The design effectiveness of controls addressing complexity may vary depending on the reason for, and the nature of, the complexity. For example, it may be easier to design more effective controls related to a method that is routinely used or over the integrity of data.

A52. When management makes extensive use of information technology in making an accounting estimate, identified controls relevant to the audit in the control activities component are likely to include general IT controls and application information processing controls. Such controls may address risks related to:

- Whether the IT applications or other aspects of the IT environment information technology system ~~has~~ has the capability and is appropriately configured to process large volumes of data;
- Complex calculations in applying a method. When diverse IT applications systems are required to process complex transactions, regular reconciliations between the IT applications systems are made, in particular when the IT applications systems do not have automated interfaces or may be subject to manual intervention;
- Whether the design and calibration of models is periodically evaluated;
- The complete and accurate extraction of data regarding accounting estimates from the entity's records or from external information sources;
- Data, including the complete and accurate flow of data through the entity's information system, the appropriateness of any modification to the data used in making accounting estimates, the maintenance of the integrity and security of the data. When using external information sources, risks related to processing or recording the data;

- Whether management has controls around access, change and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models; and
- Whether there are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over journal entries.

A53. In some industries, such as banking or insurance, the term governance may be used to describe activities within the control environment, the entity's process to monitor the system of internal control ~~monitoring of controls~~, and other components of the system of internal control, as described in ISA 315 (Revised 2019).<sup>142</sup>

A54. For entities with an internal audit function, its work may be particularly helpful to the auditor in obtaining an understanding of:

- The nature and extent of management's use of accounting estimates;
- The design and implementation of controls ~~activities~~ that address the risks related to the data, assumptions and models used to make the accounting estimates;
- The aspects of the entity's information system that generate the data on which the accounting estimates are based; and
- How new risks relating to accounting estimates are identified, assessed and managed.

*Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates* (Ref: Para. 14)

...

A58. Based on the auditor's previous assessment of the risks of material misstatement, for example, if inherent risk is assessed as higher for one or more risks of material misstatement, the auditor may judge that a more detailed retrospective review is required. As part of the detailed retrospective review, the auditor may pay particular attention, when practicable, to the effect of data and significant assumptions used in making the previous accounting estimates. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A59. The measurement objective for fair value accounting estimates and other accounting estimates, based on current conditions at the measurement date, deals

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<sup>142</sup> ISA 315 (Revised 2019), Appendix 3 paragraph A77

with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that may be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions that affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant audit evidence. In this case, audit evidence may be obtained by understanding the outcomes of assumptions (such as a cash flow projections) and understanding the effectiveness of management's prior estimation process that supports the identification and assessment of the risks of material misstatement in the current period.

- A60. A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. However, such a difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.<sup>143</sup> Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may reassess any plan to test related controls and the related assessment of control risk ~~and/or~~ may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

*Specialized Skills or Knowledge* (Ref: Para. 15)

...

#### **Identifying and Assessing the Risks of Material Misstatement** (Ref: Para. 4, 16)

- A64. Identifying and assessing risks of material misstatement at the assertion level relating to accounting estimates is important for all accounting estimates, including not only those that are recognized in the financial statements, but also those that are included in the notes to the financial statements.
- A65. Paragraph A42 of ISA 200 states that the ISAs ~~do not ordinarily refer to inherent risk and control risk separately~~ typically refer to the "risks of material misstatement" rather than to inherent risk and control risk separately. ~~However, this ISA 315 (Revised 2019) requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the risks of material misstatement at the assertion~~

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<sup>143</sup> ISA 560, Subsequent Events, paragraph 14

level,<sup>144</sup> including significant risks, ~~at the assertion level for accounting estimates~~ in accordance with ISA 330.<sup>145</sup>

A66. In identifying the risks of material misstatement and in assessing inherent risk for accounting estimates in accordance with ISA 315 (Revised 2019),<sup>146</sup> the auditor is required to take into account ~~the degree to which the accounting estimate is subject to, or affected by,~~ the inherent risk factors that affect susceptibility to misstatement of assertions, and how they do so ~~estimation uncertainty, complexity, subjectivity, or other inherent risk factors~~. The auditor's consideration of the inherent risk factors may also provide information to be used in ~~determining~~:

- Assessing the likelihood and magnitude of misstatement (i.e., ~~W~~where inherent risk is assessed on the spectrum of inherent risk); and
- Determining ~~T~~the reasons for the assessment given to the risks of material misstatement at the assertion level, and that the auditor's further audit procedures in accordance with paragraph 18 are responsive to those reasons.

The interrelationships between the inherent risk factors are further explained in Appendix 1.

A67. The reasons for the auditor's assessment of inherent risk at the assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity or other inherent risk factors. For example:

- (a) Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgments about future events or conditions. Similar considerations apply to insurance contract liabilities.
- (b) An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes, but may involve little subjectivity and the degree of estimation uncertainty may be low, depending on the nature of the inventory.
- (c) Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an accounting estimate that requires a single critical judgment about a liability, the amount of which is contingent on the outcome of the litigation.

<sup>144</sup> ISA 315 (Revised 2019), paragraphs 31 and 34

<sup>145</sup> ISA 330, paragraph 7(b)

<sup>146</sup> ISA 315 (Revised 2019), paragraph 31(a)

- A68. The relevance and significance of inherent risk factors may vary from one estimate to another. Accordingly, the inherent risk factors may, either individually or in combination, affect simple accounting estimates to a lesser degree and the auditor may identify fewer risks or assess inherent risk at close to the lower end of the spectrum of inherent risk.
- A69. Conversely, the inherent risk factors may, either individually or in combination, affect complex accounting estimates to a greater degree, and may lead the auditor to assess inherent risk at the higher end of the spectrum of inherent risk. For these accounting estimates, the auditor's consideration of the effects of the inherent risk factors is likely to directly affect the number and nature of identified risks of material misstatement, the assessment of such risks, and ultimately the persuasiveness of the audit evidence needed in responding to the assessed risks. Also, for these accounting estimates the auditor's application of professional skepticism may be particularly important.
- A70. Events occurring after the date of the financial statements may provide additional information relevant to the auditor's assessment of the risks of material misstatement at the assertion level. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise the assessment of the risks of material misstatement at the assertion level,<sup>147</sup> regardless of how the inherent risk factors affect susceptibility of assertions to misstatement relating to degree to which the accounting estimate was subject to, or affected by, estimation uncertainty, complexity, subjectivity or other inherent risk factors. Events occurring after the date of the financial statements also may influence the auditor's selection of the approach to testing the accounting estimate in accordance with paragraph 18. For example, for a simple bonus accrual that is based on a straightforward percentage of compensation for selected employees, the auditor may conclude that there is relatively little complexity or subjectivity in making the accounting estimate, and therefore may assess inherent risk at the assertion level at close to the lower end of the spectrum of inherent risk. The payment of the bonuses subsequent to period end may provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level.
- A71. The auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, minimum) or in terms of the auditor's expectation of how effective the control(s) is in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.

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<sup>147</sup> ISA 315 (Revised 2019), paragraph 373†

*Estimation Uncertainty* (Ref: Para. 16(a))

A72. In taking into account the degree to which the accounting estimate is subject to estimation uncertainty, the auditor may consider:

- Whether the applicable financial reporting framework requires:
  - The use of a method to make the accounting estimate that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of unobservable inputs.
  - The use of assumptions that inherently have a high level of estimation uncertainty, such as assumptions with a long forecast period, assumptions that are based on data that is unobservable and are therefore difficult for management to develop, or the use of various assumptions that are interrelated.
  - Disclosures about estimation uncertainty.
- The business environment. An entity may be active in a market that experiences turmoil or possible disruption (for example, from major currency movements or inactive markets) and the accounting estimate may therefore be dependent on data that is not readily observable.
- Whether it is possible (or practicable, insofar as permitted by the applicable financial reporting framework) for management:
  - To make a precise and reliable prediction about the future realization of a past transaction (for example, the amount that will be paid under a contingent contractual term), or about the incidence and impact of future events or conditions (for example, the amount of a future credit loss or the amount at which an insurance claim will be settled and the timing of its settlement); or
  - To obtain precise and complete information about a present condition (for example, information about valuation attributes that would reflect the perspective of market participants at the date of the financial statements, to develop a fair value estimate).

A73. The size of the amount recognized or disclosed in the financial statements for an accounting estimate is not, in itself, an indicator of its susceptibility to misstatement because, for example, the accounting estimate may be understated.

A74. In some circumstances, the estimation uncertainty may be so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may preclude recognition of an item in the financial statements, or its measurement at fair value. In such cases, there may be risks of material misstatement that relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but

also to the reasonableness of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the estimation uncertainty associated with them (see paragraphs A112–A113, A143–A144).

- A75. In some cases, the estimation uncertainty relating to an accounting estimate may cast significant doubt about the entity’s ability to continue as a going concern. ISA 570 (Revised)<sup>148</sup> establishes requirements and provides guidance in such circumstances.

*Complexity or Subjectivity* (Ref: Para. 16(b))

The Degree to Which Complexity Affects the Selection and Application of the Method

- A76. In taking into account the degree to which the selection and application of the method used in making the accounting estimate are affected by complexity, the auditor may consider:

- The need for specialized skills or knowledge by management which may indicate that the method used to make an accounting estimate is inherently complex and therefore the accounting estimate may have a greater susceptibility to material misstatement. There may be a greater susceptibility to material misstatement when management has developed a model internally and has relatively little experience in doing so, or uses a model that applies a method that is not established or commonly used in a particular industry or environment.
- The nature of the measurement basis required by the applicable financial reporting framework, which may result in the need for a complex method that requires multiple sources of historical and forward-looking data or assumptions, with multiple interrelationships between them. For example, an expected credit loss provision may require judgments about future credit repayments and other cash flows, based on consideration of historical experience data and the application of forward looking assumptions. Similarly, the valuation of an insurance contract liability may require judgments about future insurance contract payments to be projected based on historical experience and current and assumed future trends.

The Degree to Which Complexity Affects the Selection and Application of the Data

- A77. In taking into account the degree to which the selection and application of the data used in making the accounting estimate are affected by complexity, the auditor may consider:

- The complexity of the process to derive the data, taking into account the relevance and reliability of the data source. Data from certain sources may be more reliable than from others. Also, for confidentiality

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<sup>148</sup> ISA 570, (Revised), *Going Concern*

or proprietary reasons, some external information sources will not (or not fully) disclose information that may be relevant in considering the reliability of the data they provide, such as the sources of the underlying data they used or how it was accumulated and processed.

- The inherent complexity in maintaining the integrity of the data. When there is a high volume of data and multiple sources of data, there may be inherent complexity in maintaining the integrity of data that is used to make an accounting estimate.
- The need to interpret complex contractual terms. For example, the determination of cash inflows or outflows arising from a commercial supplier or customer rebates may depend on very complex contractual terms that require specific experience or competence to understand or interpret.

#### The Degree to Which Subjectivity Affects the Selection and Application of the Method, Assumptions or Data

A78. In taking into account the degree to which the selection and application of method, assumptions or data are affected by subjectivity, the auditor may consider:

- The degree to which the applicable financial reporting framework does not specify the valuation approaches, concepts, techniques and factors to use in the estimation method.
- The uncertainty regarding the amount or timing, including the length of the forecast period. The amount and timing is a source of inherent estimation uncertainty, and gives rise to the need for management judgment in selecting a point estimate, which in turn creates an opportunity for management bias. For example, an accounting estimate that incorporates forward looking assumptions may have a high degree of subjectivity which may be susceptible to management bias.

#### *Other Inherent Risk Factors* (Ref: Para. 16(b))

A79. The degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or ~~fraud~~ other fraud risk factors insofar as they affect inherent risk. For example, when an accounting estimate is subject to a high degree of subjectivity, the accounting estimate is likely to be more susceptible to misstatement due to management bias or fraud and this may result in a wide range of possible measurement outcomes. Management may select a point estimate from that range that is inappropriate in the circumstances, or that is inappropriately influenced by unintentional or intentional management bias, and that is therefore misstated. For continuing audits, indicators of possible management bias identified during the audit of preceding periods may influence the planning and risk assessment procedures in the current period.

*Significant Risks* (Ref: Para. 17)

A80. The auditor's assessment of inherent risk, which takes into account the degree to which an accounting estimate is subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, assists the auditor in determining whether any of the risks of material misstatement identified and assessed are a significant risk.

...

*When the Auditor Intends to Rely on the Operating Effectiveness of Relevant Controls*  
(Ref: Para: 19)

A85. Testing the operating effectiveness of relevant controls may be appropriate when inherent risk is assessed as higher on the spectrum of inherent risk, including for significant risks. This may be the case when the accounting estimate is subject to or affected by a high degree of complexity. When the accounting estimate is affected by a high degree of subjectivity, and therefore requires significant judgment by management, inherent limitations in the effectiveness of the design of controls may lead the auditor to focus more on substantive procedures than on testing the operating effectiveness of controls.

...

**Overall Evaluation Based on Audit Procedures Performed** (Ref: Para. 33)

...

*Determining Whether the Accounting Estimates are Reasonable or Misstated* (Ref: Para. 9, 35)

...

**ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)***

**Requirements**

**Understanding the Group, Its Components and Their Environments**

17. The auditor is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the system of internal control.<sup>149</sup> The group engagement team shall:

(a) ...

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<sup>149</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

## Application and Other Explanatory Material

...

### Definitions

...

*Significant Component* (Ref: Para. 9(m))

...

- A6. The group engagement team may also identify a component as likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, ~~(that is, risks that require special audit consideration<sup>150</sup>)~~. For example, a component could be responsible for foreign exchange trading and thus expose the group to a significant risk of material misstatement, even though the component is not otherwise of individual financial significance to the group.

...

### Understanding the Group, Its Components, and Their Environments

*Matters about Which the Group Engagement Team Obtains an Understanding* (Ref: Para. 17)

- A23. ISA 315 (Revised 2019) contains guidance on matters the auditor may consider when obtaining an understanding of the industry, regulatory, and other external factors that affect the entity, including the applicable financial reporting framework; the nature of the entity; objectives and strategies and related business risks; and measurement and review of the entity's financial performance.<sup>151</sup> Appendix 2 of this ISA contains guidance on matters specific to a group including the consolidation process.

## Appendix 2

### Examples of Matters about Which the Group Engagement Team Obtains an Understanding

...

#### Group-Wide Controls

1. Group-wide controls may include a combination of the following:
  - Regular meetings between group and component management to discuss business developments and to review performance.

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<sup>150</sup> ISA 315 (Revised), paragraphs 27–29

<sup>151</sup> ISA 315 (Revised 2019), paragraphs A6225–A6449 and Appendix 1

- ...
- Controls ~~activities~~ within an IT system that is common for all or some components.
- Controls within the group’s process to monitor ~~Monitoring the system of internal~~ controls, including activities of the internal audit function and self-assessment programs.
- ...

## Appendix 5

### Required and Additional Matters Included in the Group Engagement Team’s Letter of Instruction

Matters that are relevant to the planning of the work of the component auditor:

- ...
- ...

Matters that are relevant to the conduct of the work of the component auditor:

- The findings of the group engagement team’s tests of controls ~~activities~~ of a processing system that is common for all or some components, and tests of controls to be performed by the component auditor.
- ...

### ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

#### Introduction

...

#### Relationship between ISA 315 (Revised 2019) and ISA 610 (Revised 2013)

...

7. ISA 315 (Revised 2019) addresses how the knowledge and experience of the internal audit function can inform the external auditor’s understanding of the entity and its environment, the applicable financial reporting framework and the entity’s system of internal control, and identification and assessment of risks of material misstatement. ISA 315 (Revised 2019)<sup>152</sup> also explains how effective communication between the internal and external auditors also creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor’s work.

...

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<sup>152</sup> ISA 315 (Revised 2019), paragraph 24(a)(ii)(e) and Appendix 4

## Application and Other Explanatory Material

### Definition of Internal Audit Function (Ref: Para. 2, 14(a))

...

- A3. In addition, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this ISA, although they may perform controls activities that can be tested in accordance with ISA 330.<sup>12</sup> For this reason, monitoring controls performed by an owner-manager would not be considered equivalent to an internal audit function.

...

### *Evaluating the Internal Audit Function*

...

### Application of a Systematic and Disciplined Approach (Ref: Para. 15(c))

- A10. The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring controls activities that may be performed within the entity.

...

- A21. As explained in ISA 315 (Revised 2019),<sup>153</sup> significant risks ~~require special audit consideration~~ are risks assessed close to the upper end of the spectrum of inherent risk and therefore the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, where the risks of material misstatement is other than low, the use of the work of the internal audit function alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.

...

## ISA 620, *Using the Work of an Auditor's Expert*

### Application and Other Explanatory Material

...

### Determining the Need for an Auditor's Expert (Ref: Para. 7)

- A4. An auditor's expert may be needed to assist the auditor in one or more of the following:

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<sup>153</sup> ISA 315 (Revised 2019), paragraph 4(e)12(l)

- Obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the, including its entity's system of internal control.
- ...

## ***ISA 701, Communicating Key Audit Matters in the Independent Auditor's Report***

### **Application and Other Explanatory Material**

...

#### **Determining Key Audit Matters (Ref: Para. 9–10)**

...

*Considerations in Determining Those Matters that Required Significant Auditor Attention* (Ref: Para. 9)

...

Areas of Higher Assessed Risk of Material Misstatement, or Significant Risks Identified in Accordance with ISA 315 (Revised 2019) (Ref: Para. 9(a))

...

A20. ISA 315 (Revised 2019) defines a significant risk as an identified ~~and assessed~~ risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which the inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur that, in the auditor's judgment, requires special audit consideration.<sup>154</sup> Areas of significant management judgment and significant unusual transactions may often be identified as significant risks. Significant risks are therefore often areas that require significant auditor attention.

...

## ***ISA 720 (Revised), The Auditor's Responsibilities Relating to Other Information***

### **Application and Other Explanatory Material**

...

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<sup>154</sup> ISA 315 (Revised 2019), paragraph 12(l)

## Reading and Considering the Other Information (Ref: Para. 14–15)

...

*Considering Whether There Is a Material Inconsistency between the Other Information and the Auditor's Knowledge Obtained in the Audit* (Ref: Para. 14(b))

...

A31. The auditor's knowledge obtained in the audit includes the auditor's understanding of the entity and its environment, the applicable financial reporting framework, and including the entity's system of internal control, obtained in accordance with ISA 315 (Revised 2019).<sup>155</sup> ISA 315 (Revised 2019) sets out the auditor's required understanding, which includes such matters as obtaining an understanding of:

- (a) The entity's organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT;
- (b) ~~The r~~Relevant industry, regulatory, and other external factors;
- (c) The relevant measures used, internally and externally, to assess measurement and review of the entity's financial performance; and
- (b) ~~The nature of the entity;~~
- (e) ~~The entity's selection and application of accounting policies;~~
- (d) ~~The entity's objectives and strategies;~~

...

## Responding When a Material Misstatement in the Financial Statements Exists or the Auditor's Understanding of the Entity and Its Environment Needs to Be Updated (Ref: Para. 20)

A51. In reading the other information, the auditor may become aware of new information that has implications for:

- The auditor's understanding of the entity and its environment, the financial reporting framework and the entity's system of internal control and, accordingly, may indicate the need to revise the auditor's risk assessment.<sup>156</sup>
- ...

<sup>155</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraphs 1911–2112

<sup>156</sup> ISA 315 (Revised 2019), paragraphs 11.31 and A119-26 and 37

**INTERNATIONAL STANDARD ON QUALITY  
MANAGEMENT 1**

**QUALITY MANAGEMENT FOR FIRMS THAT PERFORM  
AUDITS OR REVIEWS OF FINANCIAL STATEMENTS,  
OR OTHER ASSURANCE OR RELATED SERVICES  
ENGAGEMENTS**

(Effective as of December 15, 2022)

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International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, should be read in conjunction with the *Preface to the International Quality Management, Auditing, Review, Other Assurance, and Related Services Pronouncements*.

ISQM

## Introduction

### Scope of this ISQM

1. This International Standard on Quality Management (ISQM) deals with a firm's responsibilities to design, implement and operate a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements.
2. Engagement quality reviews form part of the firm's system of quality management and:
  - (a) This ISQM deals with the firm's responsibility to establish policies or procedures addressing engagements that are required to be subject to engagement quality reviews.
  - (b) ISQM 2<sup>1</sup> deals with the appointment and eligibility of the engagement quality reviewer, and the performance and documentation of the engagement quality review.
3. Other pronouncements of the International Auditing and Assurance Standards Board (IAASB):
  - (a) Are premised on the basis that the firm is subject to the ISQMs or to national requirements that are at least as demanding;<sup>2</sup> and
  - (b) Include requirements for engagement partners and other engagement team members regarding quality management at the engagement level. For example, ISA 220 (Revised) deals with the specific responsibilities of the auditor regarding quality management at the engagement level for an audit of financial statements and the related responsibilities of the engagement partner. (Ref: Para. A1)
4. This ISQM is to be read in conjunction with relevant ethical requirements. Law, regulation or relevant ethical requirements may establish responsibilities for the firm's management of quality beyond those described in this ISQM. (Ref: Para. A2)
5. This ISQM applies to all firms performing audits or reviews of financial statements, or other assurance or related services engagements (i.e., if the firm performs any of these engagements, this ISQM applies and the system of quality management that is established in accordance with the requirements of this ISQM enables the consistent performance by the firm of all such engagements).

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<sup>1</sup> ISQM 2, *Engagement Quality Reviews*

<sup>2</sup> See, for example, International Standard on Auditing (ISA) 220 (Revised), *Quality Management for an Audit of Financial Statements* (Revised), paragraph 3

## The Firm's System of Quality Management

6. A system of quality management operates in a continual and iterative manner and is responsive to changes in the nature and circumstances of the firm and its engagements. It also does not operate in a linear manner. However, for the purposes of this ISQM, a system of quality management addresses the following eight components: (Ref: Para. A3)
  - (a) The firm's risk assessment process;
  - (b) Governance and leadership;
  - (c) Relevant ethical requirements;
  - (d) Acceptance and continuance of client relationships and specific engagements;
  - (e) Engagement performance;
  - (f) Resources;
  - (g) Information and communication; and
  - (h) The monitoring and remediation process.
7. This ISQM requires the firm to apply a risk-based approach in designing, implementing and operating the components of the system of quality management in an interconnected and coordinated manner such that the firm proactively manages the quality of engagements performed by the firm. (Ref: Para. A4)
8. The risk-based approach is embedded in the requirements of this ISQM through:
  - (a) Establishing quality objectives. The quality objectives established by the firm consist of objectives in relation to the components of the system of quality management that are to be achieved by the firm. The firm is required to establish the quality objectives specified by this ISQM and any additional quality objectives considered necessary by the firm to achieve the objectives of the system of quality management.
  - (b) Identifying and assessing risks to the achievement of the quality objectives (referred to in this standard as quality risks). The firm is required to identify and assess quality risks to provide a basis for the design and implementation of responses.
  - (c) Designing and implementing responses to address the quality risks. The nature, timing and extent of the firm's responses to address the quality risks are based on and are responsive to the reasons for the assessments given to the quality risks.
9. This ISQM requires that, at least annually, the individual(s) assigned ultimate responsibility and accountability for the system of quality management, on

behalf of the firm, evaluates the system of quality management and concludes whether the system of quality management provides the firm with reasonable assurance that the objectives of the system, stated in paragraph 14(a) and (b), are being achieved. (Ref: Para. A5)

### *Scalability*

10. In applying a risk-based approach, the firm is required to take into account:

- (a) The nature and circumstances of the firm; and
- (b) The nature and circumstances of the engagements performed by the firm.

Accordingly, the design of the firm's system of quality management, in particular the complexity and formality of the system, will vary. For example, a firm that performs different types of engagements for a wide variety of entities, including audits of financial statements of listed entities, will likely need to have a more complex and formalized system of quality management and supporting documentation, than a firm that performs only reviews of financial statements or compilation engagements.

### *Networks and Service Providers*

11. This ISQM addresses the firm's responsibilities when the firm:

- (a) Belongs to a network, and the firm complies with network requirements or uses network services in the system of quality management or in the performance of engagements; or
- (b) Uses resources from a service provider in the system of quality management or in the performance of engagements.

Even when the firm complies with network requirements or uses network services or resources from a service provider, the firm is responsible for its system of quality management.

### **Authority of this ISQM**

12. Paragraph 14 contains the objective of the firm in following this ISQM. This ISQM contains: (Ref: Para. A6)

- (a) Requirements designed to enable the firm to meet the objective in paragraph 14; (Ref: Para. A7)
- (b) Related guidance in the form of application and other explanatory material; (Ref: Para. A8)
- (c) Introductory material that provides context relevant to a proper understanding of this ISQM; and
- (d) Definitions. (Ref: Para. A9)

## Effective Date

13. Systems of quality management in compliance with this ISQM are required to be designed and implemented by December 15, 2022, and the evaluation of the system of quality management required by paragraphs 53–54 of this ISQM is required to be performed within one year following December 15, 2022.

## Objective

14. The objective of the firm is to design, implement and operate a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements performed by the firm, that provides the firm with reasonable assurance that:
  - (a) The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and
  - (b) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.
15. The public interest is served by the consistent performance of quality engagements. The design, implementation and operation of the system of quality management enables the consistent performance of quality engagements by providing the firm with reasonable assurance that the objectives of the system of quality management, stated in paragraph 14(a) and (b), are achieved. Quality engagements are achieved through planning and performing engagements and reporting on them in accordance with professional standards and applicable legal and regulatory requirements. Achieving the objectives of those standards and complying with the requirements of applicable law or regulation involves exercising professional judgment and, when applicable to the type of engagement, exercising professional skepticism.

## Definitions

16. For purposes of this ISQM, the following terms have the meanings attributed below:
  - (a) Deficiency in the firm’s system of quality management (referred to as “deficiency” in this ISQM) – This exists when: (Ref: Para. A10, A159–A160)
    - (i) A quality objective required to achieve the objective of the system of quality management is not established;
    - (ii) A quality risk, or combination of quality risks, is not identified or properly assessed; (Ref: Para. A11)
    - (iii) A response, or combination of responses, does not reduce to an

acceptably low level the likelihood of a related quality risk occurring because the response(s) is not properly designed, implemented or operating effectively; or

- (iv) An other aspect of the system of quality management is absent, or not properly designed, implemented or operating effectively, such that a requirement of this ISQM has not been addressed. (Ref: Para. A12)
- (b) Engagement documentation – The record of work performed, results obtained, and conclusions the practitioner reached (terms such as “working papers” or “work papers” are sometimes used).
- (c) Engagement partner<sup>3</sup> – The partner or other individual, appointed by the firm, who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
- (d) Engagement quality review – An objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed on or before the date of the engagement report.
- (e) Engagement quality reviewer – A partner, other individual in the firm, or an external individual, appointed by the firm to perform the engagement quality review.
- (f) Engagement team – All partners and staff performing the engagement, and any other individuals who perform procedures on the engagement, excluding an external expert<sup>4</sup> and internal auditors who provide direct assistance on an engagement. (Ref: Para. A13)
- (g) External inspections – Inspections or investigations, undertaken by an external oversight authority, related to the firm’s system of quality management or engagements performed by the firm. (Ref: Para. A14)
- (h) Findings (in relation to a system of quality management) – Information about the design, implementation and operation of the system of quality management that has been accumulated from the performance of monitoring activities, external inspections and other relevant sources, which indicates that one or more deficiencies may exist. (Ref: Para. A15–A17)
- (i) Firm – A sole practitioner, partnership or corporation or other entity of professional accountants, or public sector equivalent. (Ref: Para. A18)

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<sup>3</sup> “Engagement partner” and “partner” is to be read as referring to their public sector equivalents where relevant.

<sup>4</sup> ISA 620, *Using the Work of an Auditor’s Expert*, paragraph 6(a), defines the term “auditor’s expert.”

- (j) Listed entity – An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.
- (k) Network firm – A firm or entity that belongs to the firm’s network.
- (l) Network – A larger structure: (Ref: Para. A19)
  - (i) That is aimed at cooperation; and
  - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality management policies or procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
- (m) Partner – Any individual with authority to bind the firm with respect to the performance of a professional services engagement.
- (n) Personnel – Partners and staff in the firm. (Ref: Para. A20–A21)
- (o) Professional judgment – The application of relevant training, knowledge and experience, within the context of professional standards, in making informed decisions about the courses of action that are appropriate in the design, implementation and operation of the firm’s system of quality management.
- (p) Professional standards – IAASB Engagement Standards, as defined in the IAASB’s *Preface to the International Quality Management, Auditing, Review, Other Assurance, and Related Services Pronouncements*, and relevant ethical requirements.
- (q) Quality objectives – The desired outcomes in relation to the components of the system of quality management to be achieved by the firm.
- (r) Quality risk – A risk that has a reasonable possibility of:
  - (i) Occurring; and
  - (ii) Individually, or in combination with other risks, adversely affecting the achievement of one or more quality objectives.
- (s) Reasonable assurance – In the context of the ISQMs, a high, but not absolute, level of assurance.
- (t) Relevant ethical requirements – Principles of professional ethics and ethical requirements that are applicable to professional accountants when undertaking engagements that are audits or reviews of financial statements or other assurance or related services engagements. Relevant ethical requirements ordinarily comprise the provisions of the IESBA Code related to audits or reviews of financial statements, or other assurance or related services engagements, together with national requirements that are more restrictive. (Ref: Para. A22–A24, A62)

- (u) Response (in relation to a system of quality management) – Policies or procedures designed and implemented by the firm to address one or more quality risk(s): (Ref: Para. A25–A27, A50)
  - (i) Policies are statements of what should, or should not, be done to address a quality risk(s). Such statements may be documented, explicitly stated in communications or implied through actions and decisions.
  - (ii) Procedures are actions to implement policies.
- (v) Service provider (in the context of this ISQM) – An individual or organization external to the firm that provides a resource that is used in the system of quality management or in the performance of engagements. Service providers exclude the firm’s network, other network firms or other structures or organizations in the network. (Ref: Para. A28, A105)
- (w) Staff – Professionals, other than partners, including any experts the firm employs.
- (x) System of quality management – A system designed, implemented and operated by a firm to provide the firm with reasonable assurance that:
  - (i) The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and
  - (ii) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.

## Requirements

### Applying, and Complying with, Relevant Requirements

17. The firm shall comply with each requirement of this ISQM unless the requirement is not relevant to the firm because of the nature and circumstances of the firm or its engagements. (Ref: Para. A29)
18. The individual(s) assigned ultimate responsibility and accountability for the firm’s system of quality management, and the individual(s) assigned operational responsibility for the firm’s system of quality management shall have an understanding of this ISQM, including the application and other explanatory material, to understand the objective of this ISQM and to apply its requirements properly.

### System of Quality Management

19. The firm shall design, implement and operate a system of quality management. In doing so, the firm shall exercise professional judgment, taking into account the nature and circumstances of the firm and its engagements. The governance and leadership component of the system of quality management establishes

the environment that supports the design, implementation and operation of the system of quality management. (Ref: Para. A30–A31)

### *Responsibilities*

20. The firm shall assign: (Ref: Para. A32–A35)
  - (a) Ultimate responsibility and accountability for the system of quality management to the firm’s chief executive officer or the firm’s managing partner (or equivalent) or, if appropriate, the firm’s managing board of partners (or equivalent);
  - (b) Operational responsibility for the system of quality management;
  - (c) Operational responsibility for specific aspects of the system of quality management, including:
    - (i) Compliance with independence requirements; and (Ref: Para. A36)
    - (ii) The monitoring and remediation process.
21. In assigning the roles in paragraph 20 the firm shall determine that the individual(s): (Ref: Para. A37)
  - (a) Has the appropriate experience, knowledge, influence and authority within the firm, and sufficient time, to fulfill their assigned responsibility; and (Ref: Para. A38)
  - (b) Understands their assigned roles and that they are accountable for fulfilling them.
22. The firm shall determine that the individual(s) assigned operational responsibility for the system of quality management, compliance with independence requirements and the monitoring and remediation process, have a direct line of communication to the individual(s) assigned ultimate responsibility and accountability for the system of quality management.

### **The Firm’s Risk Assessment Process**

23. The firm shall design and implement a risk assessment process to establish quality objectives, identify and assess quality risks and design and implement responses to address the quality risks. (Ref: Para. A39–A41)
24. The firm shall establish the quality objectives specified by this ISQM and any additional quality objectives considered necessary by the firm to achieve the objectives of the system of quality management. (Ref: Para. A42–A44)
25. The firm shall identify and assess quality risks to provide a basis for the design and implementation of responses. In doing so, the firm shall:
  - (a) Obtain an understanding of the conditions, events, circumstances, actions or inactions that may adversely affect the achievement of the quality objectives, including: (Ref: Para. A45–A47)

- (i) With respect to the nature and circumstances of the firm, those relating to:
    - a. The complexity and operating characteristics of the firm;
    - b. The strategic and operational decisions and actions, business processes and business model of the firm;
    - c. The characteristics and management style of leadership;
    - d. The resources of the firm, including the resources provided by service providers;
    - e. Law, regulation, professional standards and the environment in which the firm operates; and
    - f. In the case of a firm that belongs to a network, the nature and extent of the network requirements and network services, if any.
  - (ii) With respect to the nature and circumstances of the engagements performed by the firm, those relating to:
    - a. The types of engagements performed by the firm and the reports to be issued; and
    - b. The types of entities for which such engagements are undertaken.
- (b) Take into account how, and the degree to which, the conditions, events, circumstances, actions or inactions in paragraph 25(a) may adversely affect the achievement of the quality objectives. (Ref: Para. A48)
26. The firm shall design and implement responses to address the quality risks in a manner that is based on, and responsive to, the reasons for the assessments given to the quality risks. The firm's responses shall also include the responses specified in paragraph 34. (Ref: Para. A49–A51)
27. The firm shall establish policies or procedures that are designed to identify information that indicates additional quality objectives, or additional or modified quality risks or responses, are needed due to changes in the nature and circumstances of the firm or its engagements. If such information is identified, the firm shall consider the information and when appropriate: (Ref: Para. A52–A53)
- (a) Establish additional quality objectives or modify additional quality objectives already established by the firm; (Ref: Para. A54)
  - (b) Identify and assess additional quality risks, modify the quality risks or reassess the quality risks; or
  - (c) Design and implement additional responses, or modify the responses.

## Governance and Leadership

28. The firm shall establish the following quality objectives that address the firm's governance and leadership, which establishes the environment that supports the system of quality management:
- (a) The firm demonstrates a commitment to quality through a culture that exists throughout the firm, which recognizes and reinforces: (Ref: Para. A55–A56)
    - (i) The firm's role in serving the public interest by consistently performing quality engagements;
    - (ii) The importance of professional ethics, values and attitudes;
    - (iii) The responsibility of all personnel for quality relating to the performance of engagements or activities within the system of quality management, and their expected behavior; and
    - (iv) The importance of quality in the firm's strategic decisions and actions, including the firm's financial and operational priorities.
  - (b) Leadership is responsible and accountable for quality. (Ref: Para. A57)
  - (c) Leadership demonstrates a commitment to quality through their actions and behaviors. (Ref: Para. A58)
  - (d) The organizational structure and assignment of roles, responsibilities and authority is appropriate to enable the design, implementation and operation of the firm's system of quality management. (Ref: Para. A32, A33, A35, A59)
  - (e) Resource needs, including financial resources, are planned for and resources are obtained, allocated or assigned in a manner that is consistent with the firm's commitment to quality. (Ref: Para. A60–A61)

## Relevant Ethical Requirements

29. The firm shall establish the following quality objectives that address the fulfillment of responsibilities in accordance with relevant ethical requirements, including those related to independence: (Ref: Para. A62–A64, A66)
- (a) The firm and its personnel:
    - (i) Understand the relevant ethical requirements to which the firm and the firm's engagements are subject; and (Ref: Para. A22, A24)
    - (ii) Fulfill their responsibilities in relation to the relevant ethical requirements to which the firm and the firm's engagements are subject.
  - (b) Others, including the network, network firms, individuals in the network or network firms, or service providers, who are subject to the relevant ethical requirements to which the firm and the firm's engagements are subject:

- (i) Understand the relevant ethical requirements that apply to them; and (Ref: Para. A22, A24, A65)
- (ii) Fulfill their responsibilities in relation to the relevant ethical requirements that apply to them.

### **Acceptance and Continuance of Client Relationships and Specific Engagements**

30. The firm shall establish the following quality objectives that address the acceptance and continuance of client relationships and specific engagements:
- (a) Judgments by the firm about whether to accept or continue a client relationship or specific engagement are appropriate based on:
    - (i) Information obtained about the nature and circumstances of the engagement and the integrity and ethical values of the client (including management, and, when appropriate, those charged with governance) that is sufficient to support such judgments; and (Ref: Para. A67–A71)
    - (ii) The firm’s ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements. (Ref: Para. A72)
  - (b) The financial and operational priorities of the firm do not lead to inappropriate judgments about whether to accept or continue a client relationship or specific engagement. (Ref: Para. A73–A74)

### **Engagement Performance**

31. The firm shall establish the following quality objectives that address the performance of quality engagements:
- (a) Engagement teams understand and fulfill their responsibilities in connection with the engagements, including, as applicable, the overall responsibility of engagement partners for managing and achieving quality on the engagement and being sufficiently and appropriately involved throughout the engagement. (Ref: Para. A75)
  - (b) The nature, timing and extent of direction and supervision of engagement teams and review of the work performed is appropriate based on the nature and circumstances of the engagements and the resources assigned or made available to the engagement teams, and the work performed by less experienced engagement team members is directed, supervised and reviewed by more experienced engagement team members. (Ref: Para. A76–A77)
  - (c) Engagement teams exercise appropriate professional judgment and, when applicable to the type of engagement, professional skepticism. (Ref: Para. A78)

- (d) Consultation on difficult or contentious matters is undertaken and the conclusions agreed are implemented. (Ref: Para. A79–A81)
- (e) Differences of opinion within the engagement team, or between the engagement team and the engagement quality reviewer or individuals performing activities within the firm’s system of quality management are brought to the attention of the firm and resolved. (Ref: Para. A82)
- (f) Engagement documentation is assembled on a timely basis after the date of the engagement report, and is appropriately maintained and retained to meet the needs of the firm and comply with law, regulation, relevant ethical requirements, or professional standards. (Ref: Para. A83–A85)

## Resources

32. The firm shall establish the following quality objectives that address appropriately obtaining, developing, using, maintaining, allocating and assigning resources in a timely manner to enable the design, implementation and operation of the system of quality management: (Ref: Para. A86–A87)

### *Human Resources*

- (a) Personnel are hired, developed and retained and have the competence and capabilities to: (Ref: Para. A88–A90)
  - (i) Consistently perform quality engagements, including having knowledge or experience relevant to the engagements the firm performs; or
  - (ii) Perform activities or carry out responsibilities in relation to the operation of the firm’s system of quality management.
- (b) Personnel demonstrate a commitment to quality through their actions and behaviors, develop and maintain the appropriate competence to perform their roles, and are held accountable or recognized through timely evaluations, compensation, promotion and other incentives. (Ref: Para. A91–A93)
- (c) Individuals are obtained from external sources (i.e., the network, another network firm or a service provider) when the firm does not have sufficient or appropriate personnel to enable the operation of firm’s system of quality management or performance of engagements. (Ref: Para. A94)
- (d) Engagement team members are assigned to each engagement, including an engagement partner, who have appropriate competence and capabilities, including being given sufficient time, to consistently perform quality engagements. (Ref: Para. A88–A89, A95–A97)

- (e) Individuals are assigned to perform activities within the system of quality management who have appropriate competence and capabilities, including sufficient time, to perform such activities.

*Technological Resources*

- (f) Appropriate technological resources are obtained or developed, implemented, maintained, and used, to enable the operation of the firm's system of quality management and the performance of engagements. (Ref: Para. A98–A101, A104)

*Intellectual Resources*

- (g) Appropriate intellectual resources are obtained or developed, implemented, maintained, and used, to enable the operation of the firm's system of quality management and the consistent performance of quality engagements, and such intellectual resources are consistent with professional standards and applicable legal and regulatory requirements, where applicable. (Ref: Para. A102–A104)

*Service Providers*

- (h) Human, technological or intellectual resources from service providers are appropriate for use in the firm's system of quality management and in the performance of engagements, taking into account the quality objectives in paragraph 32 (d),(e),(f) and (g). (Ref: Para. A105–A108)

**Information and Communication**

33. The firm shall establish the following quality objectives that address obtaining, generating or using information regarding the system of quality management, and communicating information within the firm and to external parties on a timely basis to enable the design, implementation and operation of the system of quality management: (Ref: Para. A109)

- (a) The information system identifies, captures, processes and maintains relevant and reliable information that supports the system of quality management, whether from internal or external sources. (Ref: Para. A110–A111)
- (b) The culture of the firm recognizes and reinforces the responsibility of personnel to exchange information with the firm and with one another. (Ref: Para. A112)
- (c) Relevant and reliable information is exchanged throughout the firm and with engagement teams, including: (Ref: Para. A112)
  - (i) Information is communicated to personnel and engagement teams, and the nature, timing and extent of the information is sufficient

- to enable them to understand and carry out their responsibilities relating to performing activities within the system of quality management or engagements; and
  - (ii) Personnel and engagement teams communicate information to the firm when performing activities within the system of quality management or engagements.
- (d) Relevant and reliable information is communicated to external parties, including:
- (i) Information is communicated by the firm to or within the firm's network or to service providers, if any, enabling the network or service providers to fulfill their responsibilities relating to the network requirements or network services or resources provided by them; and (Ref: Para. A113)
  - (ii) Information is communicated externally when required by law, regulation or professional standards, or to support external parties' understanding of the system of quality management. (Ref: Para. A114–A115)

### Specified Responses

34. In designing and implementing responses in accordance with paragraph 26, the firm shall include the following responses: (Ref: Para. A116)
- (a) The firm establishes policies or procedures for:
    - (i) Identifying, evaluating and addressing threats to compliance with the relevant ethical requirements; and (Ref: Para. A117)
    - (ii) Identifying, communicating, evaluating and reporting of any breaches of the relevant ethical requirements and appropriately responding to the causes and consequences of the breaches in a timely manner. (Ref: Para. A118–A119)
  - (b) The firm obtains, at least annually, a documented confirmation of compliance with independence requirements from all personnel required by relevant ethical requirements to be independent.
  - (c) The firm establishes policies or procedures for receiving, investigating and resolving complaints and allegations about failures to perform work in accordance with professional standards and applicable legal and regulatory requirements, or non-compliance with the firm's policies or procedures established in accordance with this ISQM. (Ref: Para. A120–A121)
  - (d) The firm establishes policies or procedures that address circumstances when:
    - (i) The firm becomes aware of information subsequent to accepting or continuing a client relationship or specific engagement that

would have caused it to decline the client relationship or specific engagement had that information been known prior to accepting or continuing the client relationship or specific engagement; or (Ref: Para. A122–A123)

- (ii) The firm is obligated by law or regulation to accept a client relationship or specific engagement. (Ref: Para. A123)
- (e) The firm establishes policies or procedures that: (Ref: Para. A124–A126)
  - (i) Require communication with those charged with governance when performing an audit of financial statements of listed entities about how the system of quality management supports the consistent performance of quality audit engagements; (Ref: Para. A127–A129)
  - (ii) Address when it is otherwise appropriate to communicate with external parties about the firm’s system of quality management; and (Ref: Para. A130)
  - (iii) Address the information to be provided when communicating externally in accordance with paragraphs 34(e)(i) and 34(e)(ii), including the nature, timing and extent and appropriate form of communication. (Ref: Para. A131–A132)
- (f) The firm establishes policies or procedures that address engagement quality reviews in accordance with ISQM 2, and require an engagement quality review for:
  - (i) Audits of financial statements of listed entities;
  - (ii) Audits or other engagements for which an engagement quality review is required by law or regulation; and (Ref: Para. A133)
  - (iii) Audits or other engagements for which the firm determines that an engagement quality review is an appropriate response to address one or more quality risk(s). (Ref: Para. A134–A137)

### **Monitoring and Remediation Process**

- 35. The firm shall establish a monitoring and remediation process to: (Ref: Para. A138)
  - (a) Provide relevant, reliable and timely information about the design, implementation and operation of the system of quality management.
  - (b) Take appropriate actions to respond to identified deficiencies such that deficiencies are remediated on a timely basis.

### *Designing and Performing Monitoring Activities*

- 36. The firm shall design and perform monitoring activities to provide a basis for the identification of deficiencies.

37. In determining the nature, timing and extent of the monitoring activities, the firm shall take into account: (Ref: Para. A139–A142)
- (a) The reasons for the assessments given to the quality risks;
  - (b) The design of the responses;
  - (c) The design of the firm’s risk assessment process and monitoring and remediation process; (Ref: Para. A143–A144)
  - (d) Changes in the system of quality management; (Ref: Para. A145)
  - (e) The results of previous monitoring activities, whether previous monitoring activities continue to be relevant in evaluating the firm’s system of quality management and whether remedial actions to address previously identified deficiencies were effective; and (Ref: Para. A146–A147)
  - (f) Other relevant information, including complaints and allegations about failures to perform work in accordance with professional standards and applicable legal and regulatory requirements or non-compliance with the firm’s policies or procedures established in accordance with this ISQM, information from external inspections and information from service providers. (Ref: Para. A148–A150)
38. The firm shall include the inspection of completed engagements in its monitoring activities and shall determine which engagements and engagement partners to select. In doing so, the firm shall: (Ref: Para. A141, A151–A154)
- (a) Take into account the matters in paragraph 37;
  - (b) Consider the nature, timing and extent of other monitoring activities undertaken by the firm and the engagements and engagement partners subject to such monitoring activities; and
  - (c) Select at least one completed engagement for each engagement partner on a cyclical basis determined by the firm.
39. The firm shall establish policies or procedures that:
- (a) Require the individuals performing the monitoring activities to have the competence and capabilities, including sufficient time, to perform the monitoring activities effectively; and
  - (b) Address the objectivity of the individuals performing the monitoring activities. Such policies or procedures shall prohibit the engagement team members or the engagement quality reviewer of an engagement from performing any inspection of that engagement. (Ref: Para. A155–A156)

*Evaluating Findings and Identifying Deficiencies*

40. The firm shall evaluate findings to determine whether deficiencies exist, including in the monitoring and remediation process. (Ref: Para. A157–A162)

*Evaluating Identified Deficiencies*

41. The firm shall evaluate the severity and pervasiveness of identified deficiencies by: (Ref: Para. A161, A163–A164)
  - (a) Investigating the root cause(s) of the identified deficiencies. In determining the nature, timing and extent of the procedures to investigate the root cause(s), the firm shall take into account the nature of the identified deficiencies and their possible severity. (Ref: Para. A165–A169)
  - (b) Evaluating the effect of the identified deficiencies, individually and in aggregate, on the system of quality management.

*Responding to Identified Deficiencies*

42. The firm shall design and implement remedial actions to address identified deficiencies that are responsive to the results of the root cause analysis. (Ref: Para. A170–A172)
43. The individual(s) assigned operational responsibility for the monitoring and remediation process shall evaluate whether the remedial actions:
  - (a) Are appropriately designed to address the identified deficiencies and their related root cause(s) and determine that they have been implemented; and
  - (b) Implemented to address previously identified deficiencies are effective.
44. If the evaluation indicates that the remedial actions are not appropriately designed and implemented or are not effective, the individual(s) assigned operational responsibility for the monitoring and remediation process shall take appropriate action to determine that the remedial actions are appropriately modified such that they are effective.

*Findings About a Particular Engagement*

45. The firm shall respond to circumstances when findings indicate that there is an engagement(s) for which procedures required were omitted during the performance of the engagement(s) or the report issued may be inappropriate. The firm's response shall include: (Ref: Para. A173)
  - (a) Taking appropriate action to comply with relevant professional standards and applicable legal and regulatory requirements; and
  - (b) When the report is considered to be inappropriate, considering the implications and taking appropriate action, including considering whether to obtain legal advice.

*Ongoing Communication Related to Monitoring and Remediation*

46. The individual(s) assigned operational responsibility for the monitoring and remediation process shall communicate on a timely basis to the individual(s)

assigned ultimate responsibility and accountability for the system of quality management and the individual(s) assigned operational responsibility for the system of quality management: (Ref: Para. A174)

- (a) A description of the monitoring activities performed;
  - (b) The identified deficiencies, including the severity and pervasiveness of such deficiencies; and
  - (c) The remedial actions to address the identified deficiencies.
47. The firm shall communicate the matters described in paragraph 46 to engagement teams and other individuals assigned activities within the system of quality management to enable them to take prompt and appropriate action in accordance with their responsibilities.

### **Network Requirements or Network Services**

48. When the firm belongs to a network, the firm shall understand, when applicable: (Ref: Para. A19, A175)
- (a) The requirements established by the network regarding the firm's system of quality management, including requirements for the firm to implement or use resources or services designed or otherwise provided by or through the network (i.e., network requirements);
  - (b) Any services or resources provided by the network that the firm chooses to implement or use in the design, implementation or operation of the firm's system of quality management (i.e., network services); and
  - (c) The firm's responsibilities for any actions that are necessary to implement the network requirements or use network services. (Ref: Para. A176)

The firm remains responsible for its system of quality management, including professional judgments made in the design, implementation and operation of the system of quality management. The firm shall not allow compliance with the network requirements or use of network services to contravene the requirements of this ISQM. (Ref: Para. A177)

49. Based on the understanding obtained in paragraph 48, the firm shall:
- (a) Determine how the network requirements or network services are relevant to, and are taken into account in, the firm's system of quality management, including how they are to be implemented; and (Ref: Para. A178)
  - (b) Evaluate whether and, if so, how the network requirements or network services need to be adapted or supplemented by the firm to be appropriate for use in its system of quality management. (Ref: Para. A179–A180)

*Monitoring Activities Undertaken by the Network on the Firm's System of Quality Management*

50. In circumstances when the network performs monitoring activities relating to the firm's system of quality management, the firm shall:
- (a) Determine the effect of the monitoring activities performed by the network on the nature, timing and extent of the firm's monitoring activities performed in accordance with paragraphs 36–38;
  - (b) Determine the firm's responsibilities in relation to the monitoring activities, including any related actions by the firm; and
  - (c) As part of evaluating findings and identifying deficiencies in paragraph 40, obtain the results of the monitoring activities from the network in a timely manner. (Ref: Para. A181)

*Monitoring Activities Undertaken by the Network Across the Network Firms*

51. The firm shall:
- (a) Understand the overall scope of the monitoring activities undertaken by the network across the network firms, including monitoring activities to determine that network requirements have been appropriately implemented across the network firms, and how the network will communicate the results of its monitoring activities to the firm;
  - (b) At least annually, obtain information from the network about the overall results of the network's monitoring activities across the network firms, if applicable, and: (Ref: Para. A182–A184)
    - (i) Communicate the information to engagement teams and other individuals assigned activities within the system of quality management, as appropriate, to enable them to take prompt and appropriate action in accordance with their responsibilities; and
    - (ii) Consider the effect of the information on the firm's system of quality management.

*Deficiencies in Network Requirements or Network Services Identified by the Firm*

52. If the firm identifies a deficiency in the network requirements or network services, the firm shall: (Ref: Para. A185)
- (a) Communicate to the network relevant information about the identified deficiency; and
  - (b) In accordance with paragraph 42, design and implement remedial actions to address the effect of the identified deficiency in the network requirements or network services. (Ref: Para. A186)

## Evaluating the System of Quality Management

53. The individual(s) assigned ultimate responsibility and accountability for the system of quality management shall evaluate, on behalf of the firm, the system of quality management. The evaluation shall be undertaken as of a point in time, and performed at least annually. (Ref: Para. A187–A189)
54. Based on the evaluation, the individual(s) assigned ultimate responsibility and accountability for the system of quality management shall conclude, on behalf of the firm, one of the following: (Ref: Para. A190, A195)
- (a) The system of quality management provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved; (Ref: Para. A191)
  - (b) Except for matters related to identified deficiencies that have a severe but not pervasive effect on the design, implementation and operation of the system of quality management, the system of quality management provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved; or (Ref: Para. A192)
  - (c) The system of quality management does not provide the firm with reasonable assurance that the objectives of the system of quality management are being achieved. (Ref: Para. A192–A194)
55. If the individual(s) assigned ultimate responsibility and accountability for the system of quality management reaches the conclusion described in paragraph 54(b) or 54(c), the firm shall: (Ref: Para. A196)
- (a) Take prompt and appropriate action; and
  - (b) Communicate to:
    - (i) Engagement teams and other individuals assigned activities within the system of quality management to the extent that it is relevant to their responsibilities; and (Ref: Para. A197)
    - (ii) External parties in accordance with the firm’s policies or procedures required by paragraph 34(e). (Ref: Para. A198)
56. The firm shall undertake periodic performance evaluations of the individual(s) assigned ultimate responsibility and accountability for the system of quality management, and the individual(s) assigned operational responsibility for the system of quality management. In doing so, the firm shall take into account the evaluation of the system of quality management. (Ref: Para. A199–A201)

## Documentation

57. The firm shall prepare documentation of its system of quality management that is sufficient to: (Ref: Para. A202–A204)

- (a) Support a consistent understanding of the system of quality management by personnel, including an understanding of their roles and responsibilities with respect to the system of quality management and the performance of engagements;
  - (b) Support the consistent implementation and operation of the responses; and
  - (c) Provide evidence of the design, implementation and operation of the responses, to support the evaluation of the system of quality management by the individual(s) assigned ultimate responsibility and accountability for the system of quality management.
58. In preparing documentation, the firm shall include:
- (a) The identification of the individual(s) assigned ultimate responsibility and accountability for the system of quality management and operational responsibility for the system of quality management;
  - (b) The firm's quality objectives and quality risks; (Ref: Para. A205)
  - (c) A description of the responses and how the firm's responses address the quality risks;
  - (d) Regarding the monitoring and remediation process:
    - (i) Evidence of the monitoring activities performed;
    - (ii) The evaluation of findings, and identified deficiencies and their related root cause(s);
    - (iii) Remedial actions to address identified deficiencies and the evaluation of the design and implementation of such remedial actions; and
    - (iv) Communications about monitoring and remediation; and
  - (e) The basis for the conclusion reached pursuant to paragraph 54.
59. The firm shall document the matters in paragraph 58 as they relate to network requirements or network services and the evaluation of the network requirements or network services in accordance with paragraph 49(b). (Ref: Para. A206)
60. The firm shall establish a period of time for the retention of documentation for the system of quality management that is sufficient to enable the firm to monitor the design, implementation and operation of the firm's system of quality management, or for a longer period if required by law or regulation.

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## Application and Other Explanatory Material

### Scope of this ISQM (Ref: Para. 3–4)

- A1. Other pronouncements of the IAASB, including ISRE 2400 (Revised)<sup>5</sup> and ISAE 3000 (Revised),<sup>6</sup> also establish requirements for the engagement partner for the management of quality at the engagement level.
- A2. The IESBA Code<sup>7</sup> contains requirements and application material for professional accountants that enable professional accountants to meet their responsibility to act in the public interest. As indicated in paragraph 15, in the context of engagement performance as described in this ISQM, the consistent performance of quality engagements forms part of the professional accountant’s responsibility to act in the public interest.

### The Firm’s System of Quality Management (Ref: Para. 6–9)

- A3. The firm may use different terminology or frameworks to describe the components of its system of quality management.
- A4. Examples of the interconnected nature of the components include the following:
  - The firm’s risk assessment process sets out the process the firm is required to follow in implementing a risk-based approach across the system of quality management.
  - The governance and leadership component establishes the environment that supports the system of quality management.
  - The resources and information and communication components enable the design, implementation and operation of the system of quality management.
  - The monitoring and remediation process is a process designed to monitor the entire system of quality management. The results of the monitoring and remediation process provide information that is relevant to the firm’s risk assessment process.
  - There may be relationships between specific matters, for example, certain aspects of relevant ethical requirements are relevant to accepting and continuing client relationships and specific engagements.

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<sup>5</sup> International Standard on Review Engagements (ISRE) 2400 (Revised), *Engagements to Review Historical Financial Statements*

<sup>6</sup> International Standard on Assurance Engagements (ISAE) 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*

<sup>7</sup> The International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code)

- A5. Reasonable assurance is obtained when the system of quality management reduces to an acceptably low level the risk that the objectives stated in paragraph 14(a) and (b) are not achieved. Reasonable assurance is not an absolute level of assurance, because there are inherent limitations of a system of quality management. Such limitations include that human judgment in decision making can be faulty and that breakdowns in a firm's system of quality management may occur, for example, due to human error or behavior or failures in information technology (IT) applications.

**Authority of this ISQM (Ref: Para. 12)**

- A6. The objective of this ISQM provides the context in which the requirements of this ISQM are set, establishes the desired outcome of this ISQM and is intended to assist the firm in understanding what needs to be accomplished and, where necessary, the appropriate means of doing so.
- A7. The requirements of this ISQM are expressed using "shall."
- A8. Where necessary, the application and other explanatory material provides further explanation of the requirements and guidance for carrying them out. In particular, it may:
- Explain more precisely what a requirement means or is intended to cover; and
  - Include examples that illustrate how the requirements might be applied.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements. The application and other explanatory material may also provide background information on matters addressed in this ISQM. Where appropriate, additional considerations specific to public sector audit organizations are included within the application and other explanatory material. These additional considerations assist in the application of the requirements in this ISQM. They do not, however, limit or reduce the responsibility of the firm to apply and comply with the requirements in this ISQM.

- A9. This ISQM includes, under the heading "Definitions," a description of the meanings attributed to certain terms for purposes of this ISQM. These definitions are provided to assist in the consistent application and interpretation of this ISQM, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. The Glossary of Terms relating to International Standards issued by the IAASB in the *Handbook of International Quality Management, Auditing, Review, Other Assurance, and Related Services Pronouncements* published by IFAC includes the terms defined in this ISQM. The Glossary of Terms also includes descriptions of other terms found in the ISQMs to assist in common and consistent interpretation and translation.

## Definitions

### *Deficiency* (Ref: Para. 16(a))

- A10. The firm identifies deficiencies through evaluating findings. A deficiency may arise from a finding, or a combination of findings.
- A11. When a deficiency is identified as a result of a quality risk, or combination of quality risks, not being identified or properly assessed, the response(s) to address such quality risk(s) may also be absent, or not appropriately designed or implemented.
- A12. The other aspects of the system of quality management consist of the requirements in this ISQM addressing:
- Assigning responsibilities (paragraphs 20–22);
  - The firm’s risk assessment process;
  - The monitoring and remediation process; and
  - The evaluation of the system of quality management.

### *Examples of deficiencies related to other aspects of the system of quality management*

- The firm’s risk assessment process fails to identify information that indicates changes in the nature and circumstances of the firm and its engagements and the need to establish additional quality objectives, or modify the quality risks or responses.
- The firm’s monitoring and remediation process is not designed or implemented in a manner that:
  - Provides relevant, reliable and timely information about the design, implementation and operation of the system of quality management.
  - Enables the firm to take appropriate actions to respond to identified deficiencies such that deficiencies are remediated on a timely basis.
- The individual(s) assigned ultimate responsibility and accountability for the system of quality management does not undertake the annual evaluation of the system of quality management.

### *Engagement Team* (Ref: Para. 16(f))

- A13. ISA 220 (Revised)<sup>8</sup> provides guidance in applying the definition of engagement team in the context of an audit of financial statements.

<sup>8</sup> ISA 220 (Revised), paragraphs A15–A25

*External Inspections* (Ref: Para. 16(g))

A14. In some circumstances, an external oversight authority may undertake other types of inspections, for example, thematic reviews that focus on, for a selection of firms, particular aspects of audit engagements or firm-wide practices.

*Findings* (Ref: Para. 16(h))

A15. As part of accumulating findings from monitoring activities, external inspections and other relevant sources, the firm may identify other observations about the firm's system of quality management, such as positive outcomes or opportunities for the firm to improve, or further enhance, the system of quality management. Paragraph A158 explains how other observations may be used by the firm in the system of quality management.

A16. Paragraph A148 provides examples of information from other relevant sources.

A17. Monitoring activities include monitoring at the engagement level, such as inspection of engagements. Furthermore, external inspections and other relevant sources may include information that relates to specific engagements. As a result, information about the design, implementation and operation of the system of quality management includes engagement-level findings that may be indicative of findings in relation to the system of quality management.

*Firm* (Ref: Para. 16(i))

A18. The definition of "firm" in relevant ethical requirements may differ from the definition set out in this ISQM.

*Network* (Ref: Para. 16(l), 48)

A19. Networks and the firms within the network may be structured in a variety of ways. For example, in the context of a firm's system of quality management:

- The network may establish requirements for the firm related to its system of quality management, or provide services that are used by the firm in its system of quality management or in the performance of engagements;
- Other firms within the network may provide services (e.g., resources) that are used by the firm in its system of quality management or in the performance of engagements; or
- Other structures or organizations within the network may establish requirements for the firm related to its system of quality management, or provide services.

For the purposes of this ISQM, any network requirements or network services that are obtained from the network, another firm within the network or another structure or organization in the network are considered "network requirements or network services."

*Personnel* (Ref: Para. 16(n))

- A20. In addition to personnel (i.e., individuals in the firm), the firm may use individuals external to the firm in performing activities in the system of quality management or in the performance of engagements. For example, individuals external to the firm may include individuals from other network firms (e.g., individuals in a service delivery center of a network firm) or individuals employed by a service provider (e.g., a component auditor from another firm not within the firm’s network).
- A21. Personnel also includes partners and staff in other structures of the firm, such as a service delivery center in the firm.

*Relevant Ethical Requirements* (Ref: Para. 16(t), 29)

- A22. The relevant ethical requirements that are applicable in the context of a system of quality management may vary, depending on the nature and circumstances of the firm and its engagements. The term “professional accountant” may be defined in relevant ethical requirements. For example, the IESBA Code defines the term “professional accountant” and further explains the scope of provisions in the IESBA Code that apply to individual professional accountants in public practice and their firms.
- A23. The IESBA Code addresses circumstances when law or regulation precludes the professional accountant from complying with certain parts of the IESBA Code. It further acknowledges that some jurisdictions might have provisions in law or regulation that differ from or go beyond those set out in the IESBA Code and that professional accountants in those jurisdictions need to be aware of those differences and comply with the more stringent provisions, unless prohibited by law or regulation.
- A24. Various provisions of the relevant ethical requirements may apply only to individuals in the context of the performance of engagements and not the firm itself. For example:
- Part 2 of the IESBA Code applies to individuals who are professional accountants in public practice when they are performing professional activities pursuant to their relationship with the firm, whether as a contractor, employee or owner, and may be relevant in the context of the performance of engagements.
  - Certain requirements in Parts 3 and 4 of the IESBA Code also apply to individuals who are professional accountants in public practice when they are performing professional activities for clients.

Compliance with such relevant ethical requirements by individuals may need to be addressed by the firm’s system of quality management.

*Example of relevant ethical requirements that are applicable only to individuals and not the firm, and which relate to the performance of engagements*

Part 2 of the IESBA Code addresses pressure to breach the fundamental principles, and includes requirements that an individual shall not:

- Allow pressure from others to result in a breach of compliance with the fundamental principles; or
- Place pressure on others that the accountant knows, or has reason to believe, would result in the other individuals breaching the fundamental principles.

For example, circumstances may arise when, in performing an engagement, an individual considers that the engagement partner or another senior member of the engagement team has pressured them to breach the fundamental principles.

*Response* (Ref: Para. 16(u))

- A25. Policies are implemented through the actions of personnel and other individuals whose actions are subject to the policies (including engagement teams), or through their restraint from taking actions that would conflict with the firm's policies.
- A26. Procedures may be mandated, through formal documentation or other communications, or may result from behaviors that are not mandated but are rather conditioned by the firm's culture. Procedures may be enforced through the actions permitted by IT applications, or other aspects of the firm's IT environment.
- A27. If the firm uses individuals external to the firm in the system of quality management or in the performance of engagements, different policies or procedures may need to be designed by the firm to address the actions of the individuals. ISA 220 (Revised)<sup>9</sup> provides guidance when different policies or procedures may need to be designed by the firm to address the actions of individuals external to the firm in the context of an audit of financial statements.

*Service Provider* (Ref: Para. 16(v))

- A28. Service providers include component auditors from other firms not within the firm's network.

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<sup>9</sup> ISA 220 (Revised), paragraphs A23–A25

**Applying, and Complying with, Relevant Requirements (Ref: Para. 17)**

A29. *Examples of when a requirement of this ISQM may not be relevant to the firm*

- The firm is a sole practitioner. For example, the requirements addressing the organizational structure and assigning roles, responsibilities and authority within the firm, direction, supervision and review and addressing differences of opinion may not be relevant.
- The firm only performs engagements that are related services engagements. For example, if the firm is not required to maintain independence for related services engagements, the requirement to obtain a documented confirmation of compliance with independence requirements from all personnel would not be relevant.

**System of Quality Management**

*Design, Implement and Operate a System of Quality Management (Ref: Para. 19)*

- A30. Quality management is not a separate function of the firm; it is the integration of a culture that demonstrates a commitment to quality with the firm's strategy, operational activities and business processes. As a result, designing the system of quality management and the firm's operational activities and business processes in an integrated manner may promote a harmonious approach to managing the firm, and enhance the effectiveness of quality management.
- A31. The quality of professional judgments exercised by the firm is likely to be enhanced when individuals making such judgments demonstrate an attitude that includes an inquiring mind, which involves:
- Considering the source, relevance and sufficiency of information obtained about the system of quality management, including information related to the nature and circumstances of the firm and its engagements; and
  - Being open and alert to a need for further investigation or other action.

*Responsibilities (Ref: Para. 20–21, 28(d))*

- A32. The governance and leadership component includes a quality objective that the firm has an organizational structure and assignment of roles, responsibilities and authority that is appropriate to enable the design, implementation and operation of the firm's system of quality management.
- A33. Notwithstanding the assignment of responsibilities related to the system of quality management in accordance with paragraph 20, the firm remains ultimately responsible for the system of quality management and holding individuals responsible and accountable for their assigned roles. For example, in

accordance with paragraphs 53 and 54, although the firm assigns the evaluation of the system of quality management and conclusion thereon to the individual(s) assigned ultimate responsibility and accountability for the system of quality management, the firm is responsible for the evaluation and conclusion.

- A34. An individual(s) assigned responsibility for the matters in paragraph 20 is typically a partner of the firm so that they have appropriate influence and authority within the firm, as required by paragraph 21. However, based on the legal structure of the firm, there may be circumstances when an individual(s) may not be a partner of the firm but the individual(s) has the appropriate influence and authority within the firm to perform their assigned role because of formal arrangements made by the firm or the firm's network.
- A35. How the firm assigns roles, responsibilities and authority within the firm may vary and law or regulation may impose certain requirements for the firm that affect the leadership and management structure or their assigned responsibilities. An individual(s) assigned responsibility for a matter(s) in paragraph 20 may further assign roles, procedures, tasks or actions to other individuals to assist them in fulfilling their responsibilities. However, an individual(s) assigned responsibility for a matter(s) in paragraph 20 remains responsible and accountable for the responsibilities assigned to them.

*Scalability example to demonstrate how assigning roles and responsibilities may be undertaken*

- In a less complex firm, ultimate responsibility and accountability for the system of quality management may be assigned to a single managing partner with sole responsibility for the oversight of the firm. This individual may also assume responsibility for all aspects of the system of quality management, including operational responsibility for the system of quality management, compliance with independence requirements and the monitoring and remediation process.
- In a more complex firm, there may be multiple levels of leadership that reflect the organizational structure of the firm, and the firm may have an independent governing body that has non-executive oversight of the firm, which may comprise external individuals. Furthermore, the firm may assign operational responsibility for specific aspects of the system of quality management beyond those specified in paragraph 20(c), such as operational responsibility for compliance with ethical requirements or operational responsibility for managing a service line.

- A36. Compliance with independence requirements is essential to the performance of audits, or reviews of financial statements, or other assurance engagements, and is an expectation of stakeholders relying on the firm's reports. The

individual(s) assigned operational responsibility for compliance with independence requirements is ordinarily responsible for the oversight of all matters related to independence so that a robust and consistent approach is designed and implemented by the firm to deal with independence requirements.

- A37. Law, regulation or professional standards may establish additional requirements for an individual assigned responsibility for a matter(s) in paragraph 20, such as requirements for professional licensing, professional education or continuing professional development.
- A38. The appropriate experience and knowledge for the individual(s) assigned operational responsibility for the system of quality management ordinarily includes an understanding of the firm's strategic decisions and actions and experience with the firm's business operations.

**The Firm's Risk Assessment Process** (Ref: Para. 23)

- A39. How the firm designs the firm's risk assessment process may be affected by the nature and circumstances of the firm, including how the firm is structured and organized.

*Scalability examples to demonstrate how the firm's risk assessment process may differ*

- In a less complex firm, the individual(s) assigned operational responsibility for the system of quality management may have a sufficient understanding of the firm and its engagements to undertake the risk assessment process. Furthermore, the documentation of the quality objectives, quality risks and responses may be less extensive than for a more complex firm (e.g., it may be documented in a single document).
- In a more complex firm, there may be a formal risk assessment process, involving multiple individuals and numerous activities. The process may be centralized (e.g., the quality objectives, quality risks and responses are established centrally for all business units, functions and service lines) or decentralized (e.g., the quality objectives, quality risks and responses are established at a business unit, function or service line level, with the outputs combined at the firm level). The firm's network may also provide the firm with quality objectives, quality risks and responses to be included in the firm's system of quality management.

- A40. The process of establishing quality objectives, identifying and assessing quality risks and designing and implementing responses is iterative, and the requirements of this ISQM are not intended to be addressed in a linear manner. For example:

- In identifying and assessing quality risks, the firm may determine that an additional quality objective(s) needs to be established.
- When designing and implementing responses, the firm may determine that a quality risk was not identified and assessed.

A41. Information sources that enable the firm to establish quality objectives, identify and assess quality risks and design and implement responses form part of the firm's information and communication component and include:

- The results of the firm's monitoring and remediation process (see paragraphs 42 and A171).
- Information from the network or service providers, including:
  - Information about network requirements or network services (see paragraph 48); and
  - Other information from the network, including information about the results of monitoring activities undertaken by the network across the network firms (see paragraphs 50–51).

Other information, both internal or external, may also be relevant to the firm's risk assessment process, such as:

- Information regarding complaints and allegations about failures to perform work in accordance with professional standards and applicable legal and regulatory requirements, or non-compliance with the firm's policies or procedures established in accordance with this ISQM.
- The results of external inspections.
- Information from regulators about the entities for whom the firm performs engagements which is made available to the firm, such as information from a securities regulator about an entity for whom the firm performs engagements (e.g., irregularities in the entity's financial statements or non-compliance with securities regulation).
- Changes in the system of quality management that affect other aspects of the system, for example, changes in the firm's resources.
- Other external sources, such as regulatory actions and litigation against the firm or other firms in the jurisdiction that may highlight areas for the firm to consider.

*Establish Quality Objectives* (Ref: Para. 24)

A42. Law, regulation or professional standards may establish requirements that give rise to additional quality objectives. For example, a firm may be required by law or regulation to appoint non-executive individuals to the firm's governance structure and the firm considers it necessary to establish additional quality objectives to address the requirements.

- A43. The nature and circumstances of the firm and its engagements may be such that the firm may not find it necessary to establish additional quality objectives.
- A44. The firm may establish sub-objectives to enhance the firm’s identification and assessment of quality risks, and design and implementation of responses.

*Identify and Assess Quality Risks (Ref: Para. 25)*

- A45. There may be other conditions, events, circumstances, actions or inactions not described in paragraph 25(a) that may adversely affect the achievement of a quality objective.
- A46. A risk arises from how, and the degree to which, a condition, event, circumstance, action or inaction may adversely affect the achievement of a quality objective. Not all risks meet the definition of a quality risk. Professional judgment assists the firm in determining whether a risk is a quality risk, which is based on the firm’s consideration of whether there is a reasonable possibility of the risk occurring, and individually, or in combination with other risks, adversely affecting the achievement of one or more quality objectives.

<i>Examples of the firm’s understanding of the conditions, events, circumstances, actions or inactions that may adversely affect the achievement of the quality objectives</i>	<i>Examples of quality risks that may arise</i>
<ul style="list-style-type: none"> <li>● The strategic and operational decisions and actions, business processes and business model of the firm: The firm’s overall financial goals are overly dependent on the extent of services provided by the firm not within the scope of this ISQM.</li> </ul>	<p>In the context of governance and leadership, this may give rise to a number of quality risks such as:</p> <ul style="list-style-type: none"> <li>● Resources are allocated or assigned in a manner that prioritizes the services not within the scope of this ISQM and may negatively affect the quality of engagements within the scope of this ISQM.</li> <li>● Decisions about financial and operational priorities do not fully or adequately consider the importance of quality in the performance of engagements within the scope of this ISQM.</li> </ul>

<ul style="list-style-type: none"> <li>The characteristics and management style of leadership: The firm is a smaller firm with a few engagement partners with shared authority.</li> </ul>	<p>In the context of governance and leadership, this may give rise to a number of quality risks such as:</p> <ul style="list-style-type: none"> <li>Leadership’s responsibilities and accountability for quality are not clearly defined and assigned.</li> <li>The actions and behaviors of leadership that do not promote quality are not questioned.</li> </ul>
<ul style="list-style-type: none"> <li>The complexity and operating characteristics of the firm: The firm has recently completed a merger with another firm.</li> </ul>	<p>In the context of resources, this may give rise to a number of quality risks including:</p> <ul style="list-style-type: none"> <li>Technological resources used by the two merged firms may be incompatible.</li> <li>Engagement teams may use intellectual resources developed by a firm prior to the merger, which are no longer consistent with the new methodology being used by the new merged firm.</li> </ul>

A47. Given the evolving nature of the system of quality management, the responses designed and implemented by the firm may give rise to conditions, events, circumstances, actions or inactions that result in further quality risks. For example, the firm may implement a resource (e.g., a technological resource) to address a quality risk, and quality risks may arise from the use of such resource.

A48. The degree to which a risk, individually, or in combination with other risks may adversely affect the achievement of a quality objective(s) may vary based on the conditions, events, circumstances, actions or inactions giving rise to the risk, taking into account, for example:

- How the condition, event, circumstance, action or inaction would affect the achievement of the quality objective.
- How frequently the condition, event, circumstance, action or inaction is expected to occur.
- How long it would take after the condition, event, circumstance, action or inaction occurred for it to have an effect, and whether in that time the firm would have an opportunity to respond to mitigate the effect of the condition, event, circumstance, action or inaction.

- How long the condition, event, circumstance, action or inaction would affect the achievement of the quality objective once it has occurred.

The assessment of quality risks need not comprise formal ratings or scores, although firms are not precluded from using them.

*Design and Implement Responses to Address the Quality Risks* (Ref: Para. 16(u), 26)

- A49. The nature, timing and extent of the responses are based on the reasons for the assessment given to the quality risks, which is the considered occurrence and effect on the achievement of one or more quality objectives.
- A50. The responses designed and implemented by the firm may operate at the firm level or engagement level, or there may be a combination of responsibilities for actions to be taken at the firm and engagement level.

*Example of a response designed and implemented by the firm that operates at both the firm and engagement level*

The firm establishes policies or procedures for consultation which include with whom consultation should be undertaken by engagement teams and the specific matters for which consultation is required. The firm appoints suitably qualified and experienced individuals to provide the consultations. The engagement team is responsible for identifying when matters for consultation occur and initiating consultation, and implementing the conclusions from consultation.<sup>10</sup>

- A51. The need for formally documented policies or procedures may be greater for firms that have many personnel or that are geographically dispersed, in order to achieve consistency across the firm.

*Changes in the Nature and Circumstances of the Firm or its Engagements* (Ref: Para. 27)

A52. *Scalability example to demonstrate how policies or procedures for identifying information about changes in the nature and circumstances of the firm and its engagements may vary*

- In a less complex firm, the firm may have informal policies or procedures to identify information about changes in the nature and circumstances of the firm or its engagements, particularly when the individual(s) responsible for establishing quality objectives, identifying and assessing quality risks and designing and implementing responses is able to identify such information in the normal course of their activities.

<sup>10</sup> ISA 220 (Revised), paragraphs 35

- In a more complex firm, the firm may need to establish more formal policies or procedures to identify and consider information about changes in the nature and circumstances of the firm or its engagements. This may include, for example, a periodic review of information relating to the nature and circumstances of the firm and its engagements, including ongoing tracking of trends and occurrences in the firm's internal and external environment.

A53. Additional quality objectives may need to be established, or quality risks and responses added to or modified, as part of the remedial actions undertaken by the firm to address an identified deficiency in accordance with paragraph 42.

A54. The firm may have established quality objectives in addition to those specified by this ISQM. The firm may also identify information that indicates that additional quality objectives already established by the firm are no longer needed, or need to be modified.

## **Governance and Leadership**

### *Commitment to Quality* (Ref: Para. 28(a))

A55. The firm's culture is an important factor in influencing the behavior of personnel. Relevant ethical requirements ordinarily establish the principles of professional ethics, and are further addressed in the relevant ethical requirements component of this ISQM. Professional values and attitudes may include:

- Professional manner, for example, timeliness, courteousness, respect, accountability, responsiveness, and dependability.
- A commitment to teamwork.
- Maintaining an open mind to new ideas or different perspectives in the professional environment.
- Pursuit of excellence.
- A commitment to continual improvement (e.g., setting expectations beyond the minimum requirements and placing a focus on continual learning).
- Social responsibility.

A56. The firm's strategic decision-making process, including the establishment of a business strategy, may include matters such as the firm's decisions about financial and operational matters, the firm's financial goals, how financial resources are managed, growth of the firm's market share, industry specialization or new service offerings. The firm's financial and operational priorities may directly or indirectly affect the firm's commitment to quality, for example, the firm may have incentives that are focused on financial and operational priorities that may discourage behaviors that demonstrate a commitment to quality.

*Leadership* (Ref: Para. 28(b) and 28(c))

- A57. The responses designed and implemented by the firm to hold leadership responsible and accountable for quality include the performance evaluations required by paragraph 56.
- A58. Although leadership establishes the tone at the top through their actions and behaviors, clear, consistent and frequent actions and communications at all levels within the firm collectively contribute to the firm's culture and demonstrates a commitment to quality.

*Organizational Structure* (Ref: Para. 28(d))

- A59. The organizational structure of the firm may include operating units, operational processes, divisions or geographical locations and other structures. In some instances, the firm may concentrate or centralize processes or activities in a service delivery center, and engagement teams may include personnel from the firm's service delivery center who perform specific tasks that are repetitive or specialized in nature.

*Resources* (Ref: Para. 28(e))

- A60. The individual(s) assigned ultimate responsibility and accountability or operational responsibility for the system of quality management is in most cases able to influence the nature and extent of resources that the firm obtains, develops, uses and maintains, and how those resources are allocated or assigned, including the timing of when they are used.
- A61. As resource needs may change over time it may not be practicable to anticipate all resource needs. The firm's resource planning may involve determining the resources currently required, forecasting the firm's future resource needs, and establishing processes to deal with unanticipated resource needs when they arise.

**Relevant Ethical Requirements** (Ref: Para. 16(t), 29)

- A62. The IESBA Code sets out the fundamental principles of ethics that establish the standards of behavior expected of a professional accountant and establishes the International Independence Standards. The fundamental principles are integrity, objectivity, professional competence and due care, confidentiality and professional behavior. The IESBA Code also specifies the approach that a professional accountant is required to apply to comply with the fundamental principles and, when applicable, the International Independence Standards. In addition, the IESBA Code addresses specific topics relevant to complying with the fundamental principles. Law or regulation in a jurisdiction may also contain provisions addressing ethical requirements, including independence, such as privacy laws affecting the confidentiality of information.

A63. In some cases, the matters addressed by the firm in its system of quality management may be more specific than, or additional to, the provisions of relevant ethical requirements.

*Examples of matters that a firm may include in its system of quality management that are more specific than, or additional to, the provisions of relevant ethical requirements*

- The firm prohibits the acceptance of gifts and hospitality from a client, even if the value is trivial and inconsequential.
- The firm sets rotation periods for all engagement partners, including those performing other assurance or related services engagements, and extends the rotation periods to all senior engagement team members.

A64. Other components may affect or relate to the relevant ethical requirements component.

*Examples of relationships between the relevant ethical requirements component and other components*

- The information and communication component may address the communication of various matters related to relevant ethical requirements, including:
  - The firm communicating the independence requirements to all personnel and others subject to independence requirements.
  - Personnel and engagement teams communicating relevant information to the firm without fear of reprisals, such as situations that may create threats to independence, or breaches of relevant ethical requirements.
- As part of the resources component, the firm may:
  - Assign individuals to manage and monitor compliance with relevant ethical requirements or to provide consultation on matters related to relevant ethical requirements.
  - Use IT applications to monitor compliance with relevant ethical requirements, including recording and maintaining information about independence.

A65. The relevant ethical requirements that apply to others depend on the provisions of the relevant ethical requirements and how the firm uses others in its system of quality management, or in the performance of engagements.

*Examples of relevant ethical requirements that apply to others*

- Relevant ethical requirements may include requirements for independence that apply to network firms or employees of network firms, for example, the IESBA Code includes independence requirements that apply to network firms.
- Relevant ethical requirements may include a definition of engagement team or other similar concept, and the definition may include any individual who performs assurance procedures on the engagement (e.g., a component auditor or a service provider engaged to attend a physical inventory count at a remote location). Accordingly, any requirements of the relevant ethical requirements that apply to the engagement team as defined in the relevant ethical requirements, or other similar concept, may also be relevant to such individuals.
- The principle of confidentiality may apply to the firm's network, other network firms or service providers, when they have access to client information obtained by the firm.

*Public Sector Considerations*

A66. In achieving the quality objectives in this ISQM related to independence, public sector auditors may address independence in the context of the public sector mandate and statutory measures.

**Acceptance and Continuance of Client Relationships and Specific Engagements**

*The Nature and Circumstances of the Engagement and the Integrity and Ethical Values of the Client (Ref: Para. 30(a)(i))*

A67. The information obtained about the nature and circumstances of the engagement may include:

- The industry of the entity for which the engagement is being undertaken and relevant regulatory factors;
- The nature of the entity, for example, its operations, organizational structure, ownership and governance, its business model and how it is financed; and
- The nature of the underlying subject matter and the applicable criteria, for example, in the case of integrated reporting:
  - The underlying subject matter may include social, environmental or health and safety information; and
  - The applicable criteria may be performance measures established by a recognized body of experts.

A68. The information obtained to support the firm's judgments about the integrity and ethical values of the client may include the identity and business reputation of the client's principal owners, key management, and those charged with its governance.

*Examples of factors that may affect the nature and extent of information obtained about the integrity and ethical values of the client*

- The nature of the entity for which the engagement is being performed, including the complexity of its ownership and management structure.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of a client-imposed limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.
- The identity and business reputation of related parties.

A69. The firm may obtain the information from a variety of internal and external sources, including:

- In the case of an existing client, information from current or previous engagements, if applicable, or inquiry of other personnel who have performed other engagements for the client.
- In the case of a new client, inquiry of existing or previous providers of professional accountancy services to the client, in accordance with relevant ethical requirements.
- Discussions with other third parties, such as bankers, legal counsel and industry peers.
- Background searches of relevant databases (which may be intellectual resources). In some cases, the firm may use a service provider to perform the background search.

A70. Information that is obtained during the firm's acceptance and continuance process may often also be relevant to the engagement team when planning and performing the engagement. Professional standards may specifically require the

engagement team to obtain or consider such information. For example, ISA 220 (Revised)<sup>11</sup> requires the engagement partner to take into account information obtained in the acceptance and continuance process in planning and performing the audit engagement.

- A71. Professional standards or applicable legal and regulatory requirements may include specific provisions that need to be addressed before accepting or continuing a client relationship or specific engagement and may also require the firm to make inquiries of an existing or predecessor firm when accepting an engagement. For example, when there has been a change of auditors, ISA 300<sup>12</sup> requires the auditor, prior to starting an initial audit, to communicate with the predecessor auditor in compliance with relevant ethical requirements. The IESBA Code also includes requirements for the consideration of conflicts of interests in accepting or continuing a client relationship or specific engagement and communication with the existing or predecessor firm when accepting an engagement that is an audit or review of financial statements.

*The Firm's Ability to Perform the Engagement* (Ref: Para. 30(a)(ii))

- A72. The firm's ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements may be affected by:
- The availability of appropriate resources to perform the engagement;
  - Having access to information to perform the engagement, or to the persons who provide such information; and
  - Whether the firm and the engagement team are able to fulfill their responsibilities in relation to the relevant ethical requirements.

*Examples of factors the firm may consider in determining whether appropriate resources are available to perform the engagement*

- The circumstances of the engagement and the reporting deadline.
- The availability of individuals with the appropriate competence and capabilities, including sufficient time, to perform the engagement. This includes having:
  - Individuals to take overall responsibility for directing and supervising the engagement;
  - Individuals with knowledge of the relevant industry or the underlying subject matter or criteria to be applied in the preparation of the subject matter information and experience with relevant regulatory or reporting requirements; and

<sup>11</sup> ISA 220 (Revised), paragraph 23

<sup>12</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraph 13(b)

- Individuals to perform audit procedures on the financial information of a component for purposes of an audit of group financial statements.
- The availability of experts, if needed.
- If an engagement quality review is needed, whether there is an individual available who meets the eligibility requirements in ISQM 2.
- The need for technological resources, for example, IT applications that enable the engagement team to perform procedures on the entity's data.
- The need for intellectual resources, for example, a methodology, industry or subject matter-specific guides, or access to information sources.

*The Firm's Financial and Operational Priorities (Ref: Para. 30(b))*

- A73. Financial priorities may focus on the profitability of the firm, and fees obtained for the performance of engagements have an effect on the firm's financial resources. Operational priorities may include strategic focus areas, such as growth of the firm's market share, industry specialization or new service offerings. There may be circumstances when the firm is satisfied with the fee quoted for an engagement but it is not appropriate for the firm to accept or continue the engagement or client relationship (e.g., when the client lacks integrity and ethical values).
- A74. There may be other circumstances when the fee quoted for an engagement is not sufficient given the nature and circumstances of the engagement, and it may diminish the firm's ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements. The IESBA Code addresses fees and other types of remuneration, including circumstances that may create a threat to compliance with the fundamental principle of professional competence and due care if the fee quoted for an engagement is too low.

**Engagement Performance**

*Responsibilities of the Engagement Team and Direction, Supervision and Review (Ref: Para. 31(a) and 31(b))*

- A75. Professional standards or applicable legal and regulatory requirements may include specific provisions regarding the overall responsibility of the engagement partner. For example, ISA 220 (Revised) deals with the overall responsibility of the engagement partner for managing and achieving quality on the engagement and for being sufficiently and appropriately involved

throughout the engagement, including having responsibility for appropriate direction and supervision of the engagement team and review of their work.

*A76. Examples of direction, supervision and review*

- Direction and supervision of the engagement team may include:
  - Tracking the progress of the engagement;
  - Considering the following with respect to members of the engagement team:
    - Whether they understand their instructions; and
    - Whether the work is being carried out in accordance with the planned approach to the engagement;
  - Addressing matters arising during the engagement, considering their significance and modifying the planned approach appropriately; and
  - Identifying matters for consultation or consideration by more experienced engagement team members during the engagement.
- A review of work performed may include considering whether:
  - The work has been performed in accordance with the firm's policies or procedures, professional standards and applicable legal and regulatory requirements;
  - Significant matters have been raised for further consideration;
  - Appropriate consultations have been undertaken and the resulting conclusions have been documented and implemented;
  - There is a need to revise the nature, timing and extent of planned work;
  - The work performed supports the conclusions reached and is appropriately documented;
  - The evidence obtained for an assurance engagement is sufficient and appropriate to support the report; and
  - The objectives of the engagement procedures have been achieved.

A77. In some circumstances, the firm may use personnel from a service delivery center in the firm or individuals from a service delivery center in another network firm to perform procedures on the engagement (i.e., the personnel or other individuals are included in the engagement team). In such circumstances,

the firm's policies or procedures may specifically address the direction and supervision of the individuals and review of their work, such as:

- What aspects of the engagement may be assigned to individuals in the service delivery center;
- How the engagement partner, or their designee, is expected to direct, supervise and review the work undertaken by individuals in the service delivery center; and
- The protocols for communication between the engagement team and individuals in the service delivery center.

*Professional Judgment and Professional Skepticism* (Ref: Para. 31(c))

A78. Professional skepticism supports the quality of judgments made on an assurance engagement and, through these judgments, the overall effectiveness of the engagement team in performing the assurance engagement. Other pronouncements of the IAASB may address the exercise of professional judgment or professional skepticism at the engagement level. For example, ISA 220 (Revised)<sup>13</sup> provides examples of impediments to the exercise of professional skepticism at the engagement level, unconscious auditor biases that may impede the exercise of professional skepticism, and possible actions that the engagement team may take to mitigate such impediments.

*Consultation* (Ref: Para. 31(d))

A79. Consultation typically involves a discussion at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, on difficult or contentious matters. An environment that reinforces the importance and benefit of consultation and encourages engagement teams to consult may contribute to supporting a culture that demonstrates a commitment to quality.

A80. Difficult or contentious matters on which consultation is needed may either be specified by the firm, or the engagement team may identify matters that require consultation. The firm may also specify how conclusions are to be agreed and implemented.

A81. ISA 220 (Revised)<sup>14</sup> includes requirements for the engagement partner related to consultation.

*Differences of Opinion* (Ref: Para. 31(e))

A82. The firm may encourage that differences of opinion are identified at an early stage, and may specify the steps to be taken in raising and dealing with them, including how the matter is to be resolved and how the related conclusions

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<sup>13</sup> ISA 220 (Revised), paragraphs A34–A36

<sup>14</sup> ISA 220 (Revised), paragraph 35

should be implemented and documented. In some circumstances, resolving differences of opinion may be achieved through consulting with another practitioner or firm, or a professional or regulatory body.

*Engagement Documentation* (Ref: Para. 31(f))

- A83. Law, regulation or professional standards may prescribe the time limits by which the assembly of final engagement files for specific types of engagements are to be completed. Where no such time limits are prescribed in law or regulation, the time limit may be determined by the firm. In the case of engagements conducted under the ISAs or ISAEs, 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 engagement report.
- A84. The retention and maintenance of engagement documentation may include managing the safe custody, integrity, accessibility or retrievability of the underlying data and the related technology. The retention and maintenance of engagement documentation may involve the use of IT applications. The integrity of engagement documentation may be compromised if it is altered, supplemented or deleted without authorization to do so, or if it is permanently lost or damaged.
- A85. Law, regulation or professional standards may prescribe the retention periods for engagement documentation. If the retention periods are not prescribed, the firm may consider the nature of the engagements performed by the firm and the firm's circumstances, including whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. In the case of engagements conducted under the ISAs or ISAEs, the retention period is ordinarily no shorter than five years from the date of the engagement report, or, if later, the date of the auditor's report on the group financial statements, when applicable.

**Resources** (Ref: Para. 32)

A86. Resources for the purposes of the resources component include:

- Human resources.
- Technological resources, for example, IT applications.
- Intellectual resources, for example, written policies or procedures, a methodology or guides.

Financial resources are also relevant to the system of quality management because they are necessary for obtaining, developing and maintaining the firm's human resources, technological resources and intellectual resources. Given that the management and allocation of financial resources is strongly influenced by leadership, the quality objectives in governance and leadership, such as those that address financial and operational priorities, address financial resources.

A87. Resources may be internal to the firm, or may be obtained externally from the firm's network, another network firm or service provider. Resources may be used in performing activities within the firm's system of quality management, or in the performance of engagements as part of operating the system of quality management. In circumstances when a resource is obtained from the firm's network or another network firm, paragraphs 48–52 form part of the responses designed and implemented by the firm in achieving the objectives in this component.

### *Human Resources*

Hiring, Developing and Retaining Personnel and Personnel Competence and Capabilities (Ref: Para. 32(a), 32(d))

A88. Competence is the ability of the individual to perform a role and goes beyond knowledge of principles, standards, concepts, facts, and procedures; it is the integration and application of technical competence, professional skills, and professional ethics, values and attitudes. Competence can be developed through a variety of methods, including professional education, continuing professional development, training, work experience or coaching of less experienced engagement team members by more experienced engagement team members.

A89. Law, regulation or professional standards may establish requirements addressing competence and capabilities, such as requirements for the professional licensing of engagement partners, including requirements regarding their professional education and continuing professional development.

A90. *Examples of policies or procedures relating to hiring, developing and retaining personnel*

The policies or procedures designed and implemented by the firm relating to hiring, developing and retaining personnel may address:

- Recruiting individuals who have, or are able to develop, appropriate competence.
- Training programs focused on developing the competence of personnel and continuing professional development.
- Evaluation mechanisms that are undertaken at appropriate intervals and include competency areas and other performance measures.
- Compensation, promotion and other incentives, for all personnel, including engagement partners and individuals assigned roles and responsibilities related to the firm's system of quality management.

Personnel's Commitment to Quality and Accountability and Recognition for Commitment to Quality (Ref: Para. 32(b))

- A91. Timely evaluations and feedback help support and promote the continual development of the competence of personnel. Less formal methods of evaluation and feedback may be used, such as in the case of firms with fewer personnel.
- A92. Positive actions or behaviors demonstrated by personnel may be recognized through various means, such as through compensation, promotion, or other incentives. In some circumstances, simple or informal incentives that are not based on monetary rewards may be appropriate.
- A93. The manner in which the firm holds personnel accountable for actions or behaviors that negatively affect quality, such as failing to demonstrate a commitment to quality, develop and maintain the competence to perform their role or implement the firm's responses as designed, may depend on the nature of the action or behavior, including its severity and frequency of occurrence. Actions the firm may take when personnel demonstrate actions or behaviors that negatively affect quality may include:
- Training or other professional development.
  - Considering the effect of the matter on the evaluation, compensation, promotion or other incentives of those involved.
  - Disciplinary action, if appropriate.

Individuals Obtained from External Sources (Ref: Para. 32(c))

- A94. Professional standards may include responsibilities for the engagement partner regarding the appropriateness of resources. For example, ISA 220 (Revised)<sup>15</sup> addresses the responsibility of the engagement partner for determining that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner in accordance with the firm's policies or procedures.

Engagement Team Members Assigned to Each Engagement (Ref: Para. 32(d))

- A95. Engagement team members may be assigned to engagements by:
- The firm, including assigning personnel from a service delivery center in the firm.
  - The firm's network or another network firm when the firm uses individuals from the firm's network or another network firm to perform procedures on the engagement (e.g., a component auditor or a service delivery center of the network or another network firm).
  - A service provider when the firm uses individuals from a service provider to perform procedures on the engagement (e.g., a component auditor from a firm that is not within the firm's network).

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<sup>15</sup> ISA 220 (Revised), paragraph 25

A96. ISA 220 (Revised)<sup>16</sup> addresses the responsibility of the engagement partner to determine that members of the engagement team, and any auditor's external experts and internal auditors who provide direct assistance who are not part of the engagement team, collectively have the appropriate competence and capabilities, including sufficient time, to perform the engagement. ISA 600<sup>17</sup> expands on how ISA 220 (Revised) is to be applied in relation to an audit of group financial statements. The responses designed and implemented by the firm to address the competence and capabilities of engagement team members assigned to the engagement may include policies or procedures that address:

- Information that may be obtained by the engagement partner and factors to consider in determining that the engagement team members assigned to the engagement, including those assigned by the firm's network, another network firm or service provider, have the competence and capabilities to perform the engagement.
- How concerns about the competence and capabilities of engagement team members, in particular those assigned by the firm's network, another network firm or service provider, may be resolved.

A97. The requirements in paragraphs 48–52 are also applicable when using individuals from the firm's network or another network firm on an engagement, including component auditors (see, for example, paragraph A179).

*Technological Resources* (Ref: Para. 32(f))

A98. Technological resources, which are typically IT applications, form part of the firm's IT environment. The firm's IT environment also includes the supporting IT infrastructure and the IT processes and human resources involved in those processes:

- An IT application is a program or a set of programs that is designed to perform a specific function directly for the user or, in some cases, for another application program.
- The IT infrastructure is comprised of the IT network, operating systems, and databases and their related hardware and software.
- The IT processes are the firm's processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations, which includes monitoring the IT environment.

A99. A technological resource may serve multiple purposes within the firm and some of the purposes may be unrelated to the system of quality

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<sup>16</sup> ISA 220 (Revised), paragraph 26

<sup>17</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph 19

management. Technological resources that are relevant for the purposes of this ISQM are:

- Technological resources that are directly used in designing, implementing or operating the firm's system of quality management;
- Technological resources that are used directly by engagement teams in the performance of engagements; and
- Technological resources that are essential to enabling the effective operation of the above, such as, in relation to an IT application, the IT infrastructure and IT processes supporting the IT application.

*Scalability examples to demonstrate how the technological resources that are relevant for the purposes of this ISQM may differ*

- In a less complex firm, the technological resources may comprise a commercial IT application used by engagement teams, which has been purchased from a service provider. The IT processes that support the operation of the IT application may also be relevant, although they may be simple (e.g., processes for authorizing access to the IT application and processing updates to the IT application).
- In a more complex firm, the technological resources may be more complex and may comprise:
  - Multiple IT applications, including custom developed applications or applications developed by the firm's network, such as:
    - IT applications used by engagement teams (e.g., engagement software and automated audit tools).
    - IT applications developed and used by the firm to manage aspects of the system of quality management (e.g., IT applications to monitor independence or assign personnel to engagements).
  - The IT processes that support the operation of these IT applications, including the individuals responsible for managing the IT infrastructure and IT processes and the firm's processes for managing program changes to the IT applications.

A100. The firm may consider the following matters in obtaining, developing, implementing and maintaining an IT application:

- The data inputs are complete and appropriate;
- Confidentiality of the data is preserved;
- The IT application operates as designed and achieves the purpose for which it is intended;

- The outputs of the IT application achieve the purpose for which they will be used;
- The general IT controls necessary to support the IT application's continued operation as designed are appropriate;
- The need for specialized skills to utilize the IT application effectively, including the training of individuals who will use the IT application; and
- The need to develop procedures that set out how the IT application operates.

A101. The firm may specifically prohibit the use of IT applications or features of IT applications until such time that it has been determined that they operate appropriately and have been approved for use by the firm. Alternatively, the firm may establish policies or procedures to address circumstances when the engagement team uses an IT application that is not approved by the firm. Such policies or procedures may require the engagement team to determine that the IT application is appropriate for use prior to using it on the engagement, through considering the matters in paragraph A100. ISA 220 (Revised)<sup>18</sup> addresses the engagement partner's responsibilities for engagement resources.

*Intellectual Resources* (Ref: Para. 32(g))

A102. Intellectual resources include the information the firm uses to enable the operation of the system of quality management and promote consistency in the performance of engagements.

*Examples of intellectual resources*

Written policies or procedures, a methodology, industry or subject matter-specific guides, accounting guides, standardized documentation or access to information sources (e.g., subscriptions to websites that provide in-depth information about entities or other information that is typically used in the performance of engagements).

A103. Intellectual resources may be made available through technological resources, for example, the firm's methodology may be embedded in the IT application that facilitates the planning and performance of the engagement.

*Use of Technological and Intellectual Resources* (Ref: Para. 32(f)–32(g))

A104. The firm may establish policies or procedures regarding the use of the firm's technological and intellectual resources. Such policies or procedures may:

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<sup>18</sup> ISA 220 (Revised), paragraphs 25–28

- Require the use of certain IT applications or intellectual resources in the performance of engagements, or relating to other aspects of the engagement, such as in archiving the engagement file.
- Specify the qualifications or experience that individuals need to use the resource, including the need for an expert or training, for example, the firm may specify the qualifications or expertise needed to use an IT application that analyzes data, given that specialized skills may be needed to interpret the results.
- Specify the responsibilities of the engagement partner regarding the use of technological and intellectual resources.
- Set out how the technological or intellectual resources are to be used, including how individuals should interact with an IT application or how the intellectual resource should be applied, and the availability of support or assistance in using the technological or intellectual resource.

*Service Providers* (Ref: Para. 16(v), 32(h))

A105. In some circumstances, the firm may use resources that are provided by a service provider, particularly in circumstances when the firm does not have access to the appropriate resources internally. Notwithstanding that a firm may use resources from a service provider, the firm remains responsible for its system of quality management.

*Examples of resources from a service provider*

- Individuals engaged to perform the firm's monitoring activities or engagement quality reviews, or to provide consultation on technical matters.
- A commercial IT application used to perform audit engagements.
- Individuals performing procedures on the firm's engagements, for example, component auditors from other firms not within the firm's network or individuals engaged to attend a physical inventory count at a remote location.
- An auditor's external expert used by the firm to assist the engagement team in obtaining audit evidence.

A106. In identifying and assessing quality risks, the firm is required to obtain an understanding of the conditions, events, circumstances, actions or inactions that may adversely affect the achievement of the quality objectives, which includes conditions, events, circumstances, actions or inactions relating to service providers. In doing so, the firm may consider the nature of the resources provided by service providers, how and the extent to which they will be used by the firm, and the general characteristics of the service providers used by

the firm (e.g., the varying types of other professional services firms that are used), in order to identify and assess quality risks related to the use of such resources.

A107. In determining whether a resource from a service provider is appropriate for use in the firm's system of quality management or in the performance of engagements, the firm may obtain information about the service provider and the resource they provide from a number of sources. Matters the firm may consider include:

- The related quality objective and quality risks. For example, in the case of a methodology from a service provider, there may be quality risks related to the quality objective in paragraph 32(g), such as a quality risk that the service provider does not update the methodology to reflect changes in professional standards and applicable legal and regulatory requirements.
- The nature and scope of the resources, and the conditions of the service (e.g., in relation to an IT application, how often updates will be provided, limitations on the use of the IT application and how the service provider addresses confidentiality of data).
- The extent to which the resource is used across the firm, how the resource will be used by the firm and whether it is suitable for that purpose.
- The extent of customization of the resource for the firm.
- The firm's previous use of the service provider.
- The service provider's experience in the industry and reputation in the market.

A108. The firm may have a responsibility to take further actions in using the resource from a service provider so that the resource functions effectively. For example, the firm may need to communicate information to the service provider in order for the resource to function effectively, or, in relation to an IT application, the firm may need to have supporting IT infrastructure and IT processes in place.

### **Information and Communication** (Ref: Para. 33)

A109. Obtaining, generating or communicating information is generally an ongoing process that involves all personnel and encompasses the dissemination of information within the firm and externally. Information and communication is pervasive to all components of the system of quality management.

#### *The Firm's Information System* (Ref: Para. 33(a))

A110. Reliable and relevant information includes information that is accurate, complete, timely and valid to enable the proper functioning of the firm's system of quality management and to support decisions regarding the system of quality management.

A111. The information system may include the use of manual or IT elements, which affect the manner in which information is identified, captured, processed, maintained and communicated. The procedures to identify, capture, process, maintain and communicate information may be enforced through IT applications, and in some cases may be embedded within the firm's responses for other components. In addition, digital records may replace or supplement physical records.

*Scalability example to demonstrate how the information system may be designed in a less complex firm*

Less complex firms with fewer personnel and direct involvement of leadership may not need rigorous policies and procedures that specify how information should be identified, captured, processed and maintained.

*Communication Within the Firm* (Ref: Para. 33(b), 33(c))

A112. The firm may recognize and reinforce the responsibility of personnel and engagement teams to exchange information with the firm and with one another by establishing communication channels to facilitate communication across the firm.

*Examples of communication among the firm, personnel and engagement teams*

- The firm communicates the responsibility for implementing the firm's responses to personnel and engagement teams.
- The firm communicates changes to the system of quality management to personnel and engagement teams, to the extent that the changes are relevant to their responsibilities and enables personnel and engagement teams to take prompt and appropriate action in accordance with their responsibilities.
- The firm communicates information that is obtained during the firm's acceptance and continuance process that is relevant to engagement teams in planning and performing engagements.
- Engagement teams communicate to the firm information about:
  - The client that is obtained during the performance of an engagement that may have caused the firm to decline the client relationship or specific engagement had that information been known prior to accepting or continuing the client relationship or specific engagement.
  - The operation of the firm's responses (e.g., concerns about the firm's processes for assigning personnel to engagements), which in some cases, may indicate a deficiency in the firm's system of quality management.

- Engagement teams communicate information to the engagement quality reviewer or individuals providing consultation.
- Group engagement teams communicate matters to component auditors in accordance with the firm's policies or procedures, including matters related to quality management at the engagement level.
- The individual(s) assigned operational responsibility for compliance with independence requirements communicates to relevant personnel and engagement teams changes in the independence requirements and the firm's policies or procedures to address such changes.

*Communication with External Parties*

Communication to or within the Firm's Network and to Service Providers (Ref: Para. 33(d)(i))

A113. In addition to the firm communicating information to or within the firm's network or to a service provider, the firm may need to obtain information from the network, a network firm or a service provider that supports the firm in the design, implementation and operation of its system of quality management.

*Example of information obtained by the firm from within the firm's network*

The firm obtains information from the network or other network firms about clients of other network firms, where there are independence requirements that affect the firm.

Communication with Others External to the Firm (Ref: Para. 33(d)(ii))

A114. *Examples of when law, regulation or professional standards may require the firm to communicate information to external parties*

- The firm becomes aware of non-compliance with laws and regulations by a client, and relevant ethical requirements require the firm to report the non-compliance with laws and regulations to an appropriate authority outside the client entity, or to consider whether such reporting is an appropriate action in the circumstances.
- Law or regulation requires the firm to publish a transparency report and specifies the nature of the information that is required to be included in the transparency report.
- Securities law or regulation requires the firm to communicate certain matters to those charged with governance.

A115. In some cases, law or regulation may preclude the firm from communicating information related to its system of quality management externally.

*Examples of when the firm may be precluded from communicating information externally*

- Privacy or secrecy law or regulation prohibits disclosure of certain information.
- Law, regulation or relevant ethical requirements include provisions addressing the duty of confidentiality.

**Specified Responses** (Ref: Para. 34)

A116. The specified responses may address multiple quality risks related to more than one quality objective across different components. For example, policies or procedures for complaints and allegations may address quality risks related to quality objectives in resources (e.g., personnel's commitment to quality), relevant ethical requirements and governance and leadership. The specified responses alone are not sufficient to achieve the objectives of the system of quality management.

*Relevant Ethical Requirements* (Ref: Para. 34(a))

A117. Relevant ethical requirements may contain provisions regarding the identification and evaluation of threats and how they are to be addressed. For example, the IESBA Code provides a conceptual framework for this purpose and, in applying the conceptual framework, requires that the firm use the reasonable and informed third party test.

A118. Relevant ethical requirements may specify how the firm is required to respond to a breach. For example, the IESBA Code sets out requirements for the firm in the event of a breach of the IESBA Code and includes specific requirements addressing breaches of the International Independence Standards, which includes requirements for communication with external parties.

A119. Matters the firm may address relating to breaches of the relevant ethical requirements include:

- The communication of breaches of the relevant ethical requirements to appropriate personnel;
- The evaluation of the significance of a breach and its effect on compliance with relevant ethical requirements;
- The actions to be taken to satisfactorily address the consequences of a breach, including that such actions be taken as soon as practicable;

- Determining whether to report a breach to external parties, such as those charged with governance of the entity to which the breach relates or an external oversight authority; and
- Determining the appropriate actions to be taken in relation to the individual(s) responsible for the breach.

*Complaints and Allegations* (Ref: Para. 34(c))

A120. Establishing policies or procedures for dealing with complaints and allegations may assist the firm in preventing engagement reports from being issued that are inappropriate. It also may assist the firm in:

- Identifying and dealing with individuals, including leadership, who do not act or behave in a manner that demonstrates a commitment to quality and supports the firm's commitment to quality; or
- Identifying deficiencies in the system of quality management.

A121. Complaints and allegations may be made by personnel, or others external to the firm (e.g., clients, component auditors or individuals within the firm's network).

*Information That Becomes Known Subsequent to Accepting or Continuing a Client Relationship or Specific Engagement* (Ref: Para. 34(d))

A122. Information that becomes known subsequent to accepting or continuing a client relationship or specific engagement may:

- Have existed at the time of the firm's decision to accept or continue the client relationship or specific engagement and the firm was not aware of such information; or
- Relate to new information that has arisen since the decision to accept or continue the client relationship or specific engagement.

*Examples of matters addressed in the firm's policies or procedures for circumstances when information becomes known subsequent to accepting or continuing a client relationship or specific engagement that may have affected the firm's decision to accept or continue a client relationship or specific engagement*

- Undertaking consultation within the firm or with legal counsel.
- Considering whether there is a professional, legal or regulatory requirement for the firm to continue the engagement.
- Discussing with the appropriate level of the client's management and with those charged with governance or the engaging party the action that the firm might take based on the relevant facts and circumstances.

- When it is determined that withdrawal is an appropriate action:
  - Informing the client’s management and those charged with governance or the engaging party of this decision and the reasons for the withdrawal.
  - Considering whether there is a professional, legal or regulatory requirement for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.

A123. In some circumstances, jurisdictional law or regulation may impose an obligation on the firm to accept or continue a client engagement, or in the case of the public sector, the firm may be appointed through statutory provisions.

- Example of matters addressed in the firm’s policies or procedures in circumstances when the firm is obligated to accept or continue an engagement or the firm is unable to withdraw from an engagement, and the firm is aware of information that would have caused the firm to decline or discontinue the engagement*
- The firm considers the effect of the information on the performance of the engagement.
  - The firm communicates the information to the engagement partner, and requests the engagement partner to increase the extent and frequency of the direction and supervision of the engagement team members and review of their work.
  - The firm assigns more experienced personnel to the engagement.
  - The firm determines that an engagement quality review should be performed.

*Communication with External Parties (Ref. Para: 34(e))*

A124. The firm’s ability to maintain stakeholder confidence in the quality of its engagements may be enhanced through relevant, reliable and transparent communication by the firm about the activities that it has undertaken to address quality, and the effectiveness of those activities.

A125. External parties who may use information about the firm’s system of quality management, and the extent of their interest in the firm’s system of quality management, may vary based on the nature and circumstances of the firm and its engagements.



*Examples of external parties who may use information about the firm's system of quality management*

- Management or those charged with governance of the firm's clients may use the information to determine whether to appoint the firm to perform an engagement.
- External oversight authorities may have indicated a desire for the information to support their responsibilities in monitoring the quality of engagements across a jurisdiction and in understanding the work of firms.
- Other firms who use the work of the firm in the performance of engagements (e.g., in relation to a group audit) may have requested such information.
- Other users of the firm's engagement reports, such as investors who use engagement reports in their decision making, may have indicated a desire for the information.

A126. The information about the system of quality management provided to external parties, including information communicated to those charged with governance about how the system of quality management supports the consistent performance of quality engagements, may address such matters as:

- The nature and circumstances of the firm, such as the organizational structure, business model, strategy and operating environment.
- The firm's governance and leadership, such as its culture, how it demonstrates a commitment to quality, and assigned roles, responsibilities and authority with respect to the system of quality management.
- How the firm fulfills its responsibilities in accordance with relevant ethical requirements, including those related to independence.
- Factors that contribute to quality engagements, for example, such information may be presented in the form of engagement quality indicators with narrative to explain the indicators.
- The results of the firm's monitoring activities and external inspections, and how the firm has remediated identified deficiencies or is otherwise responding to them.
- The evaluation undertaken in accordance with paragraphs 53–54 of whether the system of quality management provides the firm with reasonable assurance that the objectives of the system are being achieved and the conclusion thereon, including the basis for the judgments made in undertaking the evaluation and concluding.

- How the firm has responded to emerging developments and changes in the circumstances of the firm or its engagements, including how the system of quality management has been adapted to respond to such changes.
- The relationship between the firm and the network, the overall structure of the network, a description of network requirements and network services, the responsibilities of the firm and the network (including that the firm is ultimately responsible for the system of quality management), and information about the overall scope and results of network monitoring activities across the network firms.

#### Communication with Those Charged with Governance (Ref. Para: 34(e)(i))

A127. How the communication with those charged with governance is undertaken (i.e., by the firm or the engagement team) may depend on the firm's policies or procedures and the circumstances of the engagement.

A128. ISA 260 (Revised) deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements, and addresses the auditor's determination of the appropriate person(s) within the entity's governance structure with whom to communicate<sup>19</sup> and the communication process.<sup>20</sup> In some circumstances, it may be appropriate to communicate with those charged with governance of entities other than listed entities (or when performing other engagements), for example, entities that may have public interest or public accountability characteristics, such as:

- Entities that hold a significant amount of assets in a fiduciary capacity for a large number of stakeholders including financial institutions, such as certain banks, insurance companies, and pension funds.
- Entities with a high public profile, or whose management or owners have a high public profile.
- Entities with a large number and wide range of stakeholders.

#### Public sector considerations

A129. The firm may determine it is appropriate to communicate to those charged with governance of a public sector entity about how the firm's system of quality management supports the consistent performance of quality engagements, taking into account the size and complexity of the public sector entity, the range of its stakeholders, the nature of the services it provides, and the role and responsibilities of those charged with governance.

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<sup>19</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraphs 11–13

<sup>20</sup> ISA 260 (Revised), paragraphs 18–22

Determining When it is Otherwise Appropriate to Communicate with External Parties (Ref. Para: 34(e)(ii))

A130. The firm's determination of when it is appropriate to communicate with external parties about the firm's system of quality management is a matter of professional judgment and may be influenced by matters such as:

- The types of engagements performed by the firm, and the types of entities for which such engagements are undertaken.
- The nature and circumstances of the firm.
- The nature of the firm's operating environment, such as customary business practice in the firm's jurisdiction and the characteristics of the financial markets in which the firm operates.
- The extent to which the firm has already communicated with external parties in accordance with law or regulation (i.e., whether further communication is needed, and if so, the matters to be communicated).
- The expectations of stakeholders in the firm's jurisdiction, including the understanding and interest that external parties have expressed about the engagements undertaken by the firm, and the firm's processes in performing the engagements.
- Jurisdictional trends.
- The information that is already available to external parties.
- How external parties may use the information, and their general understanding of matters related to firms' system of quality management and audits or reviews of financial statements, or other assurance or related services engagements.
- The public interest benefits of external communication and whether it would reasonably be expected to outweigh the costs (monetary or otherwise) of such communication.

The above matters may also affect the information provided by the firm in the communication, and the nature, timing and extent and appropriate form of communication.

Nature, Timing and Extent and Appropriate Form of Communication with External Parties (Ref. Para: 34(e)(iii))

A131. The firm may consider the following attributes in preparing information that is communicated to external parties:

- The information is specific to the circumstances of the firm. Relating the matters in the firm's communication directly to the specific circumstances of the firm may help to minimize the potential that such information becomes overly standardized and less useful over time.

- The information is presented in a clear and understandable manner, and the manner of presentation is neither misleading nor would inappropriately influence the users of the communication (e.g., the information is presented in a manner that is appropriately balanced towards positive and negative aspects of the matter being communicated).
- The information is accurate and complete in all material respects and does not contain information that is misleading.
- The information takes into consideration the information needs of the users for whom it is intended. In considering the information needs of the users, the firm may consider matters such as the level of detail that users would find meaningful and whether users have access to relevant information through other sources (e.g., the firm's website).

A132. The firm uses professional judgment in determining, in the circumstances, the appropriate form of communication with the external party, including communication with those charged with governance when performing an audit of financial statements of listed entities, which may be made orally or in writing. Accordingly, the form of communication may vary.

*Examples of form of communication to external parties*

- A publication such as a transparency report or audit quality report.
- Targeted written communication to specific stakeholders (e.g., information about the results of the firm's monitoring and remediation process).
- Direct conversations and interactions with the external party (e.g., discussions between the engagement team and those charged with governance).
- A webpage.
- Other forms of digital media, such as social media, or interviews or presentations via webcast or video.

*Engagements Subject to an Engagement Quality Review*

Engagement Quality Review Required by Law or Regulation (Ref: Para. 34(f)(ii))

A133. Law or regulation may require an engagement quality review to be performed, for example, for audit engagements for entities that:

- Are public interest entities as defined in a particular jurisdiction;
- Operate in the public sector or which are recipients of government funding, or entities with public accountability;
- Operate in certain industries (e.g., financial institutions such as banks, insurance companies and pension funds);

- Meet a specified asset threshold; or
- Are under the management of a court or judicial process (e.g., liquidation).

Engagement Quality Review as a Response to Address One or More Quality Risk(s)  
(Ref: Para. 34(f)(iii))

A134. The firm's understanding of the conditions, events, circumstances, actions or inactions that may adversely affect the achievement of the quality objectives, as required by paragraph 25(a)(ii), relates to the nature and circumstances of the engagements performed by the firm. In designing and implementing responses to address one or more quality risk(s), the firm may determine that an engagement quality review is an appropriate response based on the reasons for the assessments given to the quality risks.

*Examples of conditions, events, circumstances, actions or inactions giving rise to one or more quality risk(s) for which an engagement quality review may be an appropriate response*

Those relating to the types of engagements performed by the firm and reports to be issued:

- Engagements that involve a high level of complexity or judgment, such as:
  - Audits of financial statements for entities operating in an industry that typically has accounting estimates with a high degree of estimation uncertainty (e.g., certain large financial institutions or mining entities), or for entities for which uncertainties exist related to events or conditions that may cast significant doubt on their ability to continue as a going concern.
  - Assurance engagements that require specialized skills and knowledge in measuring or evaluating the underlying subject matter against the applicable criteria (e.g., a greenhouse gas statement in which there are significant uncertainties associated with the quantities reported therein).
- Engagements on which issues have been encountered, such as audit engagements with recurring internal or external inspection findings, unremediated significant deficiencies in internal control, or a material restatement of comparative information in the financial statements.
- Engagements for which unusual circumstances have been identified during the firm's acceptance and continuance process (e.g., a new client that had a disagreement with its previous auditor or assurance practitioner).

- Engagements that involve reporting on financial or non-financial information that is expected to be included in a regulatory filing, and that may involve a higher degree of judgment, such as pro forma financial information to be included in a prospectus.

Those relating to the types of entities for which engagements are undertaken:

- Entities in emerging industries, or for which the firm has no previous experience.
- Entities for which concerns were expressed in communications from securities or prudential regulators.
- Entities other than listed entities that may have public interest or public accountability characteristics, for example:
  - Entities that hold a significant amount of assets in a fiduciary capacity for a large number of stakeholders including financial institutions, such as certain banks, insurance companies, and pension funds for which an engagement quality review is not otherwise required by law or regulation.
  - Entities with a high public profile, or whose management or owners have a high public profile.
  - Entities with a large number and wide range of stakeholders.

A135. The firm's responses to address quality risks may include other forms of engagement reviews that are not an engagement quality review. For example, for audits of financial statements, the firm's responses may include reviews of the engagement team's procedures relating to significant risks, or reviews of certain significant judgments, by personnel who have specialized technical expertise. In some cases, these other types of engagement reviews may be undertaken in addition to an engagement quality review.

A136. In some cases, the firm may determine that there are no audits or other engagements for which an engagement quality review or another form of engagement review is an appropriate response to address the quality risk(s).

#### Public sector considerations

A137. The nature and circumstances of public sector entities (e.g., due to their size and complexity, the range of their stakeholders, or the nature of the services they provide) may give rise to quality risks. In these circumstances, the firm may determine that an engagement quality review is an appropriate response to address such quality risks. Law or regulation may establish additional reporting requirements for the auditors of public sector entities (e.g., a separate report on instances of non-compliance with law or regulation to the legislature or other governing body or communicating such instances in the auditor's report on the

financial statements). In such cases, the firm may also consider the complexity of such reporting, and its importance to users, in determining whether an engagement quality review is an appropriate response.

**Monitoring and Remediation Process** (Ref: Para. 35–47)

A138. In addition to enabling the evaluation of the system of quality management, the monitoring and remediation process facilitates the proactive and continual improvement of engagement quality and the system of quality management. For example:

- Given the inherent limitations of a system of quality management, the firm's identification of deficiencies is not unusual and it is an important aspect of the system of quality management, because prompt identification of deficiencies enables the firm to remediate them in a timely and effective manner, and contributes to a culture of continual improvement.
- The monitoring activities may provide information that enables the firm to prevent a deficiency through responding to a finding that could, over a period of time, lead to a deficiency.

*Designing and Performing Monitoring Activities* (Ref: Para. 37–38)

A139. The firm's monitoring activities may comprise a combination of ongoing monitoring activities and periodic monitoring activities. Ongoing monitoring activities are generally routine activities, built into the firm's processes and performed on a real-time basis, reacting to changing conditions. Periodic monitoring activities are conducted at certain intervals by the firm. In most cases, ongoing monitoring activities provide information about the system of quality management in a timelier manner.

A140. Monitoring activities may include the inspection of in-process engagements. Inspections of engagements are designed to monitor that an aspect of the system of quality management is designed, implemented and operating in the manner intended. In some circumstances, the system of quality management may include responses that are designed to review engagements while they are in the process of being performed that appear similar in nature to an inspection of in-process engagements (e.g., reviews that are designed to detect failures or shortcomings in the system of quality management so that they can prevent a quality risk from occurring). The purpose of the activity will guide its design and implementation, and where it fits within the system of quality management (i.e., whether it is an inspection of an in-process engagement that is a monitoring activity or a review of an engagement that is a response to address a quality risk).

A141. The nature, timing and extent of the monitoring activities may also be affected by other matters, including:

- The size, structure and organization of the firm.
- The involvement of the firm's network in monitoring activities.
- The resources that the firm intends to use to enable monitoring activities, such as the use of IT applications.

A142. When performing monitoring activities, the firm may determine that changes to the nature, timing and extent of the monitoring activities are needed, such as when findings indicate the need for more extensive monitoring activities.

The Design of the Firm's Risk Assessment Process and Monitoring and Remediation Process (Ref: Para. 37(c))

A143. How the firm's risk assessment process is designed (e.g., a centralized or decentralized process, or the frequency of review) may affect the nature, timing and extent of the monitoring activities, including monitoring activities over the firm's risk assessment process.

A144. How the firm's monitoring and remediation process is designed (i.e., the nature, timing and extent of the monitoring and remediation activities, taking into account the nature and circumstances of the firm) may affect the monitoring activities undertaken by the firm to determine whether the monitoring and remediation process is achieving the intended purpose as described in paragraph 35.

*Scalability example to demonstrate the monitoring activities for the monitoring and remediation process*

- In a less complex firm, the monitoring activities may be simple, since information about the monitoring and remediation process may be readily available in the form of leadership's knowledge, based on their frequent interaction with the system of quality management, of the nature, timing and extent of the monitoring activities undertaken, the results of the monitoring activities, and the firm's actions to address the results.
- In a more complex firm, the monitoring activities for the monitoring and remediation process may be specifically designed to determine that the monitoring and remediation process is providing relevant, reliable and timely information about the system of quality management, and responding appropriately to identified deficiencies.

Changes in the System of Quality Management (Ref: Para. 37(d))

A145. Changes in the system of quality management may include:

- Changes to address an identified deficiency in the system of quality management.

- Changes to the quality objectives, quality risks or responses as a result of changes in the nature and circumstances of the firm and its engagements.

When changes occur, previous monitoring activities undertaken by the firm may no longer provide the firm with information to support the evaluation of the system of quality management and, therefore, the firm's monitoring activities may include monitoring of those areas of change.

#### Previous Monitoring Activities (Ref: Para. 37(e))

A146. The results of the firm's previous monitoring activities may indicate areas of the system where a deficiency may arise, particularly areas where there is a history of identified deficiencies.

A147. Previous monitoring activities undertaken by the firm may no longer provide the firm with information to support the evaluation of the system, including on areas of the system of quality management that have not changed, particularly when time has elapsed since the monitoring activities were undertaken.

#### Other Relevant Information (Ref: Para. 37(f))

A148. In addition to the sources of information indicated in paragraph 37(f), other relevant information may include:

- Information communicated by the firm's network in accordance with paragraphs 50(c) and 51(b) about the firm's system of quality management, including the network requirements or network services that the firm has included in its system of quality management.
- Information communicated by a service provider about the resources the firm uses in its system of quality management.
- Information from regulators about the entities for whom the firm performs engagements, which is made available to the firm, such as information from a securities regulator about an entity for whom the firm performs engagements (e.g., irregularities in the entity's financial statements).

A149. The results of external inspections or other relevant information, both internal and external, may indicate that previous monitoring activities undertaken by the firm failed to identify a deficiency in the system of quality management. This information may affect the firm's consideration of the nature, timing and extent of the monitoring activities.

A150. External inspections are not a substitute for the firm's internal monitoring activities. Nevertheless, the results of external inspections inform the nature, timing and extent of the monitoring activities.

*Engagement Inspections (Ref: Para. 38)*

A151. *Examples of matters in paragraph 37 that may be considered by the firm in selecting completed engagements for inspection*

- In relation to the conditions, events, circumstances, actions or inactions giving rise to the quality risks:
  - The types of engagements performed by the firm, and the extent of the firm's experience in performing the type of engagement.
  - The types of entities for which engagements are undertaken, for example:
    - Entities that are listed.
    - Entities operating in emerging industries.
    - Entities operating in industries associated with a high level of complexity or judgment.
    - Entities operating in an industry that is new to the firm.
  - The tenure and experience of engagement partners.
- The results of previous inspections of completed engagements, including for each engagement partner.
- In relation to other relevant information:
  - Complaints or allegations about an engagement partner.
  - The results of external inspections, including for each engagement partner.
  - The results of the firm's evaluation of each engagement partner's commitment to quality.

A152. The firm may undertake multiple monitoring activities, other than inspection of completed engagements, that focus on determining whether engagements have complied with policies or procedures. These monitoring activities may be undertaken on certain engagements or engagement partners. The nature and extent of these monitoring activities, and the results, may be used by the firm in determining:

- Which completed engagements to select for inspection;
- Which engagement partners to select for inspection;
- How frequently to select an engagement partner for inspection; or
- Which aspects of the engagement to consider when performing the inspection of completed engagements.

A153. The inspection of completed engagements for engagement partners on a cyclical basis may assist the firm in monitoring whether engagement partners have fulfilled their overall responsibility for managing and achieving quality on the engagements they are assigned to.

*Example of how a firm may apply a cyclical basis for the inspection of completed engagements for each engagement partner*

The firm may establish policies or procedures addressing the inspection of completed engagements that:

- Set forth the standard period of the inspection cycle, such as the inspection of a completed engagement for each engagement partner performing audits of financial statements once every three years, and for all other engagement partners, once every five years;
- Set out the criteria for selecting completed engagements, including that for an engagement partner performing audits of financial statements, the engagement(s) selected include an audit engagement;
- Address selecting engagement partners in a manner that is unpredictable; and
- Address when it is necessary or appropriate to select engagement partners more, or less, frequently than the standard period set out in the policy, for example:
  - The firm may select engagement partners more frequently than the standard period set out in the firm's policy when:
    - Multiple deficiencies have been identified by the firm that have been evaluated as severe, and the firm determines that a more frequent cyclical inspection is needed across all engagement partners.
    - The engagement partner performs engagements for entities operating in a certain industry where there are high levels of complexity or judgment.
    - An engagement performed by the engagement partner has been subject to other monitoring activities, and the results of the other monitoring activities were unsatisfactory.
    - The engagement partner has performed an engagement for an entity operating in an industry in which the engagement partner has limited experience.
    - The engagement partner is a newly appointed engagement partner, or has recently joined the firm from another firm or another jurisdiction.

- The firm may defer the selection of the engagement partner (e.g., deferring for a year beyond the standard period set out in the firm's policy) when:
  - Engagements performed by the engagement partner have been subject to other monitoring activities during the standard period set out in the firm's policy; and
  - The results of the other monitoring activities provide sufficient information about the engagement partner (i.e., performing the inspection of completed engagements would unlikely provide the firm with further information about the engagement partner).

A154. The matters considered in an inspection of an engagement depend on how the inspection will be used to monitor the system of quality management. Ordinarily, the inspection of an engagement includes determining that responses that are implemented at the engagement level (e.g., the firm's policies and procedures in respect of engagement performance), have been implemented as designed and are operating effectively.

*Individuals Performing the Monitoring Activities* (Ref: Para. 39(b))

A155. The provisions of relevant ethical requirements are relevant in designing the policies or procedures addressing the objectivity of the individuals performing the monitoring activities. A self-review threat may arise when an individual who performs:

- An inspection of an engagement was:
  - In the case of an audit of financial statements, an engagement team member or the engagement quality reviewer of that engagement or an engagement for a subsequent financial period; or
  - For all other engagements, an engagement team member or the engagement quality reviewer of that engagement.
- Another type of monitoring activity had participated in designing, executing or operating the response being monitored.

A156. In some circumstances, for example, in the case of a less complex firm, there may not be personnel who have the competence, capabilities, time or objectivity to perform the monitoring activities. In these circumstances, the firm may use network services or a service provider to perform the monitoring activities.

*Evaluating Findings and Identifying Deficiencies* (Ref: Para. 16(a), 40–41)

A157. The firm accumulates findings from the performance of monitoring activities, external inspections and other relevant sources.

A158. Information accumulated by the firm from the monitoring activities, external inspections and other relevant sources may reveal other observations about the firm's system of quality management, such as:

- Actions, behaviors or conditions that have given rise to positive outcomes in the context of quality or the effectiveness of the system of quality management; or
- Similar circumstances where no findings were noted (e.g., engagements where no findings were noted, and the engagements have a similar nature to the engagements where findings were noted).

Other observations may be useful to the firm as they may assist the firm in investigating the root cause(s) of identified deficiencies, indicate practices that the firm can support or apply more extensively (e.g., across all engagements) or highlight opportunities for the firm to enhance the system of quality management.

A159. The firm exercises professional judgment in determining whether findings, individually or in combination with other findings give rise to a deficiency in the system of quality management. In making the judgment, the firm may need to take into account the relative importance of the findings in the context of the quality objectives, quality risks, responses or other aspects of the system of quality management to which they relate. The firm's judgments may be affected by quantitative and qualitative factors relevant to the findings. In some circumstances, the firm may determine it appropriate to obtain more information about the findings in order to determine whether a deficiency exists. Not all findings, including engagement findings, will be a deficiency.

A160. *Examples of quantitative and qualitative factors that a firm may consider in determining whether findings give rise to a deficiency*

Quality Risks and Responses

- If the findings relate to a response:
  - How the response is designed, for example, the nature of the response, the frequency of its occurrence (if applicable), and the relative importance of the response to addressing the quality risk(s) and achieving the quality objective(s) to which it relates.
  - The nature of the quality risk to which the response relates, and the extent to which the findings indicate that the quality risk has not been addressed.
  - Whether there are other responses that address the same quality risk and whether there are findings for those responses.

Nature of the Findings and Their Pervasiveness

- The nature of the findings. For example, findings related to leadership actions and behaviors may be qualitatively significant, given the pervasive effect this could have on the system of quality management as a whole.
- Whether the findings, in combination with other findings, indicate a trend or systemic issue. For example, similar engagement findings that appear on multiple engagements may indicate a systemic issue.

Extent of Monitoring Activity and Extent of Findings

- The extent of the monitoring activity from which the findings arose, including the number or size of the selections.
- The extent of the findings in relation to the selection covered by the monitoring activity, and in relation to the expected deviation rate. For example, in the case of inspection of engagements, the number of engagements selected where the findings were identified, relative to the total number of engagements selected, and the expected deviation rate set by the firm.

A161. Evaluating findings and identifying deficiencies and evaluating the severity and pervasiveness of an identified deficiency, including investigating the root cause(s) of an identified deficiency, are part of an iterative and non-linear process.

*Examples of how the process of evaluating findings and identifying deficiencies, evaluating identified deficiencies, including investigating the root cause(s) of identified deficiencies, is iterative and non-linear*

- In investigating the root cause(s) of an identified deficiency, the firm may identify a circumstance that has similarities to other circumstances where there were findings that were not considered a deficiency. As a result, the firm adjusts its evaluation of the other findings and classifies them as a deficiency.
- In evaluating the severity and pervasiveness of an identified deficiency, the firm may identify a trend or systemic issue that correlates with other findings that are not considered deficiencies. As a result, the firm adjusts its evaluation of the other findings and also classifies them as deficiencies.

A162. The results of monitoring activities, results of external inspections and other relevant information (e.g., network monitoring activities or complaints and allegations) may reveal information about the effectiveness of the monitoring

and remediation process. For example, the results of external inspections may provide information about the system of quality management that has not been identified by the firm's monitoring and remediation process, which may highlight a deficiency in that process.

*Evaluating Identified Deficiencies* (Ref: Para. 41)

A163. Factors the firm may consider in evaluating the severity and pervasiveness of an identified deficiency include:

- The nature of the identified deficiency, including the aspect of the firm's system of quality management to which the deficiency relates, and whether the deficiency is in the design, implementation or operation of the system of quality management;
- In the case of identified deficiencies related to responses, whether there are compensating responses to address the quality risk to which the response relates;
- The root cause(s) of the identified deficiency;
- The frequency with which the matter giving rise to the identified deficiency occurred; and
- The magnitude of the identified deficiency, how quickly it occurred and the duration of time that it existed and had an effect on the system of quality management.

A164. The severity and pervasiveness of identified deficiencies affects the evaluation of the system of quality management that is undertaken by the individual(s) assigned ultimate responsibility and accountability for the system of quality management.

*Root Cause of the Identified Deficiencies* (Ref: Para. 41(a))

A165. The objective of investigating the root cause(s) of identified deficiencies is to understand the underlying circumstances that caused the deficiencies to enable the firm to:

- Evaluate the severity and pervasiveness of the identified deficiency; and
- Appropriately remediate the identified deficiency.

Performing a root cause analysis involves those performing the assessment exercising professional judgment based on the evidence available.

A166. The nature, timing and extent of the procedures undertaken to understand the root cause(s) of an identified deficiency may also be affected by the nature and circumstances of the firm, such as:

- The complexity and operating characteristics of the firm.
- The size of the firm.
- The geographical dispersion of the firm.
- How the firm is structured or the extent to which the firm concentrates or centralizes its processes or activities.

*Examples of how the nature of identified deficiencies and their possible severity and the nature and circumstances of the firm may affect the nature, timing and extent of the procedures to understand the root cause(s) of the identified deficiencies*

- The nature of the identified deficiency: The firm's procedures to understand the root cause(s) of an identified deficiency may be more rigorous in circumstances when an engagement report related to an audit of financial statements of a listed entity was issued that was inappropriate or the identified deficiency relates to leadership's actions and behaviors regarding quality.
- The possible severity of the identified deficiency: The firm's procedures to understand the root cause(s) of an identified deficiency may be more rigorous in circumstances when the deficiency has been identified across multiple engagements or there is an indication that policies or procedures have high rates of non-compliance.
- Nature and circumstances of the firm:
  - In the case of a less complex firm with a single location, the firm's procedures to understand the root cause(s) of an identified deficiency may be simple, since the information to inform the understanding may be readily available and concentrated, and the root cause(s) may be more apparent.
  - In the case of a more complex firm with multiple locations, the procedures to understand the root cause(s) of an identified deficiency may include using individuals specifically trained on investigating the root cause(s) of identified deficiencies, and developing a methodology with more formalized procedures for identifying root cause(s).

A167. In investigating the root cause(s) of identified deficiencies, the firm may consider why deficiencies did not arise in other circumstances that are of a similar nature to the matter to which the identified deficiency relates. Such information may also be useful in determining how to remediate an identified deficiency.

*Example of when a deficiency did not arise in other circumstances of a similar nature, and how this information assists the firm in investigating the root cause(s) of identified deficiencies*

The firm may determine that a deficiency exists because similar findings have occurred across multiple engagements. However, the findings have not occurred in several other engagements within the same population being tested. By contrasting the engagements, the firm concludes that the root cause of the identified deficiency is a lack of appropriate involvement by the engagement partners at key stages of the engagements.

A168. Identifying a root cause(s) that is appropriately specific may support the firm's process for remediating identified deficiencies.

*Example of identifying a root cause(s) that is appropriately specific*

The firm may identify that engagement teams performing audits of financial statements are failing to obtain sufficient appropriate audit evidence on accounting estimates where management's assumptions have a high degree of subjectivity. While the firm notes that these engagement teams are not exercising appropriate professional skepticism, the underlying root cause of this issue may relate to another matter, such as a cultural environment that does not encourage engagement team members to question individuals with greater authority or insufficient direction, supervision and review of the work performed on the engagements.

A169. In addition to investigating the root cause(s) of identified deficiencies, the firm may also investigate the root cause(s) of positive outcomes as doing so may reveal opportunities for the firm to improve, or further enhance, the system of quality management.

*Responding to Identified Deficiencies (Ref: Para. 42)*

A170. The nature, timing and extent of remedial actions may depend on a variety of other factors, including:

- The root cause(s).
- The severity and pervasiveness of the identified deficiency and therefore the urgency with which it needs to be addressed.
- The effectiveness of the remedial actions in addressing the root cause(s), such as whether the firm needs to implement more than one remedial action in order to effectively address the root cause(s), or needs to implement remedial actions as interim measures until the firm is able to implement more effective remedial actions.

A171. In some circumstances, the remedial action may include establishing additional quality objectives, or quality risks or responses may be added or modified, because it is determined that they are not appropriate.

A172. In circumstances when the firm determines that the root cause of an identified deficiency relates to a resource provided by a service provider, the firm may also:

- Consider whether to continue using the resource provided by the service provider.
- Communicate the matter to the service provider.

The firm is responsible for addressing the effect of the identified deficiency related to a resource provided by a service provider on the system of quality management and taking action to prevent the deficiency from recurring with respect to the firm's system of quality management. However, the firm is not ordinarily responsible for remediating the identified deficiency on behalf of the service provider or further investigating the root cause of the identified deficiency at the service provider.

#### Findings About a Particular Engagement (Ref: Para. 45)

A173. In circumstances when procedures were omitted or the report issued is inappropriate, the action taken by the firm may include:

- Consulting with appropriate individuals regarding the appropriate action.
- Discussing the matter with management of the entity or those charged with governance.
- Performing the omitted procedures.

The actions taken by the firm do not relieve the firm of the responsibility to take further actions relating to the finding in the context of the system of quality management, including evaluating the findings to identify deficiencies and when a deficiency exists, investigating the root cause(s) of the identified deficiency.

#### *Ongoing Communication Related to the Monitoring and Remediation* (Ref: Para. 46)

A174. The information communicated about the monitoring and remediation to the individual(s) assigned ultimate responsibility and accountability for the system of quality management may be communicated on an ongoing basis or periodically. The individual(s) may use the information in multiple ways, for example:

- As a basis for further communications to personnel about the importance of quality.
- To hold individuals accountable for their roles assigned to them.
- To identify key concerns about the system of quality management in a timely manner.

The information also provides a basis for the evaluation of the system of quality management, and conclusion thereon, as required by paragraphs 53–54.

**Network Requirements or Network Services** (Ref: Para. 48)

A175. In some circumstances, the firm may belong to a network. Networks may establish requirements regarding the firm’s system of quality management or may make services or resources available that the firm may choose to implement or use in the design, implementation and operation of its system of quality management. Such requirements or services may be intended to promote the consistent performance of quality engagements across the firms that belong to the network. The extent to which the network will provide the firm with quality objectives, quality risks and responses that are common across the network will depend on the firm’s arrangements with the network.

*Examples of network requirements*

- Requirements for the firm to include additional quality objectives or quality risks in the firm’s system of quality management that are common across the network firms.
- Requirements for the firm to include responses in the firm’s system of quality management that are common across the network firms. Such responses designed by the network may include network policies or procedures that specify the leadership roles and responsibilities, including how the firm is expected to assign authority and responsibility within the firm, or resources, such as network developed methodologies for the performance of engagements or IT applications.
- Requirements that the firm be subject to the network’s monitoring activities. These monitoring activities may relate to network requirements (e.g., monitoring that the firm has implemented the network’s methodology appropriately), or to the firm’s system of quality management in general.

*Examples of network services*

- Services or resources that are optional for the firm to use in its system of quality management or in the performance of engagements, such as voluntary training programs, use of component auditors or experts from within the network, or use of a service delivery center established at the network level, or by another network firm or group of network firms.

A176. The network may establish responsibilities for the firm in implementing the network requirements or network services.

*Examples of responsibilities for the firm in implementing network requirements or network services*

- The firm is required to have certain IT infrastructure and IT processes in place to support an IT application provided by the network that the firm uses in the system of quality management.
- The firm is required to provide firm-wide training on the methodology provided by the network, including when updates are made to the methodology.

A177. The firm's understanding of the network requirements or network services and the firm's responsibilities relating to the implementation thereof may be obtained through inquiries of, or documentation provided by, the network about matters such as:

- The network's governance and leadership.
- The procedures undertaken by the network in designing, implementing and, if applicable, operating, the network requirements or network services.
- How the network identifies and responds to changes that affect the network requirements or network services or other information, such as changes in the professional standards or information that indicates a deficiency in the network requirements or network services.
- How the network monitors the appropriateness of the network requirements or network services, which may include through the network firms' monitoring activities, and the network's processes for remediating identified deficiencies.

*Network Requirements or Network Services in the Firm's System of Quality Management (Ref: Para. 49)*

A178. The characteristics of the network requirements or network services are a condition, event, circumstance, action or inaction in identifying and assessing quality risks.

*Example of a network requirement or network service that gives rise to a quality risk*

The network may require the firm to use an IT application for the acceptance and continuance of client relationships and specific engagements that is standardized across the network. This may give rise to a quality risk that the IT application does not address matters in local law or regulation that need to be considered by the firm in accepting and continuing client relationships and specific engagements.

A179. The purpose of the network requirements may include the promotion of consistent performance of quality engagements across the network firms. The firm may be expected by the network to implement the network requirements, however, the firm may need to adapt or supplement the network requirements such that they are appropriate for the nature and circumstances of the firm and its engagements.

<i>Examples of how the network requirements or networks services may need to be adapted or supplemented</i>	
Network Requirement or Network Service	How the Firm Adapts or Supplements the Network Requirement or Network Service
The network requires the firm to include certain quality risks in the system of quality management, so that all firms in the network address the quality risks.	<p>As part of identifying and assessing quality risks, the firm includes the quality risks that are required by the network.</p> <p>The firm also designs and implements responses to address the quality risks that are required by the network.</p>
The network requires that the firm design and implement certain responses.	<p>As part of designing and implementing responses, the firm determines:</p> <ul style="list-style-type: none"> <li>● Which quality risks the responses address.</li> <li>● How the responses required by the network will be incorporated into the firm's system of quality management, given the nature and circumstances of the firm. This may include tailoring the response to reflect the nature and circumstances of the firm and its engagements (e.g., tailoring a methodology to include matters related to law or regulation).</li> </ul>

<p>The firm uses individuals from other network firms as component auditors. Network requirements are in place that drive a high degree of commonality across the network firms' systems of quality management. The network requirements include specific criteria that apply to individuals assigned to work on a component for a group audit.</p>	<p>The firm establishes policies or procedures that require the engagement team to confirm with the component auditor (i.e., the other network firm) that the individuals assigned to the component meet the specific criteria set out in the network requirements.</p>
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A180. In some circumstances, in adapting or supplementing the network requirements or network services, the firm may identify possible improvements to the network requirements or network services and may communicate these improvements to the network.

*Monitoring Activities Undertaken by the Network on the Firm's System of Quality Management* (Ref: Para. 50(c))

A181. The results of the network's monitoring activities of the firm's system of quality management may include information such as:

- A description of the monitoring activities, including their nature, timing and extent;
- Findings, identified deficiencies, and other observations about the firm's system of quality management (e.g., positive outcomes or opportunities for the firm to improve, or further enhance, the system of quality management); and
- The network's evaluation of the root cause(s) of the identified deficiencies, the assessed effect of the identified deficiencies and recommended remedial actions.

*Monitoring Activities Undertaken by the Network Across the Network Firms* (Ref: Para. 51(b))

A182. The information from the network about the overall results of the network's monitoring activities undertaken across the network firms' systems of quality management may be an aggregation or summary of the information described in paragraph A181, including trends and common areas of identified deficiencies across the network, or positive outcomes that may be replicated across the network. Such information may:

- Be used by the firm:
  - In identifying and assessing quality risks.

- As part of other relevant information considered by the firm in determining whether deficiencies exist in the network requirements or network services used by the firm in its system of quality management.
- Be communicated to group engagement partners, in the context of considering the competence and capabilities of component auditors from a network firm who are subject to common network requirements (e.g., common quality objectives, quality risks and responses).

A183. In some circumstances, the firm may obtain information from the network about deficiencies identified in a network firm's system of quality management that affects the firm. The network may also gather information from network firms regarding the results of external inspections over network firms' systems of quality management. In some instances, law or regulation in a particular jurisdiction may prevent the network from sharing information with other network firms or may restrict the specificity of such information.

A184. In circumstances when the network does not provide the information about the overall results of the network's monitoring activities across the network firms, the firm may take further actions, such as:

- Discussing the matter with the network; and
- Determining the effect on the firm's engagements, and communicating the effect to engagement teams.

*Deficiencies in Network Requirements or Network Services Identified by the Firm*  
(Ref: Para. 52)

A185. As network requirements or network services used by the firm form part of the firm's system of quality management, they are also subject to the requirements of this ISQM regarding monitoring and remediation. The network requirements or network services may be monitored by the network, the firm, or a combination of both.

*Example of when a network requirement or network service is monitored by both the network and the firm*

A network may undertake monitoring activities at a network level for a common methodology. The firm also monitors the application of the methodology by engagement team members through performing engagement inspections.

A186. In designing and implementing the remedial actions to address the effect of the identified deficiency in the network requirements or network services, the firm may:

- Understand the planned remedial actions by the network, including whether the firm has any responsibilities for implementing the remedial actions; and
- Consider whether supplementary remedial actions need to be taken by the firm to address the identified deficiency and the related root cause(s), such as when:

- The network has not taken appropriate remedial actions; or
- The network's remedial actions will take time to effectively address the identified deficiency.

**Evaluating the System of Quality Management (Ref: Para. 53)**

A187. The individual(s) assigned ultimate responsibility and accountability for the system of quality management may be assisted by other individuals in performing the evaluation. Nevertheless, the individual(s) assigned ultimate responsibility and accountability for the system of quality management remains responsible and accountable for the evaluation.

A188. The point in time at which the evaluation is undertaken may depend on the circumstances of the firm, and may coincide with the fiscal year end of the firm or the completion of an annual monitoring cycle.

A189. The information that provides the basis for the evaluation of the system of quality management includes the information communicated to the individual(s) assigned ultimate responsibility and accountability for the system of quality management in accordance with paragraph 46.

*Scalability examples to demonstrate how the information that provides the basis for the evaluation of the system of quality management may be obtained*

- In a less complex firm, the individual(s) assigned ultimate responsibility and accountability for the system of quality management may be directly involved in the monitoring and remediation and will therefore be aware of the information that supports the evaluation of the system of quality management.
- In a more complex firm, the individual(s) assigned ultimate responsibility and accountability for the system of quality management may need to establish processes to collate, summarize and communicate the information needed to evaluate the system of quality management.

*Concluding on the System of Quality Management (Ref: Para. 54)*

A190. In the context of this ISQM, it is intended that the operation of the system as a whole provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved. In concluding on the system of quality management, the individual(s) assigned ultimate responsibility and accountability for the system of quality management may, in using the results of the monitoring and remediation process, consider the following:

- The severity and pervasiveness of identified deficiencies, and the effect on the achievement of the objectives of the system of quality management;

- Whether remedial actions have been designed and implemented by the firm, and whether the remedial actions taken up to the time of the evaluation are effective; and
- Whether the effect of identified deficiencies on the system of quality management have been appropriately corrected, such as whether further actions have been taken in accordance with paragraph 45.

A191. There may be circumstances when identified deficiencies that are severe (including identified deficiencies that are severe and pervasive) have been appropriately remediated and the effect of them corrected at the point in time of the evaluation. In such cases, the individual(s) assigned ultimate responsibility and accountability for the system of quality management may conclude that the system of quality management provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved.

A192. An identified deficiency may have a pervasive effect on the design, implementation and operation of the system of quality management when, for example:

- The deficiency affects several components or aspects of the system of quality management.
- The deficiency is confined to a specific component or aspect of the system of quality management, but is fundamental to the system of quality management.
- The deficiency affects several business units or geographical locations of the firm.
- The deficiency is confined to a business unit or geographical location, but the business unit or location affected is fundamental to the firm overall.
- The deficiency affects a substantial portion of engagements that are of a certain type or nature.

*Example of an identified deficiency that may be considered severe but not pervasive*

The firm identifies a deficiency in a smaller regional office of the firm. The identified deficiency relates to non-compliance with many firm policies or procedures. The firm determines that the culture in the regional office, particularly the actions and behavior of leadership in the regional office which were overly focused on financial priorities, has contributed to the root cause of the identified deficiency. The firm determines that the effect of the identified deficiency is:

- Severe, because it relates to the culture of the regional office and overall compliance with firm policies or procedures; and
- Not pervasive, because it is limited to the smaller regional office.

A193. The individual(s) assigned ultimate responsibility and accountability for the system of quality management may conclude that the system of quality management does not provide the firm with reasonable assurance that the objectives of the system of quality management are being achieved in circumstances when identified deficiencies are severe and pervasive, actions taken to remediate the identified deficiencies are not appropriate, and the effect of the identified deficiencies have not been appropriately corrected.

*Example of an identified deficiency that may be considered severe and pervasive*

The firm identifies a deficiency in a regional office, which is the largest office of the firm and provides financial, operational and technical support for the entire region. The identified deficiency relates to non-compliance with many firm policies or procedures. The firm determines that the culture in the regional office, particularly the actions and behavior of leadership in the regional office which were overly focused on financial priorities, has contributed to the root cause of the identified deficiency. The firm determines that the effect of the identified deficiency is:

- Severe, because it relates to the culture of the regional office and overall compliance with firm policies or procedures; and
- Pervasive, because the regional office is the largest office and provides support to many other offices, and the non-compliance with firm policies or procedures may have had a broader effect on the other offices.

A194. It may take time for the firm to remediate identified deficiencies that are severe and pervasive. As the firm continues to take action to remediate the identified deficiencies, the pervasiveness of the identified deficiencies may be diminished and it may be determined that the identified deficiencies are still severe, but no longer severe and pervasive. In such cases, the individual(s) assigned ultimate responsibility and accountability for the system of quality management may conclude that, except for matters related to identified deficiencies that have a severe but not pervasive effect on the design, implementation and operation of the system of quality management, the system of quality management provides the firm with reasonable assurance that the objectives of the system of quality management are being achieved.

A195. This ISQM does not require the firm to obtain an independent assurance report on its system of quality management, or preclude the firm from doing so.

*Taking Prompt and Appropriate Action and Further Communication* (Ref: Para. 55)

A196. In circumstances when the individual(s) assigned ultimate responsibility and accountability for the system of quality management reaches the conclusion described in paragraph 54(b) or 54(c), the prompt and appropriate action taken by the firm may include:

- Taking measures to support the performance of engagements through assigning more resources or developing more guidance and to confirm that reports issued by the firm are appropriate in the circumstances, until such time as the identified deficiencies are remediated, and communicating such measures to engagement teams.
- Obtaining legal advice.

A197. In some circumstances the firm may have an independent governing body that has non-executive oversight of the firm. In such circumstances, communications may include informing the independent governing body.

A198. *Examples of circumstances when it may be appropriate for the firm to communicate to external parties about the evaluation of the system of quality management*

- When the firm belongs to a network.
- When other network firms use the work performed by the firm, for example, in the case of a group audit.
- When a report issued by the firm is determined by the firm to be inappropriate as a result of the failure of the system of quality management, and management or those charged with governance of the entity need to be informed.
- When law or regulation requires the firm to communicate to an oversight authority or a regulatory body.

*Performance Evaluations* (Ref: Para. 56)

A199. Periodic performance evaluations promote accountability. In considering the performance of an individual, the firm may take into account:

- The results of the firm's monitoring activities for aspects of the system of quality management that relate to the responsibility of the individual. In some circumstances, the firm may set targets for the individual and measure the results of the firm's monitoring activities against those targets.
- The actions taken by the individual in response to identified deficiencies that relate to the responsibility of that individual, including the timeliness and effectiveness of such actions.

*Scalability examples to demonstrate how the firm may undertake the performance evaluations*

- In a less complex firm, the firm may engage a service provider to perform the evaluation, or the results of the firm's monitoring activities may provide an indication of the performance of the individual.
- In a more complex firm, the performance evaluations may be undertaken by an independent non-executive member of the firm's governing body, or a special committee overseen by the firm's governing body.

A200. A positive performance evaluation may be rewarded through compensation, promotion and other incentives that focus on the individual's commitment to quality, and reinforce accountability. On the other hand, the firm may take corrective actions to address a negative performance evaluation that may affect the firm's achievement of its quality objectives.

#### Public Sector Considerations

A201. In the case of the public sector, it may not be practicable to perform a performance evaluation of the individual(s) assigned ultimate responsibility and accountability for the system of quality management, or to take actions to address the results of the performance evaluation, given the nature of the individual's appointment. Nevertheless, performance evaluations may still be undertaken for other individuals in the firm who are assigned operational responsibility for aspects of the system of quality management.

#### Documentation (Ref: Para. 57–59)

A202. Documentation provides evidence that the firm complies with this ISQM, as well as law, regulation or relevant ethical requirements. It may also be useful for training personnel and engagement teams, ensuring the retention of organizational knowledge and providing a history of the basis for decisions made by the firm about its system of quality management. It is neither necessary nor practicable for the firm to document every matter considered, or judgment made, about its system of quality management. Furthermore, compliance with this ISQM may be evidenced by the firm through its information and communication component, documents or other written materials, or IT applications that are integral to the components of the system of quality management.

A203. Documentation may take the form of formal written manuals, checklists and forms, may be informally documented (e.g., e-mail communication or postings on websites), or may be held in IT applications or other digital forms (e.g., in databases). Factors that may affect the firm's judgments about the form, content and extent of documentation, including how often documentation is updated, may include:

- The complexity of the firm and the number of offices;
- The nature and complexity of the firm's practice and organization;
- The nature of engagements the firm performs and the nature of the entities for whom engagements are performed;
- The nature and complexity of the matter being documented, such as whether it relates to an aspect of the system of quality management that has changed or an area of greater quality risk, and the complexity of the judgments relating to the matter; and
- The frequency and extent of changes in the system of quality management.

In a less complex firm, it may not be necessary to have documentation supporting matters communicated because informal communication methods may be effective. Nevertheless, a less complex firm may determine it appropriate to document such communications in order to provide evidence that they occurred.

A204. In some instances, an external oversight authority may establish documentation requirements, either formally or informally, for example, as a result of the outcome of external inspection findings. Relevant ethical requirements may also include specific requirements addressing documentation, for example, the IESBA Code requires documentation of particular matters, including certain situations related to conflicts of interest, non-compliance with laws and regulations and independence.

A205. The firm is not required to document the consideration of every condition, event, circumstance, action or inaction for each quality objective, or each risk that may give rise to a quality risk. However, in documenting the quality risks and how the firm's responses address the quality risks, the firm may document the reasons for the assessment given to the quality risks (i.e., the considered occurrence and effect on the achievement of one or more quality objectives), in order to support the consistent implementation and operation of the responses.

A206. The documentation may be provided by the network, other network firms, or other structures or organizations within the network.

# INTERNATIONAL STANDARD ON QUALITY MANAGEMENT 2

## ENGAGEMENT QUALITY REVIEWS

(Effective for audits and reviews of financial statements for periods beginning on or after December 15, 2022; and effective for other assurance and related services engagements beginning on or after December 15, 2022)

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International Standard on Quality Management (ISQM) 2, *Engagement Quality Reviews*, should be read in conjunction with ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*.

## Introduction

### Scope of this ISQM

1. This International Standard on Quality Management (ISQM) deals with:
  - (a) The appointment and eligibility of the engagement quality reviewer; and
  - (b) The engagement quality reviewer's responsibilities relating to the performance and documentation of an engagement quality review.
2. This ISQM applies to all engagements for which an engagement quality review is required to be performed in accordance with ISQM 1.<sup>1</sup> This ISQM is premised on the basis that the firm is subject to ISQM 1 or to national requirements that are at least as demanding. This ISQM is to be read in conjunction with relevant ethical requirements.
3. An engagement quality review performed in accordance with this ISQM is a specified response that is designed and implemented by the firm in accordance with ISQM 1.<sup>2</sup> The performance of an engagement quality review is undertaken at the engagement level by the engagement quality reviewer on behalf of the firm.

### *Scalability*

4. The nature, timing and extent of the engagement quality reviewer's procedures required by this ISQM vary depending on the nature and circumstances of the engagement or the entity. For example, the engagement quality reviewer's procedures would likely be less extensive for engagements involving fewer significant judgments made by the engagement team.

### **The Firm's System of Quality Management and Role of Engagement Quality Reviews**

5. ISQM 1 establishes the firm's responsibilities for its system of quality management and requires the firm to design and implement responses to address the quality risks in a manner that is based on, and responsive to, the reasons for the assessments given to the quality risks.<sup>3</sup> The specified responses in ISQM 1 include establishing policies or procedures addressing engagement quality reviews in accordance with this ISQM.
6. The firm is responsible for designing, implementing and operating the system of quality management. Under ISQM 1, the objective of the firm is to design, implement and operate a system of quality management for audits

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<sup>1</sup> International Standard on Quality Management (ISQM) 1 (Previously International Standard on Quality Control 1), Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements, paragraph 34(f)

<sup>2</sup> ISQM 1, paragraph 34(f)

<sup>3</sup> ISQM 1, paragraph 26

or reviews of financial statements, or other assurance or related services engagements performed by the firm, that provides the firm with reasonable assurance that:

- (a) The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and
  - (b) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.<sup>4</sup>
7. As explained in ISQM 1,<sup>5</sup> the public interest is served by the consistent performance of quality engagements. Quality engagements are achieved through planning and performing engagements and reporting on them in accordance with professional standards and applicable legal and regulatory requirements. Achieving the objectives of those standards and complying with the requirements of applicable law or regulation involves exercising professional judgment and, when applicable to the type of engagement, exercising professional skepticism.
8. An engagement quality review is an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon. The engagement quality reviewer's evaluation of significant judgments is performed in the context of professional standards and applicable legal and regulatory requirements. However, an engagement quality review is not intended to be an evaluation of whether the entire engagement complies with professional standards and applicable legal and regulatory requirements, or with the firm's policies or procedures.
9. The engagement quality reviewer is not a member of the engagement team. The performance of an engagement quality review does not change the responsibilities of the engagement partner for managing and achieving quality on the engagement, or for the direction and supervision of the members of the engagement team and the review of their work. The engagement quality reviewer is not required to obtain evidence to support the opinion or conclusion on the engagement, but the engagement team may obtain further evidence in responding to matters raised during the engagement quality review.

### Authority of this ISQM

10. This ISQM contains the objective for the firm in following this ISQM, and requirements designed to enable the firm and the engagement quality reviewer to meet that stated objective. In addition, this ISQM contains related guidance in the form of application and other explanatory material and introductory

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<sup>4</sup> ISQM 1, paragraph 14

<sup>5</sup> ISQM 1, paragraph 15

material that provides context relevant to a proper understanding of this ISQM, and definitions. ISQM 1<sup>6</sup> explains the terms objective, requirements, application and other explanatory material, introductory material, and definitions.

### Effective Date

11. This ISQM is effective for:
- (a) Audits and reviews of financial statements for periods beginning on or after December 15, 2022; and
  - (b) Other assurance and related services engagements beginning on or after December 15, 2022.

### Objective

12. The objective of the firm, through appointing an eligible engagement quality reviewer, is to perform an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon.

### Definitions

13. For purposes of this ISQM, the following terms have the meanings attributed below:
- (a) Engagement quality review – An objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed on or before the date of the engagement report.
  - (b) Engagement quality reviewer – A partner, other individual in the firm, or an external individual, appointed by the firm to perform the engagement quality review.
  - (c) Relevant ethical requirements – Principles of professional ethics and ethical requirements that are applicable to a professional accountant when undertaking the engagement quality review. Relevant ethical requirements ordinarily comprise the provisions of the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) related to audits or reviews of financial statements, or other assurance or related services engagements, together with national requirements that are more restrictive. (Ref: Para. A12–A15)

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<sup>6</sup> ISQM 1, paragraphs 12 and A6–A9

## Requirements

### Applying, and Complying with, Relevant Requirements

14. The firm and the engagement quality reviewer shall have an understanding of this ISQM, including the application and other explanatory material, to understand the objective of this ISQM and to properly apply the requirements relevant to them.
15. The firm or the engagement quality reviewer, as applicable, shall comply with each requirement of this ISQM, unless the requirement is not relevant in the circumstances of the engagement.
16. The proper application of the requirements is expected to provide a sufficient basis for the achievement of the objective of this standard. However, if the firm or the engagement quality reviewer determines that the application of the relevant requirements does not provide a sufficient basis for the achievement of the objective of this standard, the firm or the engagement quality reviewer, as applicable, shall take further actions to achieve the objective.

### Appointment and Eligibility of Engagement Quality Reviewers

17. The firm shall establish policies or procedures that require the assignment of responsibility for the appointment of engagement quality reviewers to an individual(s) with the competence, capabilities and appropriate authority within the firm to fulfill the responsibility. Those policies or procedures shall require such individual(s) to appoint the engagement quality reviewer. (Ref: Para. A1–A3)
18. The firm shall establish policies or procedures that set forth the criteria for eligibility to be appointed as an engagement quality reviewer. Those policies or procedures shall require that the engagement quality reviewer not be a member of the engagement team, and: (Ref: Para. A4)
  - (a) Has the competence and capabilities, including sufficient time, and the appropriate authority to perform the engagement quality review; (Ref: Para. A5–A11)
  - (b) Complies with relevant ethical requirements, including in relation to threats to objectivity and independence of the engagement quality reviewer; and (Ref: Para. A12–A15)
  - (c) Complies with provisions of law and regulation, if any, that are relevant to the eligibility of the engagement quality reviewer. (Ref: Para. A16)
19. The firm's policies or procedures established in accordance with paragraph 18(b) shall also address threats to objectivity created by an individual being appointed as an engagement quality reviewer after previously serving as the engagement partner. Such policies or procedures shall specify a cooling-off period of two years, or a longer period if required by relevant ethical requirements, before the

engagement partner can assume the role of engagement quality reviewer. (Ref: Para. A17–A18)

20. The firm shall establish policies or procedures that set forth the criteria for eligibility of individuals who assist the engagement quality reviewer. Those policies or procedures shall require that such individuals not be members of the engagement team, and:
  - (a) Have the competence and capabilities, including sufficient time, to perform the duties assigned to them; and (Ref: Para. A19)
  - (b) Comply with relevant ethical requirements, including in relation to threats to their objectivity and independence and, if applicable, the provisions of law and regulation. (Ref: Para. A20–A21)
21. The firm shall establish policies or procedures that:
  - (a) Require the engagement quality reviewer to take overall responsibility for the performance of the engagement quality review; and
  - (b) Address the engagement quality reviewer’s responsibility for determining the nature, timing and extent of the direction and supervision of the individuals assisting in the review, and the review of their work. (Ref: Para. A22)

*Impairment of the Engagement Quality Reviewer’s Eligibility to Perform the Engagement Quality Review*

22. The firm shall establish policies or procedures that address circumstances in which the engagement quality reviewer’s eligibility to perform the engagement quality review is impaired and the appropriate actions to be taken by the firm, including the process for identifying and appointing a replacement in such circumstances. (Ref: Para. A23)
23. When the engagement quality reviewer becomes aware of circumstances that impair the engagement quality reviewer’s eligibility, the engagement quality reviewer shall notify the appropriate individual(s) in the firm, and: (Ref: Para. A24)
  - (a) If the engagement quality review has not commenced, decline the appointment to perform the engagement quality review; or
  - (b) If the engagement quality review has commenced, discontinue the performance of the engagement quality review.

**Performance of the Engagement Quality Review**

24. The firm shall establish policies or procedures regarding the performance of the engagement quality review that address:
  - (a) The engagement quality reviewer’s responsibilities to perform procedures in accordance with paragraphs 25–26 at appropriate points in time

during the engagement to provide an appropriate basis for an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon;

- (b) The responsibilities of the engagement partner in relation to the engagement quality review, including that the engagement partner is precluded from dating the engagement report until notification has been received from the engagement quality reviewer in accordance with paragraph 27 that the engagement quality review is complete; and (Ref: Para. A25–A26)
  - (c) Circumstances when the nature and extent of engagement team discussions with the engagement quality reviewer about a significant judgment give rise to a threat to the objectivity of the engagement quality reviewer, and appropriate actions to take in these circumstances. (Ref: Para. A27)
25. In performing the engagement quality review, the engagement quality reviewer shall: (Ref: Para. A28–A33)
- (a) Read, and obtain an understanding of, information communicated by: (Ref: Para. A34)
    - (i) The engagement team regarding the nature and circumstances of the engagement and the entity; and
    - (ii) The firm related to the firm’s monitoring and remediation process, in particular identified deficiencies that may relate to, or affect, the areas involving significant judgments made by the engagement team.
  - (b) Discuss with the engagement partner and, if applicable, other members of the engagement team, significant matters and significant judgments made in planning, performing and reporting on the engagement. (Ref: Para. A35–A38)
  - (c) Based on the information obtained in (a) and (b), review selected engagement documentation relating to the significant judgments made by the engagement team and evaluate: (Ref: Para. A39–A43)
    - (i) The basis for making those significant judgments, including, when applicable to the type of engagement, the exercise of professional skepticism by the engagement team;
    - (ii) Whether the engagement documentation supports the conclusions reached; and
    - (iii) Whether the conclusions reached are appropriate.
  - (d) For audits of financial statements, evaluate the basis for the engagement partner’s determination that relevant ethical requirements relating to independence have been fulfilled. (Ref: Para. A44)

- (e) Evaluate whether appropriate consultation has taken place on difficult or contentious matters or matters involving differences of opinion and the conclusions arising from those consultations. (Ref: Para. A45)
- (f) For audits of financial statements, evaluate the basis for the engagement partner's determination that the engagement partner's involvement has been sufficient and appropriate throughout the audit engagement such that the engagement partner has the basis for determining that the significant judgments made and the conclusions reached are appropriate given the nature and circumstances of the engagement. (Ref: Para. A46)
- (g) Review:
  - (i) For audits of financial statements, the financial statements and the auditor's report thereon, including, if applicable, the description of the key audit matters; (Ref: Para. A47)
  - (ii) For review engagements, the financial statements or financial information and the engagement report thereon; or (Ref: Para. A47)
  - (iii) For other assurance and related services engagements, the engagement report, and when applicable, the subject matter information. (Ref: Para. A48)

26. The engagement quality reviewer shall notify the engagement partner if the engagement quality reviewer has concerns that the significant judgments made by the engagement team, or the conclusions reached thereon, are not appropriate. If such concerns are not resolved to the engagement quality reviewer's satisfaction, the engagement quality reviewer shall notify an appropriate individual(s) in the firm that the engagement quality review cannot be completed. (Ref: Para. A49)

*Completion of the Engagement Quality Review*

27. The engagement quality reviewer shall determine whether the requirements in this ISQM with respect to the performance of the engagement quality review have been fulfilled, and whether the engagement quality review is complete. If so, the engagement quality reviewer shall notify the engagement partner that the engagement quality review is complete.

**Documentation**

28. The firm shall establish policies or procedures that require the engagement quality reviewer to take responsibility for documentation of the engagement quality review. (Ref: Para. A50)

29. The firm shall establish policies or procedures that require documentation of the engagement quality review in accordance with paragraph 30, and that such documentation be included with the engagement documentation.

30. The engagement quality reviewer shall determine that the documentation of the engagement quality review is sufficient to enable an experienced practitioner, having no previous connection with the engagement, to understand the nature, timing and extent of the procedures performed by the engagement quality reviewer and, when applicable, individuals who assisted the reviewer, and the conclusions reached in performing the review. The engagement quality reviewer also shall determine that the documentation of the engagement quality review includes: (Ref: Para. A51–A53)
- (a) The names of the engagement quality reviewer and individuals who assisted with the engagement quality review;
  - (b) An identification of the engagement documentation reviewed;
  - (c) The basis for the engagement quality reviewer’s determination in accordance with paragraph 27;
  - (d) The notifications required in accordance with paragraphs 26 and 27; and
  - (e) The date of completion of the engagement quality review.

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## **Application and Other Explanatory Material**

### **Appointment and Eligibility of Engagement Quality Reviewers**

*Assignment of Responsibility for the Appointment of Engagement Quality Reviewers*  
(Ref: Para. 17)

- A1. Competence and capabilities that are relevant to an individual’s ability to fulfill responsibility for the appointment of the engagement quality reviewer may include appropriate knowledge about:
- The responsibilities of an engagement quality reviewer;
  - The criteria in paragraphs 18 and 19 regarding the eligibility of engagement quality reviewers; and
  - The nature and circumstances of the engagement or the entity subject to an engagement quality review, including the composition of the engagement team.
- A2. The firm’s policies or procedures may specify that the individual responsible for the appointment of engagement quality reviewers not be a member of the engagement team for which an engagement quality review is to be performed. However, in certain circumstances (e.g., in the case of a smaller firm or a sole practitioner), it may not be practicable for an individual other than a member of the engagement team to appoint the engagement quality reviewer.

- A3. The firm may assign more than one individual to be responsible for appointing engagement quality reviewers. For example, the firm’s policies or procedures may specify a different process for appointing engagement quality reviewers for audits of listed entities than for audits of non-listed entities or other engagements, with different individuals responsible for each process.

*Eligibility of the Engagement Quality Reviewer (Ref: Para. 18)*

- A4. In some circumstances, for example, in the case of a smaller firm or a sole practitioner, there may not be a partner or other individual in the firm who is eligible to perform the engagement quality review. In these circumstances, the firm may contract with, or obtain the services of, individuals external to the firm to perform the engagement quality review. An individual external to the firm may be a partner or an employee of a network firm, a structure or an organization within the firm’s network, or a service provider. When using such an individual, the provisions in ISQM 1 addressing network requirements or network services or service providers apply.

*Eligibility Criteria for the Engagement Quality Reviewer*

Competence and Capabilities, Including Sufficient Time (Ref: Para. 18(a))

- A5. ISQM 1 describes characteristics related to competence, including the integration and application of technical competence, professional skills, and professional ethics, values and attitudes.<sup>7</sup> Matters that the firm may consider in determining that an individual has the necessary competence to perform an engagement quality review include, for example:
- An understanding of professional standards and applicable legal and regulatory requirements and of the firm’s policies or procedures relevant to the engagement;
  - Knowledge of the entity’s industry;
  - An understanding of, and experience relevant to, engagements of a similar nature and complexity; and
  - An understanding of the responsibilities of the engagement quality reviewer in performing and documenting the engagement quality review, which may be attained or enhanced by receiving relevant training from the firm.
- A6. The conditions, events, circumstances, actions or inactions considered by the firm in determining that an engagement quality review is an appropriate response to address one or more quality risk(s)<sup>8</sup> may be an important consideration in the firm’s determination of the competence and capabilities required to perform the

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<sup>7</sup> ISQM 1, paragraph A88

<sup>8</sup> ISQM 1, paragraph A134

engagement quality review for that engagement. Other considerations that the firm may take into account in determining whether the engagement quality reviewer has the competence and capabilities, including sufficient time, needed to evaluate the significant judgments made by the engagement team and the conclusions reached thereon include, for example:

- The nature of the entity.
- The specialization and complexity of the industry or regulatory environment in which the entity operates.
- The extent to which the engagement relates to matters requiring specialized expertise (e.g., with respect to information technology (IT) or specialized areas of accounting or auditing), or scientific and engineering expertise, such as may be needed for certain assurance engagements. Also see paragraph A19.

A7. In evaluating the competence and capabilities of an individual who may be appointed as an engagement quality reviewer, the findings arising from the firm's monitoring activities (e.g., findings from the inspection of engagements for which the individual was an engagement team member or engagement quality reviewer) or the results of external inspections may also be relevant considerations.

A8. A lack of appropriate competence or capabilities affects the ability of the engagement quality reviewer to exercise appropriate professional judgment in performing the review. For example, an engagement quality reviewer who lacks relevant industry experience may not possess the ability or confidence necessary to evaluate and, where appropriate, challenge significant judgments made, and the exercise of professional skepticism, by the engagement team on a complex, industry-specific accounting or auditing matter.

Appropriate Authority (Ref: Para. 18(a))

A9. Actions at the firm level help to establish the authority of the engagement quality reviewer. For example, by creating a culture of respect for the role of the engagement quality reviewer, the engagement quality reviewer is less likely to experience pressure from the engagement partner or other personnel to inappropriately influence the outcome of the engagement quality review. In some cases, the engagement quality reviewer's authority may be enhanced by the firm's policies or procedures to address differences of opinion, which may include actions the engagement quality reviewer may take when a disagreement occurs between the engagement quality reviewer and the engagement team.

A10. The authority of the engagement quality reviewer may be diminished when:

- The culture within the firm promotes respect for authority only of personnel at a higher level of hierarchy within the firm.

- The engagement quality reviewer has a reporting line to the engagement partner, for example, when the engagement partner holds a leadership position in the firm or is responsible for determining the compensation of the engagement quality reviewer.

#### Public Sector Considerations

A11. In the public sector, an auditor (e.g., an Auditor General, or other suitably qualified individual appointed on behalf of the Auditor General) may act in a role equivalent to that of the engagement partner with overall responsibility for public sector audits. In such circumstances, the selection of the engagement quality reviewer may include consideration of the need for independence and the ability of the engagement quality reviewer to provide an objective evaluation.

#### Relevant Ethical Requirements (Ref: Para. 13(c), 18(b))

A12. The relevant ethical requirements that are applicable when undertaking an engagement quality review may vary, depending on the nature and circumstances of the engagement or the entity. Various provisions of relevant ethical requirements may apply only to individual professional accountants, such as an engagement quality reviewer, and not the firm itself.

A13. Relevant ethical requirements may include specific independence requirements that would apply to individual professional accountants, such as an engagement quality reviewer. Relevant ethical requirements may also include provisions that address threats to independence created by long association with an audit or assurance client. The application of any such provisions dealing with long association is distinct from, but may need to be taken into consideration in applying, the required cooling-off period in accordance with paragraph 19.

#### Threats to the objectivity of the engagement quality reviewer

A14. Threats to the engagement quality reviewer's objectivity may be created by a broad range of facts and circumstances. For example:

- A self-review threat may be created when the engagement quality reviewer previously was involved with significant judgments made by the engagement team, in particular as the engagement partner or other engagement team member.
- A familiarity or self-interest threat may arise when the engagement quality reviewer is a close or immediate family member of the engagement partner or another member of the engagement team, or through close personal relationships with members of the engagement team.

- An intimidation threat may be created when actual or perceived pressure is exerted on the engagement quality reviewer (e.g., when the engagement partner is an aggressive or dominant individual, or the engagement quality reviewer has a reporting line to the engagement partner).

A15. Relevant ethical requirements may include requirements and guidance to identify, evaluate and address threats to objectivity. For example, the IESBA Code provides specific guidance, including examples of:

- Circumstances where threats to objectivity may be created when a professional accountant is appointed as an engagement quality reviewer;
- Factors that are relevant in evaluating the level of such threats; and
- Actions, including safeguards, that might address such threats.

Law or Regulation Relevant to the Eligibility of the Engagement Quality Reviewer  
(Ref: Para. 18(c))

A16. Law or regulation may prescribe additional requirements regarding the eligibility of the engagement quality reviewer. For example, in some jurisdictions, the engagement quality reviewer may need to possess certain qualifications or be licensed to be able to perform the engagement quality review.

*Cooling-Off Period for an Individual After Previously Serving as the Engagement Partner* (Ref: Para. 19)

A17. In recurring engagements, the matters on which significant judgments are made often do not vary. Therefore, significant judgments made in prior periods may continue to affect judgments of the engagement team in subsequent periods. The ability of an engagement quality reviewer to perform an objective evaluation of significant judgments is therefore affected when the individual was previously involved with those judgments as the engagement partner. In such circumstances, it is important that appropriate safeguards are put in place to reduce threats to objectivity, in particular the self-review threat, to an acceptable level. Accordingly, this ISQM requires the firm to establish policies or procedures that specify a cooling-off period during which the engagement partner is precluded from being appointed as the engagement quality reviewer.

A18. The firm's policies or procedures also may address whether a cooling-off period is appropriate for an individual other than the engagement partner before becoming eligible to be appointed as the engagement quality reviewer on that engagement. In this regard, the firm may consider the nature of that individual's role and previous involvement with the significant judgments made on the engagement. For example, the firm may determine that an engagement partner responsible for the performance of audit procedures on the financial information of a component in a group audit engagement may not be eligible to be appointed as the group engagement quality reviewer because of that audit partner's involvement in the significant judgments affecting the group audit engagement.

*Circumstances When the Engagement Quality Reviewer Uses Assistants* (Ref: Para. 20–21)

- A19. In certain circumstances, it may be appropriate for the engagement quality reviewer to be assisted by an individual or team of individuals with the relevant expertise. For example, highly specialized knowledge, skills or expertise may be useful for understanding certain transactions undertaken by the entity to help the engagement quality reviewer evaluate the significant judgments made by the engagement team related to those transactions.
- A20. The guidance in paragraph A14 may be helpful to the firm when establishing policies or procedures that address threats to objectivity of individuals who assist the engagement quality reviewer.
- A21. When the engagement quality reviewer is assisted by an individual external to the firm, the assistant’s responsibilities, including those related to compliance with relevant ethical requirements, may be set out in the contract or other agreement between the firm and the assistant.
- A22. The firm’s policies or procedures may include responsibilities of the engagement quality reviewer to:
- Consider whether assistants understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement quality review; and
  - Address matters raised by assistants, considering their significance and modifying the planned approach appropriately.

*Impairment of the Engagement Quality Reviewer’s Eligibility to Perform the Engagement Quality Review* (Ref: Para. 22–23)

- A23. Factors that may be relevant to the firm in considering whether the eligibility of the engagement quality reviewer to perform the engagement quality review is impaired include:
- Whether changes in the circumstances of the engagement result in the engagement quality reviewer no longer having the appropriate competence and capabilities to perform the review;
  - Whether changes in the other responsibilities of the engagement quality reviewer indicate that the individual no longer has sufficient time to perform the review; or
  - Notification from the engagement quality reviewer in accordance with paragraph 23.
- A24. In circumstances in which the engagement quality reviewer’s eligibility to perform the engagement quality review becomes impaired, the firm’s policies or procedures may set out a process by which alternative eligible individuals are identified. The firm’s policies or procedures may also address the responsibility

of the individual appointed to replace the engagement quality reviewer to perform procedures sufficient to fulfill the requirements of this ISQM with respect to the performance of the engagement quality review. Such policies or procedures may further address the need for consultation in such circumstances.

### **Performance of the Engagement Quality Review** (Ref: Para. 24–27)

#### *Engagement Partner Responsibilities in Relation to the Engagement Quality Review* (Ref: Para. 24(b))

A25. ISA 220 (Revised)<sup>9</sup> establishes the requirements for the engagement partner in audit engagements for which an engagement quality review is required, including:

- Determining that an engagement quality reviewer has been appointed;
- Cooperating with the engagement quality reviewer and informing other members of the engagement team of their responsibility to do so;
- Discussing significant matters and significant judgments arising during the audit engagement, including those identified during the engagement quality review, with the engagement quality reviewer; and
- Not dating the auditor’s report until the completion of the engagement quality review.

A26. ISAE 3000 (Revised)<sup>10</sup> also establishes requirements for the engagement partner in relation to the engagement quality review.

#### *Discussions Between the Engagement Quality Reviewer and the Engagement Team* (Ref: Para. 24(c))

A27. Frequent communication between the engagement team and engagement quality reviewer throughout the engagement may assist in facilitating an effective and timely engagement quality review. However, a threat to the objectivity of the engagement quality reviewer may be created depending on the timing and extent of the discussions with the engagement team about a significant judgment. The firm’s policies or procedures may set out the actions to be taken by the engagement quality reviewer or the engagement team to avoid situations in which the engagement quality reviewer is, or may be perceived to be, making decisions on behalf of the engagement team. For example, in these circumstances the firm may require consultation about such significant judgments with other relevant personnel in accordance with the firm’s consultation policies or procedures.

<sup>9</sup> International Standard on Auditing (ISA) 220 (Revised), *Quality Management for an Audit of Financial Statements*, paragraph 36

<sup>10</sup> International Standard on Assurance Engagements (ISAE) 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, paragraph 36

*Procedures Performed by the Engagement Quality Reviewer (Ref: Para. 25–27)*

- A28. The firm's policies or procedures may specify the nature, timing and extent of the procedures performed by the engagement quality reviewer and also may emphasize the importance of the engagement quality reviewer exercising professional judgment in performing the review.
- A29. The timing of the procedures performed by the engagement quality reviewer may depend on the nature and circumstances of the engagement or the entity, including the nature of the matters subject to the review. Timely review of the engagement documentation by the engagement quality reviewer throughout all stages of the engagement (e.g., planning, performing and reporting) allows matters to be promptly resolved to the engagement quality reviewer's satisfaction, on or before the date of the engagement report. For example, the engagement quality reviewer may perform procedures in relation to the overall strategy and plan for the engagement at the completion of the planning phase. Timely performance of the engagement quality review also may reinforce the exercise of professional judgment and, when applicable to the type of engagement, professional skepticism, by the engagement team in planning and performing the engagement.
- A30. The nature and extent of the engagement quality reviewer's procedures for a specific engagement may depend on, among other factors:
- The reasons for the assessments given to quality risks,<sup>11</sup> for example, engagements performed for entities in emerging industries or with complex transactions.
  - Identified deficiencies, and the remedial actions to address the identified deficiencies, related to the firm's monitoring and remediation process, and any related guidance issued by the firm, which may indicate areas where more extensive procedures need to be performed by the engagement quality reviewer.
  - The complexity of the engagement.
  - The nature and size of the entity, including whether the entity is a listed entity.
  - Findings relevant to the engagement, such as the results of inspections undertaken by an external oversight authority in a prior period, or other concerns raised about the quality of the work of the engagement team.
  - Information obtained from the firm's acceptance and continuance of client relationships and specific engagements.

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<sup>11</sup> ISQM 1, paragraph A49

- For assurance engagements, the engagement team’s identification and assessment of, and responses to, risks of material misstatement in the engagement.
- Whether members of the engagement team have cooperated with the engagement quality reviewer. The firm’s policies or procedures may address the actions the engagement quality reviewer takes in circumstances when the engagement team has not cooperated with the engagement quality reviewer, for example, informing an appropriate individual in the firm so appropriate action can be taken to resolve the issue.

A31. The nature, timing and extent of the engagement quality reviewer’s procedures may need to change based on circumstances encountered in performing the engagement quality review.

#### Group Audit Considerations

A32. The performance of an engagement quality review for an audit of group financial statements may involve additional considerations for the individual appointed as the engagement quality reviewer for the group audit, depending on the size and complexity of the group. Paragraph 21(a) requires the firm’s policies or procedures to require the engagement quality reviewer to take overall responsibility for the performance of the engagement quality review. In doing so, for larger and more complex group audits, the group engagement quality reviewer may need to discuss significant matters and significant judgments with key members of the engagement team other than the group engagement team (e.g., those responsible for performing audit procedures on the financial information of a component). In these circumstances, the engagement quality reviewer may be assisted by individuals in accordance with paragraph 20. The guidance in paragraph A22 may be helpful when the engagement quality reviewer for the group audit is using assistants.

A33. In some cases, an engagement quality reviewer may be appointed for an audit of an entity or business unit that is part of a group, for example, when such an audit is required by law, regulation or other reasons. In these circumstances, communication between the engagement quality reviewer for the group audit and the engagement quality reviewer for the audit of that entity or business unit may help the group engagement quality reviewer in fulfilling the responsibilities in accordance with paragraph 21(a). For example, this may be the case when the entity or business unit has been identified as a component for purposes of the group audit and significant judgments related to the group audit have been made at the component level.

#### Information Communicated by the Engagement Team and the Firm (Ref: Para. 25(a))

A34. Obtaining an understanding of information communicated by the engagement team and the firm in accordance with paragraph 25(a) may assist the engagement

quality reviewer in understanding the significant judgments that may be expected for the engagement. Such an understanding may also provide the engagement quality reviewer with a basis for discussions with the engagement team about the significant matters and significant judgments made in planning, performing and reporting on the engagement. For example, a deficiency identified by the firm may relate to significant judgments made by other engagement teams for certain accounting estimates for a particular industry. When this is the case, such information may be relevant to the significant judgments made on the engagement with respect to those accounting estimates, and therefore may provide the engagement quality reviewer with a basis for discussions with the engagement team in accordance with paragraph 25(b).

#### Significant Matters and Significant Judgments (Ref: Para. 25(b)–25(c))

- A35. For audits of financial statements, ISA 220 (Revised)<sup>12</sup> requires the engagement partner to review audit documentation relating to significant matters<sup>13</sup> and significant judgments, including those relating to difficult or contentious matters identified during the engagement, and the conclusions reached.
- A36. For audits of financial statements, ISA 220 (Revised)<sup>14</sup> provides examples of significant judgments that may be identified by the engagement partner related to the overall audit strategy and audit plan for undertaking the engagement, the execution of the engagement and the overall conclusions reached by the engagement team.
- A37. For engagements other than audits of financial statements, the significant judgments made by the engagement team may depend on the nature and circumstances of the engagement or the entity. For example, in an assurance engagement performed in accordance with ISAE 3000 (Revised), the engagement team's determination of whether the criteria to be applied in the preparation of the subject matter information are suitable for the engagement may involve or require significant judgment.
- A38. In performing the engagement quality review, the engagement quality reviewer may become aware of other areas where significant judgments would have been expected to be made by the engagement team for which further information may be needed about the engagement team's procedures performed or the basis for conclusions reached. In those circumstances, discussions with the engagement quality reviewer may result in the engagement team concluding that additional procedures need to be performed.
- A39. The information obtained in accordance with paragraphs 25(a) and 25(b), and the review of selected engagement documentation, assists the engagement quality reviewer in evaluating the engagement team's basis for making the significant

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<sup>12</sup> ISA 220 (Revised), paragraph 31

<sup>13</sup> ISA 230, *Audit Documentation*, paragraph 8(c)

<sup>14</sup> ISA 220 (Revised), paragraph A92

judgments. Other considerations that may be relevant to the engagement quality reviewer's evaluation include, for example:

- Remaining alert to changes in the nature and circumstances of the engagement or the entity that may result in changes in the significant judgments made by the engagement team;
- Applying an unbiased view in evaluating responses from the engagement team; and
- Following up on inconsistencies identified in reviewing engagement documentation, or inconsistent responses by the engagement team to questions relating to the significant judgments made.

- A40. The firm's policies or procedures may specify engagement documentation to be reviewed by the engagement quality reviewer. In addition, such policies or procedures may indicate that the engagement quality reviewer exercises professional judgment in selecting additional engagement documentation to be reviewed relating to significant judgments made by the engagement team.
- A41. Discussions about significant judgments with the engagement partner, and if applicable, other members of the engagement team, together with the engagement team's documentation, may assist the engagement quality reviewer in evaluating the exercise of professional skepticism, when applicable to the engagement, by the engagement team in relation to those significant judgments.
- A42. For audits of financial statements, ISA 220 (Revised)<sup>15</sup> provides examples of the impediments to the exercise of professional skepticism at the engagement level, unconscious auditor biases that may impede the exercise of professional skepticism, and possible actions that the engagement team may take to mitigate impediments to the exercise of professional skepticism at the engagement level.
- A43. For audits of financial statements, the requirements and relevant application material in ISA 315 (Revised 2019),<sup>16</sup> ISA 540 (Revised)<sup>17</sup> and other ISAs also provide examples of areas in an audit where the auditor exercises professional skepticism, or examples of where appropriate documentation may help provide evidence about how the auditor exercised professional skepticism. Such guidance may also assist the engagement quality reviewer in evaluating the exercise of professional skepticism by the engagement team.

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<sup>15</sup> ISA 220 (Revised), paragraphs A34-A36

<sup>16</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*, paragraph A238

<sup>17</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, paragraph A11

Whether Relevant Ethical Requirements Relating to Independence Have Been Fulfilled (Ref: Para. 25(d))

A44. ISA 220 (Revised)<sup>18</sup> requires the engagement partner, prior to dating the auditor’s report, to take responsibility for determining whether relevant ethical requirements, including those related to independence, have been fulfilled.

Whether Consultation Has Taken Place on Difficult or Contentious Matters or Matters Involving Differences of Opinion (Ref: Para. 25(e))

A45. ISQM 1<sup>19</sup> addresses consultation on difficult or contentious matters and differences of opinion within the engagement team, or between the engagement team and the engagement quality reviewer or individuals performing activities within the firm’s system of quality management.

Sufficient and Appropriate Involvement of the Engagement Partner on the Engagement (Ref: Para. 25(f))

A46. ISA 220 (Revised)<sup>20</sup> requires the engagement partner to determine, prior to dating the auditor’s report, that the engagement partner’s involvement has been sufficient and appropriate throughout the audit engagement such that the engagement partner has the basis for determining that the significant judgments made and the conclusions reached are appropriate given the nature and circumstances of the engagement. ISA 220 (Revised)<sup>21</sup> also indicates that the documentation of the involvement of the engagement partner may be accomplished in different ways. Discussions with the engagement team, and review of such engagement documentation, may assist the engagement quality reviewer’s evaluation of the basis for the engagement partner’s determination that the engagement partner’s involvement has been sufficient and appropriate.

Review of Financial Statements and Engagement Reports (Ref: Para. 25(g))

A47. For audits of financial statements, the engagement quality reviewer’s review of the financial statements and auditor’s report thereon may include consideration of whether the presentation and disclosure of matters relating to the significant judgments made by the engagement team are consistent with the engagement quality reviewer’s understanding of those matters based on the review of selected engagement documentation, and discussions with the engagement team. In reviewing the financial statements, the engagement quality reviewer may also become aware of other areas where significant judgments would have been expected to be made by the engagement team for which further information

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<sup>18</sup> ISA 220 (Revised), paragraph 21

<sup>19</sup> ISQM 1, paragraphs 31(d), 31(e) and A79-A82

<sup>20</sup> ISA 220 (Revised), paragraph 40(a)

<sup>21</sup> ISA 220 (Revised), paragraph A118

may be needed about the engagement team’s procedures or conclusions. The guidance in this paragraph also applies to review engagements, and the related engagement report.

- A48. For other assurance and related services engagements, the engagement quality reviewer’s review of the engagement report and, when applicable, the subject matter information may include considerations similar to those described in paragraph A47 (e.g., whether the presentation or description of matters relating to the significant judgments made by the engagement team are consistent with the engagement quality reviewer’s understanding based on the procedures performed in connection with the review).

**Unresolved Concerns of the Engagement Quality Reviewer (Ref: Para. 26)**

- A49. The firm’s policies or procedures may specify the individual(s) in the firm to be notified if the engagement quality reviewer has unresolved concerns that the significant judgments made by the engagement team, or the conclusions reached thereon, are not appropriate. Such individual(s) may include the individual assigned the responsibility for the appointment of engagement quality reviewers. With respect to such unresolved concerns, the firm’s policies or procedures may also require consultation within or outside the firm (e.g., a professional or regulatory body).

**Documentation (Ref: Para. 28–30)**

- A50. Paragraphs 57 to 60 of ISQM 1 address the firm’s documentation of its system of quality management. An engagement quality review performed in accordance with this ISQM is therefore subject to the documentation requirements in ISQM 1.
- A51. The form, content and extent of the documentation of the engagement quality review may depend on factors such as:
- The nature and complexity of the engagement;
  - The nature of the entity;
  - The nature and complexity of the matters subject to the engagement quality review; and
  - The extent of the engagement documentation reviewed.
- A52. The performance and notification of the completion of the engagement quality review may be documented in a number of ways. For example, the engagement quality reviewer may document the review of engagement documentation electronically in the IT application for the performance of the engagement. Alternatively, the engagement quality reviewer may document the review through means of a memorandum. The engagement quality reviewer’s procedures may also be documented in other ways, for example, in the minutes of the engagement team’s discussions where the engagement quality reviewer was present.

A53. Paragraph 24(b) requires that the firm's policies or procedures preclude the engagement partner from dating the engagement report until the completion of the engagement quality review, which includes resolving matters raised by the engagement quality reviewer. Provided that all requirements with respect to the performance of the engagement quality review have been fulfilled, the documentation of the review may be finalized after the date of the engagement report, but before the assembly of the final engagement file. However, firm policies or procedures may specify that the documentation of the engagement quality review needs to be finalized on or before the date of the engagement report.

**INTERNATIONAL STANDARD ON AUDITING 220  
(REVISED)**

**QUALITY MANAGEMENT FOR AN AUDIT OF  
FINANCIAL STATEMENTS**

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2022)

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International Standard on Auditing (ISA) 220, *Quality Management for an Audit of Financial Statements*, should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the specific responsibilities of the auditor regarding quality management at the engagement level for an audit of financial statements, and the related responsibilities of the engagement partner. This ISA is to be read in conjunction with relevant ethical requirements. (Ref: Para. A1, A38)

### The Firm's System of Quality Management and Role of Engagement Teams

2. Under ISQM 1, the objective of the firm is to design, implement and operate a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements performed by the firm, that provides the firm with reasonable assurance that: (Ref: Para. A13–A14)
  - (a) The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and
  - (b) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.<sup>1</sup>
3. This ISA is premised on the basis that the firm is subject to the ISQMs or to national requirements that are at least as demanding. (Ref: Para. A2–A3)
4. The engagement team, led by the engagement partner, is responsible, within the context of the firm's system of quality management and through complying with the requirements of this ISA, for: (Ref: Para. A4–A11)
  - (a) Implementing the firm's responses to quality risks (i.e., the firm's policies or procedures) that are applicable to the audit engagement using information communicated by, or obtained from, the firm;
  - (b) Given the nature and circumstances of the audit engagement, determining whether to design and implement responses at the engagement level beyond those in the firm's policies or procedures; and
  - (c) Communicating to the firm information from the audit engagement that is required to be communicated by the firm's policies or procedures to support the design, implementation and operation of the firm's system of quality management.
5. Complying with the requirements in other ISAs may provide information that is relevant to quality management at the engagement level. (Ref: Para. A12)

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<sup>1</sup> ISQM 1, paragraph 14

6. The public interest is served by the consistent performance of quality audit engagements through achieving the objective of this standard and other ISAs for each engagement. A quality audit engagement is achieved through planning and performing the engagement and reporting on it in accordance with professional standards and applicable legal and regulatory requirements. Achieving the objectives of those standards and complying with the requirements of applicable law or regulation involves exercising professional judgment and exercising professional skepticism.
7. In accordance with ISA 200,<sup>2</sup> the engagement team is required to plan and perform an audit with professional skepticism and to exercise professional judgment. Professional judgment is exercised in making informed decisions about the courses of action that are appropriate to manage and achieve quality given the nature and circumstances of the audit engagement. Professional skepticism supports the quality of judgments made by the engagement team and, through these judgments, supports the overall effectiveness of the engagement team in achieving quality at the engagement level. The appropriate exercise of professional skepticism may be demonstrated through the actions and communications of the engagement team. Such actions and communications may include specific steps to mitigate impediments that may impair the appropriate exercise of professional skepticism, such as unconscious bias or resource constraints. (Ref: Para. A33–A36)

### *Scalability*

8. The requirements of this ISA are intended to be applied in the context of the nature and circumstances of each audit. For example:
  - (a) When an audit is carried out entirely by the engagement partner, which may be the case for an audit of a less complex entity, some requirements in this ISA are not relevant because they are conditional on the involvement of other members of the engagement team. (Ref: Para. A13–A14)
  - (b) When an audit is not carried out entirely by the engagement partner or in an audit of an entity whose nature and circumstances are more complex, the engagement partner may assign the design or performance of some procedures, tasks or actions to other members of the engagement team.

### The Engagement Partner's Responsibilities

9. The engagement partner remains ultimately responsible, and therefore accountable, for compliance with the requirements of this ISA. The term “the engagement partner shall take responsibility for...” is used for those requirements that the engagement partner is permitted to assign the design or performance of procedures, tasks or actions to appropriately skilled or suitably experienced members of the engagement team. For other requirements, this ISA expressly intends that the requirement or responsibility be fulfilled by the

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<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraphs 15–16 and A20–A24

engagement partner and the engagement partner may obtain information from the firm or other members of the engagement team. (Ref: Para. A22–A25)

### Effective Date

10. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2022.

### Objective

11. The objective of the auditor is to manage quality at the engagement level to obtain reasonable assurance that quality has been achieved such that:
- (a) The auditor has fulfilled the auditor’s responsibilities, and has conducted the audit, in accordance with professional standards and applicable legal and regulatory requirements; and
  - (b) The auditor’s report issued is appropriate in the circumstances.

### Definitions

12. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Engagement partner<sup>3</sup> – The partner or other individual, appointed by the firm, who is responsible for the audit engagement and its performance, and for the auditor’s report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
  - (b) Engagement quality review – An objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, performed by the engagement quality reviewer and completed on or before the date of the engagement report.
  - (c) Engagement quality reviewer – A partner, other individual in the firm, or an external individual, appointed by the firm to perform the engagement quality review.
  - (d) Engagement team – All partners and staff performing the audit engagement, and any other individuals who perform audit procedures on the engagement, excluding an auditor’s external expert<sup>4</sup> and internal auditors who provide direct assistance on an engagement.<sup>5</sup> (Ref: Para. A15–A25)

<sup>3</sup> “Engagement partner,” “partner,” and “firm” is to be read as referring to their public sector equivalents where relevant.

<sup>4</sup> ISA 620, *Using the Work of an Auditor’s Expert*, paragraph 6(a), defines the term “auditor’s expert.”

<sup>5</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, establishes limits on the use of direct assistance. It also acknowledges that the external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. Therefore, the use of direct assistance is restricted to situations where it is permitted.

- (e) Firm – A sole practitioner, partnership or corporation or other entity of professional accountants, or public sector equivalent. (Ref: Para. A26)
- (f) Network firm – A firm or entity that belongs to the firm’s network. (Ref: Para. A27)
- (g) Network – A larger structure: (Ref: Para. A27)
  - (i) That is aimed at cooperation, and
  - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality management policies or procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
- (h) Partner – Any individual with authority to bind the firm with respect to the performance of a professional services engagement.
- (i) Personnel – Partners and staff in the firm.
- (j) Professional standards – International Standards on Auditing (ISAs) and relevant ethical requirements.
- (k) Relevant ethical requirements – Principles of professional ethics and ethical requirements that are applicable to professional accountants when undertaking the audit engagement. Relevant ethical requirements ordinarily comprise the provisions of the International Ethics Standards Board for Accountants’ *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code) related to audits of financial statements, together with national requirements that are more restrictive.
- (l) Response (in relation to a system of quality management) – Policies or procedures designed and implemented by the firm to address one or more quality risk(s):
  - (i) Policies are statements of what should, or should not, be done to address a quality risk(s). Such statements may be documented, explicitly stated in communications or implied through actions and decisions.
  - (ii) Procedures are actions to implement policies.
- (m) Staff – Professionals, other than partners, including any experts the firm employs.

## Requirements

### Leadership Responsibilities for Managing and Achieving Quality on Audits

13. The engagement partner shall take overall responsibility for managing and achieving quality on the audit engagement, including taking responsibility

for creating an environment for the engagement that emphasizes the firm's culture and expected behavior of engagement team members. In doing so, the engagement partner shall be sufficiently and appropriately involved throughout the audit engagement such that the engagement partner has the basis for determining whether the significant judgments made, and the conclusions reached, are appropriate given the nature and circumstances of the engagement. (Ref: Para. A28–A37)

14. In creating the environment described in paragraph 13, the engagement partner shall take responsibility for clear, consistent and effective actions being taken that reflect the firm's commitment to quality and establish and communicate the expected behavior of engagement team members, including emphasizing: (Ref: Para. A30–A34)
  - (a) That all engagement team members are responsible for contributing to the management and achievement of quality at the engagement level;
  - (b) The importance of professional ethics, values and attitudes to the members of the engagement team;
  - (c) The importance of open and robust communication within the engagement team, and supporting the ability of engagement team members to raise concerns without fear of reprisal; and
  - (d) The importance of each engagement team member exercising professional skepticism throughout the audit engagement.
15. If the engagement partner assigns the design or performance of procedures, tasks or actions related to a requirement of this ISA to other members of the engagement team to assist the engagement partner in complying with the requirements of this ISA, the engagement partner shall continue to take overall responsibility for managing and achieving quality on the audit engagement through direction and supervision of those members of the engagement team, and review of their work. (Ref: Para. 9, A37)

### **Relevant Ethical Requirements, Including Those Related to Independence**

16. The engagement partner shall have an understanding of the relevant ethical requirements, including those related to independence, that are applicable given the nature and circumstances of the audit engagement. (Ref: Para. A38–A42, A48)
17. The engagement partner shall take responsibility for other members of the engagement team having been made aware of relevant ethical requirements that are applicable given the nature and circumstances of the audit engagement, and the firm's related policies or procedures, including those that address: (Ref: Para. A23–A25, A40–A44)
  - (a) Identifying, evaluating and addressing threats to compliance with relevant ethical requirements, including those related to independence;

- (b) Circumstances that may cause a breach of relevant ethical requirements, including those related to independence, and the responsibilities of members of the engagement team when they become aware of breaches; and
  - (c) The responsibilities of members of the engagement team when they become aware of an instance of noncompliance with laws and regulations by the entity.<sup>6</sup>
18. If matters come to the engagement partner's attention that indicate that a threat to compliance with relevant ethical requirements exists, the engagement partner shall evaluate the threat through complying with the firm's policies or procedures, using relevant information from the firm, the engagement team or other sources, and take appropriate action. (Ref: Para. A43–A44)
  19. The engagement partner shall remain alert throughout the audit engagement, through observation and making inquiries as necessary, for breaches of relevant ethical requirements or the firm's related policies or procedures by members of the engagement team. (Ref: Para. A45)
  20. If matters come to the engagement partner's attention through the firm's system of quality management, or from other sources, that indicate that relevant ethical requirements applicable to the nature and circumstances of the audit engagement have not been fulfilled, the engagement partner, in consultation with others in the firm, shall take appropriate action. (Ref: Para. A46)
  21. Prior to dating the auditor's report, the engagement partner shall take responsibility for determining whether relevant ethical requirements, including those related to independence, have been fulfilled. (Ref: Para. A38 and A47)

### **Acceptance and Continuance of Client Relationships and Audit Engagements**

22. The engagement partner shall determine that the firm's policies or procedures for the acceptance and continuance of client relationships and audit engagements have been followed, and that conclusions reached in this regard are appropriate. (Ref: Para. A49–A52, A58)
23. The engagement partner shall take into account information obtained in the acceptance and continuance process in planning and performing the audit engagement in accordance with the ISAs and complying with the requirements of this ISA. (Ref: Para. A53–A56)
24. If the engagement team becomes aware of information that may have caused the firm to decline the audit engagement had that information been known by the firm prior to accepting or continuing the client relationship or specific engagement, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A57)

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<sup>6</sup> ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*

## Engagement Resources

25. The engagement partner shall determine that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner, taking into account the nature and circumstances of the audit engagement, the firm's policies or procedures, and any changes that may arise during the engagement. (Ref: Para. A59–A70, A73–A74, A79)
26. The engagement partner shall determine that members of the engagement team, and any auditor's external experts and internal auditors who provide direct assistance who are not part of the engagement team, collectively have the appropriate competence and capabilities, including sufficient time, to perform the audit engagement. (Ref: Para. A62, A71–A74)
27. If, as a result of complying with the requirements in paragraphs 25 and 26, the engagement partner determines that resources assigned or made available are insufficient or inappropriate in the circumstances of the audit engagement, the engagement partner shall take appropriate action, including communicating with appropriate individuals about the need to assign or make available additional or alternative resources to the engagement. (Ref: Para. A75–A78)
28. The engagement partner shall take responsibility for using the resources assigned or made available to the engagement team appropriately, given the nature and circumstances of the audit engagement. (Ref: Para. A63–A69)

## Engagement Performance

### *Direction, Supervision and Review*

29. The engagement partner shall take responsibility for the direction and supervision of the members of the engagement team and the review of their work. (Ref: Para. A80)
30. The engagement partner shall determine that the nature, timing and extent of direction, supervision and review is: (Ref: Para. A81–A89, A94–A97)
  - (a) Planned<sup>7</sup> and performed in accordance with the firm's policies or procedures, professional standards and applicable legal and regulatory requirements; and
  - (b) Responsive to the nature and circumstances of the audit engagement and the resources assigned or made available to the engagement team by the firm.
31. The engagement partner shall review audit documentation at appropriate points in time during the audit engagement, including audit documentation relating to: (Ref: Para. A90–A93)

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<sup>7</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraph 11

- (a) Significant matters;<sup>8</sup>
  - (b) Significant judgments, including those relating to difficult or contentious matters identified during the audit engagement, and the conclusions reached; and
  - (c) Other matters that, in the engagement partner’s professional judgment, are relevant to the engagement partner’s responsibilities.
32. On or before the date of the auditor’s report, the engagement partner shall determine, through review of audit documentation and discussion with the engagement team, that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor’s report to be issued. (Ref: Para. A90–A94)
33. Prior to dating the auditor’s report, the engagement partner shall review the financial statements and the auditor’s report, including, if applicable, the description of the key audit matters<sup>9</sup> and related audit documentation, to determine that the report to be issued will be appropriate in the circumstances.<sup>10</sup>
34. The engagement partner shall review, prior to their issuance, formal written communications to management, those charged with governance or regulatory authorities. (Ref: Para. A98)

### *Consultation*

35. The engagement partner shall: (Ref: Para. A99–A102)
- (a) Take responsibility for the engagement team undertaking consultation on:
    - (i) Difficult or contentious matters and matters on which the firm’s policies or procedures require consultation; and
    - (ii) Other matters that, in the engagement partner’s professional judgment, require consultation;
  - (b) Determine that members of the engagement team have undertaken appropriate consultation during the audit engagement, both within the engagement team, and between the engagement team and others at the appropriate level within or outside the firm;
  - (c) Determine that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
  - (d) Determine that conclusions agreed have been implemented.

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<sup>8</sup> ISA 230, *Audit Documentation*, paragraph 8(c)

<sup>9</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*

<sup>10</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements* or ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor’s Report*

*Engagement Quality Review*

36. For audit engagements for which an engagement quality review is required, the engagement partner shall: (Ref: Para. A103)
- (a) Determine that an engagement quality reviewer has been appointed;
  - (b) Cooperate with the engagement quality reviewer and inform other members of the engagement team of their responsibility to do so;
  - (c) Discuss significant matters and significant judgments arising during the audit engagement, including those identified during the engagement quality review, with the engagement quality reviewer; and
  - (d) Not date the auditor's report until the completion of the engagement quality review. (Ref: Para. A104–A106)

*Differences of Opinion*

37. If differences of opinion arise within the engagement team, or between the engagement team and the engagement quality reviewer or individuals performing activities within the firm's system of quality management, including those who provide consultation, the engagement team shall follow the firm's policies or procedures for dealing with and resolving such differences of opinion. (Ref: Para. A107–A108)
38. The engagement partner shall:
- (a) Take responsibility for differences of opinion being addressed and resolved in accordance with the firm's policies or procedures;
  - (b) Determine that conclusions reached are documented and implemented; and
  - (c) Not date the auditor's report until any differences of opinion are resolved.

**Monitoring and Remediation**

39. The engagement partner shall take responsibility for: (Ref: Para. A109–A112)
- (a) Obtaining an understanding of the information from the firm's monitoring and remediation process, as communicated by the firm including, as applicable, the information from the monitoring and remediation process of the network and across the network firms;
  - (b) Determining the relevance and effect on the audit engagement of the information referred to in paragraph 39(a) and take appropriate action; and
  - (c) Remaining alert throughout the audit engagement for information that may be relevant to the firm's monitoring and remediation process and communicate such information to those responsible for the process.

## Taking Overall Responsibility for Managing and Achieving Quality

40. Prior to dating the auditor’s report, the engagement partner shall determine that the engagement partner has taken overall responsibility for managing and achieving quality on the audit engagement. In doing so, the engagement partner shall determine that: (Ref: Para. A113–A116)
- (a) The engagement partner’s involvement has been sufficient and appropriate throughout the audit engagement such that the engagement partner has the basis for determining that the significant judgments made and the conclusions reached are appropriate given the nature and circumstances of the engagement; and
  - (b) The nature and circumstances of the audit engagement, any changes thereto, and the firm’s related policies or procedures have been taken into account in complying with the requirements of this ISA.

## Documentation

41. In applying ISA 230,<sup>11</sup> the auditor shall include in the audit documentation: (Ref: Para. A117–A120)
- (a) Matters identified, relevant discussions with personnel, and conclusions reached with respect to:
    - (i) Fulfillment of responsibilities relating to relevant ethical requirements, including those related to independence.
    - (ii) The acceptance and continuance of the client relationship and audit engagement.
  - (b) The nature and scope of, and conclusions resulting from, consultations undertaken during the audit engagement and how such conclusions were implemented.
  - (c) If the audit engagement is subject to an engagement quality review, that the engagement quality review has been completed on or before the date of the auditor’s report.

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## Application and Other Explanatory Material

### Scope of this ISA (Ref: Para. 1)

- A1. This ISA applies to all audits of financial statements, including audits of group financial statements. ISA 600<sup>12</sup> deals with special considerations that apply to an

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<sup>11</sup> ISA 230, paragraphs 8–11 and A6

<sup>12</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

audit of group financial statements and when component auditors are involved. ISA 600, adapted as necessary in the circumstances, may also be useful in an audit of financial statements when the engagement team includes individuals from another firm. For example, ISA 600 may be useful when involving such an individual to attend a physical inventory count, inspect property, plant and equipment, or perform audit procedures at a shared service center at a remote location.

### **The Firm's System of Quality Management and Role of Engagement Teams**

(Ref: Para. 2–9)

- A2. ISQM 1 deals with a firm's responsibilities for designing, implementing and operating its system of quality management.
- A3. Firms or national requirements may use different terminology or frameworks to describe the components of the system of quality management. National requirements that deal with the firm's responsibilities to design, implement and operate a system of quality management are at least as demanding as ISQM 1 when they address the requirements of ISQM 1 and impose obligations on the firm to achieve the objective of ISQM 1.

#### *The Engagement Team's Responsibilities Relating to the Firm's System of Quality Management* (Ref: Para. 4)

- A4. Quality management at the engagement level is supported by the firm's system of quality management and informed by the specific nature and circumstances of the audit engagement. In accordance with ISQM 1, the firm is responsible for communicating information that enables the engagement team to understand and carry out their responsibilities relating to performing engagements. For example, such communications may cover policies or procedures to undertake consultations with designated individuals in certain situations involving complex technical or ethical matters, or to involve firm-designated experts in specific engagements to perform audit procedures related to particular matters (e.g., the firm may specify that firm-designated credit experts are to be involved in auditing expected credit loss allowances in audits of financial institutions).
- A5. Firm-level responses may include policies or procedures established by a network, or by other firms, structures or organizations within the same network (network requirements or network services are described further in ISQM 1 within the "Network Requirements or Network Services" section).<sup>13</sup> The requirements of this ISA are based on the premise that the firm is responsible for taking the necessary action to enable engagement teams to implement or use network requirements or network services on the audit engagement (for example, a requirement to use an audit methodology developed for use by a network firm). Under ISQM 1, the firm is responsible for determining how network requirements or network

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<sup>13</sup> ISQM 1, paragraph 49(b)

services are relevant to, and are taken into account in, the firm's system of quality management.<sup>14</sup>

- A6. Some firm-level responses to quality risks are not performed at the engagement level but are nevertheless relevant when complying with the requirements of this ISA. For example, firm-level responses that the engagement team may be able to depend on when complying with the requirements of this ISA include:
- Personnel recruitment and professional training processes;
  - The information technology (IT) applications that support the firm's monitoring of independence;
  - The development of IT applications that support the acceptance and continuance of client relationships and audit engagements; and
  - The development of audit methodologies and related implementation tools and guidance.
- A7. Due to the specific nature and circumstances of each audit engagement and changes that may occur during the audit engagement, a firm cannot identify all quality risks that may arise at the engagement level or set forth all relevant and appropriate responses. Accordingly, the engagement team exercises professional judgment in determining whether to design and implement responses, beyond those set forth in the firm's policies or procedures, at the engagement level to meet the objective of this ISA.<sup>15</sup>
- A8. The engagement team's determination of whether engagement level responses are necessary (and, if so, what those responses are) is influenced by the requirements of this ISA, the engagement team's understanding of the nature and circumstances of the engagement and any changes during the audit engagement. For example, unanticipated circumstances may arise during the engagement that may cause the engagement partner to request the involvement of appropriately experienced personnel in addition to those initially assigned or made available.
- A9. The relative balance of the engagement team's efforts to comply with the requirements of this ISA (i.e., between implementing the firm's responses and designing and implementing engagement specific responses beyond those set forth in the firm's policies or procedures) may vary. For example, the firm may design an audit program to be used in circumstances that are applicable to the audit engagement (e.g., an industry-specific audit program). Other than determining the timing and extent of procedures to be performed, there may be little or no need for supplemental audit procedures to be added to the audit program at the engagement level. Alternatively, the engagement team's actions in complying with the engagement performance requirements of this ISA may

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<sup>14</sup> ISQM 1, paragraph 49(a)

<sup>15</sup> ISA 200 requires the auditor to exercise professional judgment in planning and performing an audit of financial statements.

be more focused on designing and implementing responses at the engagement level to deal with the specific nature and circumstances of the engagement (e.g., planning and performing procedures to address risks of material misstatement not contemplated by the firm's audit programs).

- A10. Ordinarily, the engagement team may depend on the firm's policies or procedures in complying with the requirements of this ISA, unless:
- The engagement team's understanding or practical experience indicates that the firm's policies or procedures will not effectively address the nature and circumstances of the engagement; or
  - Information provided by the firm or other parties, about the effectiveness of such policies or procedures suggests otherwise (e.g., information provided by the firm's monitoring activities, external inspections or other relevant sources, indicates that the firm's policies or procedures are not operating effectively).
- A11. If the engagement partner becomes aware (including through being informed by other members of the engagement team) that the firm's responses to quality risks are ineffective in the context of the specific engagement or the engagement partner is unable to depend on the firm's policies or procedures, the engagement partner communicates such information promptly to the firm in accordance with paragraph 39(c) as such information is relevant to the firm's monitoring and remediation process. For example, if an engagement team member identifies that an audit software program has a security weakness, timely communication of such information to the appropriate personnel enables the firm to take steps to update and reissue the audit program. See also paragraph A70 in respect of sufficient and appropriate resources.

Information Relevant to Quality Management at the Engagement Level (Ref: Para. 6)

- A12. Complying with the requirements in other ISAs may provide information that is relevant to quality management at the engagement level. For example, the understanding of the entity and its environment required to be obtained under ISA 315 (Revised 2019)<sup>16</sup> provides information that may be relevant to complying with the requirements of this ISA. Such information may be relevant to the determination of:
- The nature of resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas, or the involvement of experts to deal with complex matters;
  - The amount of resources to allocate to specific audit areas, such as the number of team members assigned to attend the physical inventory count at multiple locations;

<sup>16</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*

- The nature, timing and extent of review of the work performed by members of the team based on the assessed risks of material misstatement; or
- The allocation of the budgeted audit hours, including allocating more time, and the time of more\_experienced engagement team members to those areas where there are more risks of material misstatement or the identified risks are assessed as higher.

Scalability (Ref: Para. 2, 8)

- A13. In a smaller firm, the firm’s policies or procedures may designate an engagement partner, on behalf of the firm, to design many of the responses to the firm’s quality risks, as doing so may be a more effective approach to designing and implementing responses as part of the firm’s system of quality management. Additionally, a smaller firm’s policies or procedures may be less formal. For example, in a very small firm with a relatively small number of audit engagements, the firm may determine that there is no need to establish a firm-wide system to monitor independence, and rather, independence will be monitored at the individual engagement level by the engagement partner.
- A14. The requirements relating to direction, supervision and review of the work of other members of the engagement team are only relevant if there are members of the engagement team other than the engagement partner.

## Definitions

*Engagement Team* (Ref: Para. 12(d))

- A15. The engagement team may be organized in a variety of ways. For example, engagement team members may be located together or across different geographic locations and may be organized in groups by the activity they are performing. Regardless of how the engagement team is organized, any individual who performs audit procedures<sup>17</sup> on the audit engagement is a member of the engagement team.
- A16. The definition of an engagement team focuses on individuals who perform audit procedures on the audit engagement. Audit evidence, which is necessary to support the auditor’s opinion and report, is primarily obtained from audit procedures performed during the course of the audit.<sup>18</sup> Audit procedures comprise risk assessment procedures<sup>19</sup> and further audit procedures.<sup>20</sup> As explained in ISA 500, audit procedures include inspection, observation, confirmation, recalculation, reperformance, analytical procedures and inquiry,

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<sup>17</sup> ISA 500, *Audit Evidence*, paragraph A10

<sup>18</sup> ISA 200, paragraph A30

<sup>19</sup> ISA 315 (Revised 2019) provides requirements related to risk assessment procedures.

<sup>20</sup> ISA 330, *The Auditor’s Responses to Assessed Risks*, provides requirements related to further audit procedures, including tests of controls and substantive procedures.

often performed in some combination.<sup>21</sup> Other ISAs may also include specific procedures to obtain audit evidence, for example, ISA 520.<sup>22</sup>

A17. Engagement teams include personnel and may also include other individuals who perform audit procedures who are from:

- (a) A network firm; or
- (b) A firm that is not a network firm, or another service provider.<sup>23</sup>

For example, an individual from another firm may perform audit procedures on the financial information of a component in a group audit engagement, attend a physical inventory count or inspect physical fixed assets at a remote location.

A18. Engagement teams may also include individuals from service delivery centers who perform audit procedures. For example, it may be determined that specific tasks that are repetitive or specialized in nature will be performed by a group of appropriately skilled personnel and the engagement team therefore includes such individuals. Service delivery centers may be established by the firm, the network, or by other firms, structures or organizations within the same network. For example, a centralized function may be used to facilitate external confirmation procedures.

A19. Engagement teams may include individuals with expertise in a specialized area of accounting or auditing who perform audit procedures on the audit engagement, for example, individuals with expertise in accounting for income taxes, or in analyzing complex information produced by automated tools and techniques for the purpose of identifying unusual or unexpected relationships. An individual is not a member of the engagement team if that individual's involvement with the engagement is limited to consultation. Consultations are addressed in paragraphs 35 and A99–A102.

A20. If the audit engagement is subject to an engagement quality review, the engagement quality reviewer, and any other individuals performing the engagement quality review, are not members of the engagement team. Such individuals may be subject to specific independence requirements.

A21. An internal auditor providing direct assistance and an auditor's external expert whose work is used in the engagement are not members of the engagement team.<sup>24</sup> ISA 610 (Revised) 2013 and ISA 620 provide requirements and guidance for the auditor when using the work of internal auditors in a direct assistance capacity or when using the work of an external expert, respectively. Compliance with these ISAs requires the auditor to obtain sufficient appropriate audit evidence on the work performed by an internal auditor providing direct assistance and perform audit procedures on the work of an auditor's expert.

<sup>21</sup> ISA 500, paragraphs A14–A25

<sup>22</sup> ISA 520, *Analytical Procedures*

<sup>23</sup> ISQM 1, paragraph 16(v)

<sup>24</sup> See ISA 620, paragraphs 12–13 and ISA 610 (Revised 2013), paragraphs 21–25.

## The Engagement Partner's Responsibilities (Ref: Para. 9, 12(d))

A22. When this ISA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the engagement partner may need to obtain information from the firm or other members of the engagement team to fulfil the requirement (e.g., information to make the required decision or judgment). For example, the engagement partner is required to determine that members of the engagement team collectively have the appropriate competence and capabilities to perform the audit engagement. To make a judgment on whether the competence and capabilities of the engagement team is appropriate, the engagement partner may need to use information compiled by the engagement team or from the firm's system of quality management.

## The Application of Firm Policies or Procedures by Members of the Engagement Team (Ref: Para. 9, 12(d),17)

A23. Within the context of the firm's system of quality management, engagement team members from the firm are responsible for implementing the firm's policies or procedures that are applicable to the audit engagement. As engagement team members from another firm are neither partners nor staff of the engagement partner's firm, they may not be subject to the firm's system of quality management or the firm's policies or procedures. Further, the policies or procedures of another firm may not be similar to that of the engagement partner's firm. For example, policies or procedures regarding direction, supervision and review may be different, particularly when the other firm is in a jurisdiction with a different legal system, language or culture than that of the engagement partner's firm. Accordingly, if the engagement team includes individuals who are from another firm, different actions may need to be taken by the firm or the engagement partner to implement the firm's policies or procedures in respect of the work of those individuals.

A24. In particular, the firm's policies or procedures may require the firm or the engagement partner to take different actions from those applicable to personnel when obtaining an understanding of whether an individual from another firm:

- Has the appropriate competence and capabilities to perform the audit engagement. For example, the individual would not be subject to the firm's recruitment and training processes and therefore the firm's policies or procedures may state that this determination can be made through other actions such as obtaining information from the other firm or a licensing or registration body. Paragraphs 19 and A38 of ISA 600 contain guidance on obtaining an understanding of the competence and capabilities of component auditors.
- Understands the ethical requirements that are relevant to the group audit engagement. For example, the individual would not be subject to the firm's training in respect of the firm's policies or procedures for relevant ethical requirements. The firm's policies or procedures may state that

this understanding is obtained through other actions such as providing information, manuals, or guides containing the provisions of the relevant ethical requirements applicable to the audit engagement to the individual.

- Will confirm independence. For example, individuals who are not personnel may not be able to complete independence declarations directly on the firm’s independence systems. The firm’s policies or procedures may state that such individuals can provide evidence of their independence in relation to the audit engagement in other ways, such as written confirmation.

A25. When firm policies or procedures require specific activities to be undertaken in certain circumstances (e.g., consultation on a particular matter), it may be necessary for the firm’s related policies or procedures to be communicated to individuals who are not personnel. Such individuals are then able to alert the engagement partner if the circumstance arises, and this enables the engagement partner to comply with the firm’s policies or procedures. For example, in a group audit engagement, if a component auditor is performing audit procedures on the financial information of a component and identifies a difficult or contentious matter that is relevant to the group financial statements and subject to consultation<sup>25</sup> under the group auditor’s policies or procedures, the component auditor is able to alert the group engagement team about the matter.

*Firm* (Ref: Para. 12(e))

A26. The definition of “firm” in relevant ethical requirements may differ from the definition set out in this ISA.

*“Network” and “Network Firm”* (Ref: Para. 12(f)–12(g))

A27. The definitions of “network” or “network firm” in relevant ethical requirements may differ from those set out in this ISA. The IESBA Code also provides guidance in relation to the terms “network” and “network firm.” Networks and the other network firms may be structured in a variety of ways, and are in all cases external to the firm. The provisions in this ISA in relation to networks also apply to any structures or organizations that do not form part of the firm, but that exist within the network.

## **Leadership Responsibilities for Managing and Achieving Quality on Audits**

(Ref: Para. 13–15)

*Taking Overall Responsibility for Managing and Achieving Quality*

A28. ISQM 1 requires the firm to establish quality objectives that address the firm’s governance and leadership that supports the design, implementation and operation of the system of quality management. The engagement partner’s responsibility for managing and achieving quality is supported by

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<sup>25</sup> See paragraph 35.

a firm culture that demonstrates a commitment to quality. In addressing the requirements in paragraphs 13 and 14 of this ISA, the engagement partner may communicate directly to other members of the engagement team and reinforce this communication through personal conduct and actions (e.g., leading by example). A culture that demonstrates a commitment to quality is further shaped and reinforced by the engagement team members as they demonstrate expected behaviors when performing the engagement.

### Scalability

A29. The nature and extent of the actions of the engagement partner to demonstrate the firm's commitment to quality may depend on a variety of factors including the size, structure, geographical dispersion and complexity of the firm and the engagement team, and the nature and circumstances of the audit engagement. With a smaller engagement team with few engagement team members, influencing the desired culture through direct interaction and conduct may be sufficient, whereas for a larger engagement team that is dispersed over many locations, more formal communications may be necessary.

### *Sufficient and Appropriate Involvement*

A30. Being sufficiently and appropriately involved throughout the audit engagement may be demonstrated by the engagement partner in different ways, including:

- Taking responsibility for the nature, timing and extent of the direction and supervision of the members of the engagement team, and the review of their work in complying with the requirements of this ISA; and
- Varying the nature, timing and extent of such direction, supervision and review in the context of the nature and circumstances of the engagement.

### *Communication*

A31. Communication is the means through which the engagement team shares relevant information on a timely basis to comply with the requirements of this ISA, thereby contributing to the achievement of quality on the audit engagement. Communication may be between or among members of the engagement team, or with:

- (a) The firm, (e.g., individuals performing activities within the firm's system of quality management, including those assigned ultimate or operational responsibility for the firm's system of quality management);
- (b) Others involved in the audit (e.g., internal auditors who provide direct assistance<sup>26</sup> or an auditor's external expert<sup>27</sup>); and
- (c) Parties that are external to the firm (e.g., management, those charged with governance or regulatory authorities).

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<sup>26</sup> See ISA 610 (Revised 2013), paragraph A41.

<sup>27</sup> See ISA 620, paragraphs 11(c) and A30.

A32. The nature and circumstances of the audit engagement may affect the engagement partner's decisions regarding the appropriate means of effective communication with the members of the engagement team. For example, to support appropriate direction, supervision and review, the firm may use IT applications to facilitate the communication between the members of the engagement team when they are performing work across different geographical locations.

*Professional Skepticism* (Ref: Para. 7)

A33. The engagement partner is responsible for emphasizing the importance of each engagement team member exercising professional skepticism throughout the audit engagement. Conditions inherent in some audit engagements can create pressures on the engagement team that may impede the appropriate exercise of professional skepticism when designing and performing audit procedures and evaluating audit evidence. Accordingly, when developing the overall audit strategy in accordance with ISA 300, the engagement team may need to consider whether such conditions exist in the audit engagement and, if so, what actions the firm or the engagement team may need to undertake to mitigate such impediments.

A34. Impediments to the exercise of professional skepticism at the engagement level may include, but are not limited to:

- Budget constraints, which may discourage the use of sufficiently experienced or technically qualified resources, including experts, necessary for audits of entities where technical expertise or specialized skills are needed for effective understanding, assessment of and responses to risks and informed questioning of management.
- Tight deadlines, which may negatively affect the behavior of those who perform the work as well as those who direct, supervise and review. For example, external time pressures may create restrictions to analyzing complex information effectively.
- Lack of cooperation or undue pressures imposed by management, which may negatively affect the engagement team's ability to resolve complex or contentious issues.
- Insufficient understanding of the entity and its environment, its system of internal control and the applicable financial reporting framework, which may constrain the ability of the engagement team to make appropriate judgments and an informed questioning of management's assertions.
- Difficulties in obtaining access to records, facilities, certain employees, customers, vendors or others, which may cause the engagement team to bias the selection of sources of audit evidence and seek audit evidence from sources that are more easily accessible.
- Overreliance on automated tools and techniques, which may result in the engagement team not critically assessing audit evidence.

A35. Unconscious or conscious auditor biases may affect the engagement team’s professional judgments, including for example, in the design and performance of audit procedures, or the evaluation of audit evidence. Examples of unconscious auditor biases that may impede the exercise of professional skepticism, and therefore the reasonableness of the professional judgments made by the engagement team in complying with the requirements of this ISA, may include:

- Availability bias, which is a tendency to place more weight on events or experiences that immediately come to mind or are readily available than on those that are not.
- Confirmation bias, which is a tendency to place more weight on information that corroborates an existing belief than information that contradicts or casts doubt on that belief.
- Groupthink, which is a tendency to think or make decisions as a group that discourages creativity or individual responsibility.
- Overconfidence bias, which is a tendency to overestimate one’s own ability to make accurate assessments of risk or other judgments or decisions.
- Anchoring bias, which is a tendency to use an initial piece of information as an anchor against which subsequent information is inadequately assessed.
- Automation bias, which is a tendency to favor output generated from automated systems, even when human reasoning or contradictory information raises questions as to whether such output is reliable or fit for purpose.

A36. Possible actions that the engagement team may take to mitigate impediments to the exercise of professional skepticism at the engagement level may include:

- Remaining alert to changes in the nature or circumstances of the audit engagement that necessitate additional or different resources for the engagement, and requesting additional or different resources from those individuals within the firm responsible for allocating or assigning resources to the engagement.
- Explicitly alerting the engagement team to instances or situations when vulnerability to unconscious or conscious auditor biases may be greater (e.g., areas involving greater judgment) and emphasizing the importance of seeking advice from more experienced members of the engagement team in planning and performing audit procedures.
- Changing the composition of the engagement team, for example, requesting that more experienced individuals with greater skills or knowledge or specific expertise are assigned to the engagement.

- Involving more experienced members of the engagement team when dealing with members of management who are difficult or challenging to interact with.
- Involving members of the engagement team with specialized skills and knowledge or an auditor's expert to assist the engagement team with complex or subjective areas of the audit.
- Modifying the nature, timing and extent of direction, supervision or review by involving more experienced engagement team members, more in-person oversight on a more frequent basis or more in-depth reviews of certain working papers for:
  - Complex or subjective areas of the audit;
  - Areas that pose risks to achieving quality on the audit engagement;
  - Areas with a fraud risk; and
  - Identified or suspected non-compliance with laws or regulations.
- Setting expectations for:
  - Less experienced members of the engagement team to seek advice frequently and in a timely manner from more experienced engagement team members or the engagement partner; and
  - More experienced members of the engagement team to be available to less experienced members of the engagement team throughout the audit engagement and to respond positively and in a timely manner to their insights, requests for advice or assistance.
- Communicating with those charged with governance when management imposes undue pressure or the engagement team experiences difficulties in obtaining access to records, facilities, certain employees, customers, vendors or others from whom audit evidence may be sought.

*Assigning Procedures, Tasks, or Actions to Other Members of the Engagement Team*  
(Ref: Para. 15)

- A37. Being sufficiently and appropriately involved throughout the audit engagement when procedures, tasks or actions have been assigned to other members of the engagement team may be demonstrated by the engagement partner in different ways, including:
- Informing assignees about the nature of their responsibilities and authority, the scope of the work being assigned and the objectives thereof; and to provide any other necessary instructions and relevant information.
  - Direction and supervision of the assignees.
  - Review of the assignees' work to evaluate the conclusions reached, in addition to the requirements in paragraphs 29–34.

**Relevant Ethical Requirements, Including Those Related to Independence** (Ref: Para. 16–21)*Relevant Ethical Requirements (Ref: Para. 1, 16–21)*

- A38. ISA 200<sup>28</sup> requires that the auditor comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements may vary depending on the nature and circumstances of the engagement. For example, certain requirements related to independence may be applicable only when performing audits of listed entities. ISA 600 includes additional requirements and guidance to those in this ISA regarding communications about relevant ethical requirements with component auditors.
- A39. Based on the nature and circumstances of the audit engagement, certain law, regulation or aspects of relevant ethical requirements, such as those pertaining to non-compliance with laws or regulations, may be relevant to the engagement, for example laws or regulations dealing with money laundering, corruption, or bribery.
- A40. The firm's information system and the resources provided by the firm may assist the engagement team in understanding and fulfilling relevant ethical requirements applicable to the nature and circumstances of the audit engagement. For example, the firm may:
- Communicate the independence requirements to engagement teams.
  - Provide training for engagement teams on relevant ethical requirements.
  - Establish manuals and guides (i.e., intellectual resources) containing the provisions of the relevant ethical requirements and guidance on how they are applied in the nature and circumstances of the firm and its engagements.
  - Assign personnel to manage and monitor compliance with relevant ethical requirements (e.g., ISQM 1 requires that the firm obtains, at least annually, a documented confirmation of compliance with the independence requirements from all personnel required by relevant ethical requirements to be independent) or provide consultation on matters related to relevant ethical requirements.
  - Establish policies or procedures for engagement team members to communicate relevant and reliable information to appropriate parties within the firm or to the engagement partner, such as policies or procedures for engagement teams to:
    - Communicate information about client engagements and the scope of services, including non-assurance services, to enable the

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<sup>28</sup> ISA 200, paragraphs 14 and A16–A19

- firm to identify threats to independence during the period of the engagement and during the period covered by the subject matter.
- Communicate circumstances and relationships that may create a threat to independence, so that the firm can evaluate whether such a threat is at an acceptable level and if it is not, address the threat by eliminating it or reducing it to an acceptable level.
  - Promptly communicate any breaches of the relevant ethical requirements, including those related to independence.
- A41. The engagement partner may take into account the information, communication, and resources described in paragraph A40 when determining whether the engagement partner may depend on the firm’s policies or procedures in complying with relevant ethical requirements.
- A42. Open and robust communication between the members of the engagement team about relevant ethical requirements may also assist in:
- Drawing the attention of engagement team members to relevant ethical requirements that may be of particular significance to the audit engagement; and
  - Keeping the engagement partner informed about matters relevant to the engagement team’s understanding and fulfillment of relevant ethical requirements and the firm’s related policies or procedures.

*Identifying and Evaluating Threats to Compliance with Relevant Ethical Requirements* (Ref: Para. 17–18)

- A43. In accordance with ISQM 1, the firm’s responses to address the quality risks in relation to relevant ethical requirements, including those related to independence for engagement team members, include policies or procedures for identifying, evaluating and addressing threats to compliance with the relevant ethical requirements.
- A44. Relevant ethical requirements may contain provisions regarding the identification and evaluation of threats and how they are to be dealt with. For example, the IESBA Code explains that a self-interest threat to compliance with the fundamental principle of professional competence and due care may arise if the fee quoted for an audit engagement is so low that it might be difficult to perform the engagement in accordance with professional standards.<sup>29</sup>

*Breaches of Relevant Ethical Requirements* (Ref: Para. 19)

- A45. In accordance with ISQM 1, the firm is required to establish policies or procedures for identifying, communicating, evaluating and reporting of any

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<sup>29</sup> IESBA Code, paragraph 330.3 A2

breaches of relevant ethical requirements and appropriately responding to the causes and consequences of the breaches in a timely manner.

*Taking Appropriate Action* (Ref: Para. 20)

A46. Appropriate actions may include, for example:

- Following the firm’s policies or procedures regarding breaches of relevant ethical requirements, including communicating to or consulting with the appropriate individuals so that appropriate action can be taken, including as applicable, disciplinary action(s).
- Communicating with those charged with governance.
- Communicating with regulatory authorities or professional bodies. In some circumstances, communication with regulatory authorities may be required by law or regulation.
- Seeking legal advice.
- Withdrawing from the audit engagement, when withdrawal is possible under applicable law or regulation.

*Prior to Dating the Auditor’s Report* (Ref: Para. 21)

A47. ISA 700 (Revised) requires that the auditor’s report include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and that the auditor has fulfilled the auditor’s other ethical responsibilities in accordance with these requirements.<sup>30</sup> Performing the procedures required by paragraphs 16–21 of this ISA provides the basis for these statements in the auditor’s report.

*Considerations Specific to Public Sector Entities*

A48. Statutory measures may provide safeguards for the independence of public sector auditors. However, public sector auditors or audit firms carrying out public sector audits on behalf of the statutory auditor may, depending on the terms of the mandate in a particular jurisdiction, need to adapt their approach to promote compliance with paragraph 16. This may include, where the public sector auditor’s mandate does not permit withdrawal from the audit engagement, disclosure through a public report of circumstances that have arisen that would, if they were in the private sector, lead the auditor to withdraw.

**Acceptance and Continuance of Client Relationships and Audit Engagements**  
(Ref: Para. 22–24)

A49. ISQM 1 requires the firm to establish quality objectives that address the acceptance and continuance of client relationships and specific engagements.

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<sup>30</sup> ISA 700 (Revised), paragraph 28(c)

- A50. Information such as the following may assist the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:
- The integrity and ethical values of the principal owners, key management and those charged with governance of the entity;
  - Whether sufficient and appropriate resources are available to perform the engagement;
  - Whether management and those charged with governance have acknowledged their responsibilities in relation to the engagement;
  - Whether the engagement team has the competence and capabilities, including sufficient time, to perform the engagement; and
  - Whether significant matters that have arisen during the current or previous engagement have implications for continuing the engagement.
- A51. Under ISQM 1, for acceptance and continuance decisions, the firm is required to make judgments about the firm's ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements. The engagement partner may use the information considered by the firm in this regard in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate. If the engagement partner has concerns regarding the appropriateness of the conclusions reached, the engagement partner may discuss the basis for those conclusions with those involved in the acceptance and continuance process.
- A52. If the engagement partner is directly involved throughout the firm's acceptance and continuance process, the engagement partner will be aware of the information obtained or used by the firm, in reaching the related conclusions. Such direct involvement may also provide a basis for the engagement partner's determination that the firm's policies or procedures have been followed and that the conclusions reached are appropriate.
- A53. Information obtained during the acceptance and continuance process may assist the engagement partner in complying with the requirements of this ISA and making informed decisions about appropriate courses of action. Such information may include:
- Information about the size, complexity and nature of the entity, including whether it is a group audit, the industry in which it operates and the applicable financial reporting framework;
  - The entity's timetable for reporting, such as at interim and final stages;
  - In relation to group audits, the nature of the control relationships between the parent and its components; and

- Whether there have been changes in the entity or in the industry in which the entity operates since the previous audit engagement that may affect the nature of resources required, as well as the manner in which the work of the engagement team will be directed, supervised and reviewed.

A54. Information obtained during acceptance and continuance may also be relevant in complying with the requirements of other ISAs, as well as this ISA, for example with respect to:

- Establishing an understanding of the terms of the audit engagement, as required by ISA 210;<sup>31</sup>
- Identifying and assessing risks of material misstatement, whether due to error or fraud, in accordance with ISA 315 (Revised 2019) and ISA 240;<sup>32</sup>
- Understanding the group, its components and their environments, in the case of an audit of group financial statements in accordance with ISA 600, and directing, supervising and reviewing the work of component auditors;
- Determining whether, and how, to involve an auditor's expert in accordance with ISA 620; and
- The entity's governance structure in accordance with ISA 260 (Revised)<sup>33</sup> and ISA 265.<sup>34</sup>

A55. Law, regulation, or relevant ethical requirements may require the successor auditor to request, prior to accepting the audit engagement, the predecessor auditor to provide known information regarding any facts or circumstances that, in the predecessor auditor's judgment, the successor auditor needs to be aware of before deciding whether to accept the engagement. In some circumstances, the predecessor auditor may be required, on request by the proposed successor auditor, to provide information regarding identified or suspected non-compliance with laws and regulations to the proposed successor auditor. For example, if the predecessor auditor has withdrawn from the engagement as a result of identified or suspected non-compliance with laws and regulations, the IESBA Code requires that the predecessor auditor, on request by a proposed successor auditor, provide all relevant facts and other information concerning such non-compliance that, in the predecessor auditor's opinion, the proposed successor auditor needs to be aware of before deciding whether to accept the audit appointment.

A56. In circumstances when the firm is obligated by law or regulation to accept or continue an audit engagement, the engagement partner may take into account information obtained by the firm about the nature and circumstances of the engagement.

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<sup>31</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraph 9

<sup>32</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

<sup>33</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

<sup>34</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

A57. In deciding on the necessary action, the engagement partner and the firm may conclude that it is appropriate to continue with the audit engagement and, if so, determine what additional steps are necessary at the engagement level (e.g., the assignment of more staff or staff with specific expertise). If the engagement partner has further concerns or is not satisfied that the matter has been appropriately dealt with, the firm's policies or procedures for resolving differences of opinion may be applicable.

*Considerations Specific to Public Sector Entities* (Ref: Para. 22–24)

A58. In the public sector, auditors may be appointed in accordance with statutory procedures and the public sector auditor may not need to establish all policies or procedures regarding the acceptance and continuance of audit engagements. Nevertheless, the requirements and considerations for the acceptance and continuance of client relationships and engagements as set out in paragraphs 22–24 and A49–A57 may be valuable to public sector auditors in performing risk assessments and in carrying out reporting responsibilities.

**Engagement Resources** (Ref: Para. 25–28)

A59. Under ISQM 1, the resources assigned or made available by the firm to support the performance of audit engagements include:

- Human resources;
- Technological resources; and
- Intellectual resources.

A60. Resources for an audit engagement are primarily assigned or made available by the firm, although there may be circumstances when the engagement team directly obtains resources for the audit engagement. For example, this may be the case when a component auditor is required by statute, regulation or for another reason to express an audit opinion on the financial statements of a component, and the component auditor is also appointed by component management to perform audit procedures on behalf of the group engagement team.<sup>35</sup> In such circumstances, the firm's policies or procedures may require the engagement partner to take different actions, such as requesting information from the component auditor, to determine whether sufficient and appropriate resources are assigned or made available.

A61. A relevant consideration for the engagement partner, in complying with the requirements in paragraphs 25 and 26, may be whether the resources assigned or made available to the engagement team enable fulfillment of relevant ethical requirements, including ethical principles such as professional competence and due care.

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<sup>35</sup> ISA 600, paragraph 3

*Human Resources*

A62. Human resources include members of the engagement team (see also paragraphs A5, A15–A21) and, where applicable, an auditor’s external expert and individuals from within the entity’s internal audit function who provide direct assistance on the audit.

*Technological Resources*

A63. The use of technological resources on the audit engagement may assist the auditor in obtaining sufficient appropriate audit evidence. Technological tools may allow the auditor to more effectively and efficiently manage the audit. Technological tools may also allow the auditor to evaluate large amounts of data more easily to, for example, provide deeper insights, identify unusual trends or more effectively challenge management’s assertions, which enhances the ability of the auditor to exercise professional skepticism. Technological tools may also be used to conduct meetings and provide communication tools to the engagement team. Inappropriate use of such technological resources may, however, increase the risk of overreliance on the information produced for decision making purposes, or may create threats to complying with relevant ethical requirements, for example, requirements related to confidentiality.

A64. The firm’s policies or procedures may include required considerations or responsibilities for the engagement team when using firm approved technological tools to perform audit procedures and may require the involvement of individuals with specialized skills or expertise in evaluating or analyzing the output.

A65. When the engagement partner requires individuals from another firm to use specific automated tools and techniques when performing audit procedures, communications with those individuals may indicate that the use of such automated tools and techniques needs to comply with the engagement team’s instructions.

A66. The firm’s policies or procedures may specifically prohibit the use of certain IT applications or features of IT applications (e.g., software that has not yet been specifically approved for use by the firm). Alternatively, the firm’s policies or procedures may require the engagement team to take certain actions before using an IT application that is not firm-approved to determine it is appropriate for use, for example by requiring:

- The engagement team to have appropriate competence and capabilities to use the IT application.
- Testing the operation and security of the IT application.
- Specific documentation to be included in the audit file.

A67. The engagement partner may exercise professional judgment in considering whether the use of an IT application on the audit engagement is appropriate

in the context of the engagement, and if so, how the IT application is to be used. Factors that may be considered in determining whether a particular IT application, that has not been specifically approved for use by the firm, is appropriate for use in the audit engagement include whether:

- Use and security of the IT application complies with the firm's policies or procedures.
- The IT application operates as intended.
- Personnel have the competence and capabilities required to use the IT application.

### *Intellectual Resources*

- A68. Intellectual resources include, for example, audit methodologies, implementation tools, auditing guides, model programs, templates, checklists or forms.
- A69. The use of intellectual resources on the audit engagement may facilitate the consistent application and understanding of professional standards, law and regulation, and related firm policies or procedures. For this purpose, the engagement team may be required, in accordance with the firm's policies or procedures, to use the firm's audit methodology and specific tools and guidance. The engagement team may also consider whether the use of other intellectual resources is appropriate and relevant based on the nature and circumstances of the engagement, for example, an industry specific methodology or related guides and performance aids.

### *Sufficient and Appropriate Resources to Perform the Engagement (Ref: Para. 25)*

- A70. In determining whether sufficient and appropriate resources to perform the engagement have been assigned or made available to the engagement team, ordinarily the engagement partner may depend on the firm's related policies or procedures (including resources) as described in paragraph A6. For example, based on information communicated by the firm, the engagement partner may be able to depend on the firm's technological development, implementation and maintenance programs when using firm-approved technology to perform audit procedures.

### *Competence and Capabilities of the Engagement Team (Ref: Para. 26)*

- A71. When determining that the engagement team has the appropriate competence and capabilities, the engagement partner may take into consideration such matters as the team's:
- Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
  - Understanding of professional standards and applicable legal and regulatory requirements.

- Expertise in specialized areas of accounting or auditing.
- Expertise in IT used by the entity or automated tools or techniques that are to be used by the engagement team in planning and performing the audit engagement.
- Knowledge of relevant industries in which the entity being audited operates.
- Ability to exercise professional skepticism and professional judgment.
- Understanding of the firm’s policies or procedures.

A72. Internal auditors and an auditor’s external expert are not members of the engagement team. ISA 610 (Revised 2013)<sup>36</sup> and ISA 620<sup>37</sup> include requirements and guidance relating to the assessment of the competence and capabilities of internal auditors and an auditor’s external expert, respectively.

### Project Management

A73. In situations where there are many engagement team members, for example in an audit of a larger or more complex entity, the engagement partner may involve an individual who has specialized skills or knowledge in project management, supported by appropriate technological and intellectual resources of the firm. Conversely, in an audit of a less complex entity with few engagement team members, project management may be achieved by a member of the engagement team through less formal means.

A74. Project management techniques and tools may support the engagement team in managing the quality of the audit engagement by, for example:

- Increasing the engagement team’s ability to exercise professional skepticism through alleviating budget or time constraints that may otherwise impede the exercise of professional skepticism;
- Facilitating timely performance of audit work to effectively manage time constraints at the end of the audit process when more difficult or contentious matters may arise;
- Monitoring the progress of the audit against the audit plan,<sup>38</sup> including the achievement of key milestones, which may assist the engagement team in being proactive in identifying the need for making timely adjustments to the audit plan and the assigned resources; or
- Facilitating communication among members of the engagement team, for example, coordinating arrangements with component auditors and auditor’s experts.

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<sup>36</sup> ISA 610 (Revised 2013), paragraph 15

<sup>37</sup> ISA 620, paragraph 9

<sup>38</sup> See ISA 300, paragraph 9.

*Insufficient or Inappropriate Resources* (Ref: Para. 27)

- A75. ISQM 1 addresses the firm's commitment to quality through its culture that exists throughout the firm, which recognizes and reinforces the firm's role in serving the public interest by consistently performing quality engagements, and the importance of quality in the firm's strategic decisions and actions, including the firm's financial and operational priorities. ISQM 1 also addresses the firm's responsibilities for planning for resource needs, and obtaining, allocating or assigning resources in a manner that is consistent with the firm's commitment to quality. However, in certain circumstances, the firm's financial and operational priorities may place constraints on the resources assigned or made available to the engagement team. In such circumstances, these constraints do not override the engagement partner's responsibility for achieving quality at the engagement level, including for determining that the resources assigned or made available by the firm are sufficient and appropriate to perform the audit engagement.
- A76. In an audit of group financial statements, when there are insufficient or inappropriate resources in relation to work being performed at a component by a component auditor, the engagement partner may discuss the matter with the component auditor, management or the firm to make sufficient and appropriate resources available.
- A77. The engagement partner's determination of whether additional engagement level resources are required is a matter of professional judgment and is influenced by the requirements of this ISA and the nature and circumstances of the audit engagement. As described in paragraph A11, in certain circumstances, the engagement partner may determine that the firm's responses to quality risks are ineffective in the context of the specific engagement, including that certain resources assigned or made available to the engagement team are insufficient. In those circumstances, the engagement partner is required to take appropriate action, including communicating such information to the appropriate individuals in accordance with paragraph 27 and paragraph 39(c). For example, if an audit software program provided by the firm has not incorporated new or revised audit procedures in respect of recently issued industry regulation, timely communication of such information to the firm enables the firm to take steps to update and reissue the software promptly or to provide an alternative resource that enables the engagement team to comply with the new regulation in the performance of the audit engagement.
- A78. If the resources assigned or made available are insufficient or inappropriate in the circumstances of the engagement and additional or alternative resources have not been made available, appropriate actions may include:
- Changing the planned approach to the nature, timing and extent of direction, supervision and review (see also paragraph A94).

- Discussing an extension to reporting deadlines with management or those charged with governance, when an extension is possible under applicable law or regulation.
- Following the firm’s policies or procedures for resolving differences of opinion if the engagement partner does not obtain the necessary resources for the audit engagement.
- Following the firm’s policies or procedures for withdrawing from the audit engagement, when withdrawal is possible under applicable law or regulation.

*Considerations Specific to Public Sector Entities* (Ref: Para. 25–28)

A79. In the public sector, specialized skills may be necessary to discharge the terms of the audit mandate in a particular jurisdiction. Such skills may include an understanding of the applicable reporting arrangements, including reporting to the legislature or other governing body or reporting in the public interest. The wider scope of a public sector audit may include, for example, some aspects of performance auditing.

**Engagement Performance**

*Scalability* (Ref: Para. 29)

A80. When an audit is not carried out entirely by the engagement partner, or in an audit of an entity whose nature and circumstances are more complex, it may be necessary for the engagement partner to assign direction, supervision, and review to other members of the engagement team. However, as part of the engagement partner’s overall responsibility for managing and achieving quality on the audit engagement and to be sufficiently and appropriately involved, the engagement partner is required to determine that the nature, timing and extent of direction, supervision and review is undertaken in accordance with paragraph 30. In such circumstances, personnel or members of the engagement team, including component auditors, may provide information to the engagement partner to enable the engagement partner to make the determination required by paragraph 30.

*Direction, Supervision and Review* (Ref: Para. 30)

A81. Under ISQM 1, the firm is required to establish a quality objective that addresses the nature, timing and extent of the direction and supervision of engagement teams and review of their work. ISQM 1 also requires that such direction, supervision and review is planned and performed on the basis that the work performed by less experienced members of the engagement team is directed, supervised and reviewed by more experienced engagement team members.

A82. Direction and supervision of the engagement team and the review of the work of the engagement team are firm-level responses that are implemented at the

engagement level, of which the nature, timing and extent may be further tailored by the engagement partner in managing the quality of the audit engagement. Accordingly, the approach to direction, supervision and review will vary from one engagement to the next, taking into account the nature and circumstances of the engagement. The approach will generally include a combination of addressing the firm's policies or procedures and engagement specific responses.

- A83. The approach to the direction and supervision of the members of the engagement team and the review of their work provides support for the engagement partner in fulfilling the requirements of this ISA, and in concluding that the engagement partner has been sufficiently and appropriately involved throughout the audit engagement in accordance with paragraph 40.
- A84. Ongoing discussion and communication among members of the engagement team allows less experienced engagement team members to raise questions with more experienced engagement team members (including the engagement partner) in a timely manner and enables effective direction, supervision and review in accordance with paragraph 30.

#### Direction

- A85. Direction of the engagement team may involve informing the members of the engagement team of their responsibilities, such as:
- Contributing to the management and achievement of quality at the engagement level through their personal conduct, communication and actions.
  - Maintaining a questioning mind and being aware of unconscious or conscious auditor biases in exercising professional skepticism when gathering and evaluating audit evidence (see paragraph A35).
  - Fulfilling relevant ethical requirements.
  - The responsibilities of respective partners when more than one partner is involved in the conduct of an audit engagement.
  - The responsibilities of respective engagement team members to perform audit procedures and of more experienced engagement team members to direct, supervise and review the work of less experienced engagement team members.
  - Understanding the objectives of the work to be performed and the detailed instructions regarding the nature, timing and extent of planned audit procedures as set forth in the overall audit strategy and audit plan.
  - Addressing threats to the achievement of quality, and the engagement team's expected response. For example, budget constraints or resource constraints should not result in the engagement team members modifying planned audit procedures or failing to perform planned audit procedures.

## Supervision

A86. Supervision may include matters such as:

- Tracking the progress of the audit engagement, which includes monitoring:
  - The progress against the audit plan;
  - Whether the objective of work performed has been achieved; and
  - The ongoing adequacy of assigned resources.
- Taking appropriate action to address issues arising during the engagement, including for example, reassigning planned audit procedures to more experienced engagement team members when issues are more complex than initially anticipated.
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.
- Providing coaching and on-the-job training to help engagement team members develop skills or competencies.
- Creating an environment where engagement team members raise concerns without fear of reprisals.

## Review

A87. Review of the engagement team's work provides support for the conclusion that the requirements of this ISA have been addressed.

A88. Review of the engagement team's work consists of consideration of whether, for example:

- The work has been performed in accordance with the firm's policies or procedures, professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion; and
- The objectives of the audit procedures have been achieved.

- A89. The firm's policies or procedures may contain specific requirements regarding:
- The nature, timing and extent of review of audit documentation;
  - Different types of review that may be appropriate in different situations (e.g., review of each individual working paper or selected working papers); and
  - Which members of the engagement team are required to perform the different types of review.

The Engagement Partner's Review (Ref: Para. 30–34)

- A90. As required by ISA 230, the engagement partner documents the date and extent of the review.<sup>39</sup>
- A91. Timely review of documentation by the engagement partner at appropriate stages throughout the audit engagement enables significant matters to be resolved to the engagement partner's satisfaction on or before the date of the auditor's report. The engagement partner need not review all audit documentation.
- A92. The engagement partner exercises professional judgment in identifying the areas of significant judgment made by the engagement team. The firm's policies or procedures may specify certain matters that are commonly expected to be significant judgments. Significant judgments in relation to the audit engagement may include matters related to the overall audit strategy and audit plan for undertaking the engagement, the execution of the engagement and the overall conclusions reached by the engagement team, for example:
- Matters related to planning the engagement, such as matters related to determining materiality.
  - The composition of the engagement team, including:
    - Personnel using expertise in a specialized area of accounting or auditing;
    - The use of personnel from service delivery centers.
  - The decision to involve an auditor's expert, including the decision to involve an external expert.
  - The engagement team's consideration of information obtained in the acceptance and continuance process and proposed responses to that information.
  - The engagement team's risk assessment process, including situations where consideration of inherent risk factors and the assessment of inherent risk requires significant judgment by the engagement team.

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<sup>39</sup> ISA 230, paragraph 9(c)

- The engagement team’s consideration of related party relationships and transactions and disclosures.
- Results of the procedures performed by the engagement team on significant areas of the engagement, for example, conclusions in respect of certain accounting estimates, accounting policies or going concern considerations.
- The engagement team’s evaluation of the work performed by experts and conclusions drawn therefrom.
- In group audit situations:
  - The proposed overall group audit strategy and group audit plan;
  - Decisions about the involvement of component auditors, including how to direct and supervise them and review their work, including, for example, when there are areas of higher assessed risk of material misstatement of the financial information of a component; and
  - The evaluation of work performed by component auditors and the conclusions drawn therefrom.
- How matters affecting the overall audit strategy and audit plan have been addressed.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The proposed audit opinion and matters to be communicated in the auditor’s report, for example, key audit matters, or a “Material Uncertainty Related to Going Concern” paragraph.

A93. The engagement partner exercises professional judgment in determining other matters to review, for example based on:

- The nature and circumstances of the audit engagement.
- Which engagement team member performed the work.
- Matters relating to recent inspection findings.
- The requirements of the firm’s policies or procedures.

#### Nature, Timing and Extent

A94. The nature, timing and extent of the direction, supervision and review are required to be planned and performed in accordance with the firm’s policies or procedures, as well as professional standards and applicable legal and regulatory requirements. For example, the firm’s policies or procedures may include that:

- Work planned to be performed at an interim date is to be directed, supervised and reviewed at the same time as the performance of the procedures rather than at the end of the period, so that any necessary corrective action can be taken in a timely manner.
- Certain matters are to be reviewed by the engagement partner and the firm may specify the circumstances or engagements in which such matters are expected to be reviewed.

### Scalability

A95. The approach to direction, supervision and review may be tailored depending on, for example:

- The engagement team member's previous experience with the entity and the area to be audited. For example, if the work related to the entity's information system is being performed by the same engagement team member who performed the work in the prior period and there are no significant changes to the information system, the extent and frequency of the direction and supervision of the engagement team member may be less and the review of the related working papers may be less detailed.
- The complexity of the audit engagement. For example, if significant events have occurred that make the audit engagement more complex, the extent and frequency of the direction and supervision of the engagement team member may be greater and the review of the related working papers may be more detailed.
- The assessed risks of material misstatement. For example, a higher assessed risk of material misstatement may require a corresponding increase in the extent and frequency of the direction and supervision of engagement team members and a more detailed review of their work.
- The competence and capabilities of the individual engagement team members performing the audit work. For example, less experienced engagement team members may require more detailed instructions and more frequent, or in-person, interactions as the work is performed.
- The manner in which the reviews of the work performed are expected to take place. For example, in some circumstances, remote reviews may not be effective in providing the necessary direction and may need to be supplemented by in-person interactions.
- The structure of the engagement team and the location of engagement team members. For example, direction and supervision of individuals located at service delivery centers and the review of their work may:

- Be more formalized and structured than when members of the engagement team are all situated in the same location; or
- Use IT to facilitate the communication between the members of the engagement team.

A96. Identification of changes in the engagement circumstances may warrant reevaluation of the planned approach to the nature, timing or extent of direction, supervision or review. For example, if the assessed risk of material misstatement at the financial statement level increases because of a complex transaction, the engagement partner may need to change the planned level of review of the work related to the transaction.

A97. In accordance with paragraph 30(b), the engagement partner is required to determine that the approach to direction, supervision and review is responsive to the nature and circumstances of the audit engagement. For example, if a more experienced engagement team member becomes unavailable to participate in the supervision and review of the engagement team, the engagement partner may need to increase the extent of supervision and review of the less experienced engagement team members.

*Review of Communications to Management, Those Charged with Governance, or Regulatory Authorities (Ref: Para. 34)*

A98. The engagement partner uses professional judgment in determining which written communications to review, taking into account the nature and circumstances of the audit engagement. For example, it may not be necessary for the engagement partner to review communications between the engagement team and management in the ordinary course of the audit.

*Consultation (Ref: Para. 35)*

A99. ISQM 1 requires the firm to establish a quality objective that addresses consultation on difficult or contentious matters and how the conclusions agreed are implemented. Consultation may be appropriate or required, for example for:

- Issues that are complex or unfamiliar (e.g., issues related to an accounting estimate with a high degree of estimation uncertainty);
- Significant risks;
- Significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual;
- Limitations imposed by management; and
- Non-compliance with laws or regulations.

A100. Effective consultation on significant technical, ethical and other matters within the firm or, where applicable, outside the firm may be achieved when those consulted:

- Are given all the relevant facts that will enable them to provide informed advice; and
- Have appropriate knowledge, seniority and experience.

A101. It may be appropriate for the engagement team, in the context of the firm's policies or procedures, to consult outside the firm, for example, where the firm lacks appropriate internal resources. The engagement team may take advantage of advisory services provided by firms, professional and regulatory bodies or commercial organizations that provide relevant quality control services.

A102. The need for consultation outside the engagement team on a difficult or contentious matter may be an indicator that the matter is a key audit matter.<sup>40</sup>

#### *Engagement Quality Review* (Ref: Para. 36)

A103. ISQM 1 contains requirements that the firm establish policies or procedures addressing engagement quality reviews in accordance with ISQM 2,<sup>41</sup> and requiring an engagement quality review for certain types of engagements.<sup>42</sup> ISQM 2 deals with the appointment and eligibility of the engagement quality reviewer and the engagement quality reviewer's responsibilities relating to performing and documenting an engagement quality review.

#### Completion of the Engagement Quality Review Before Dating of the Auditor's Report (Ref: Para. 36(d))

A104. ISA 700 (Revised) requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.<sup>43</sup> If applicable to the audit engagement, ISQM 2 and this ISA require that the engagement partner be precluded from dating the engagement report until notification has been received from the engagement quality reviewer that the engagement quality review is complete. For example, if the engagement quality reviewer has communicated to the engagement partner concerns about the significant judgments made by the engagement team or that the conclusions reached thereon were not appropriate then the engagement quality review is not complete.<sup>44</sup>

A105. An engagement quality review that is conducted in a timely manner at appropriate stages during the audit engagement may assist the engagement team in promptly resolving matters raised to the engagement quality reviewer's satisfaction on or before the date of the auditor's report.

A106. Frequent communications between the engagement team and the engagement quality reviewer throughout the audit engagement may assist in facilitating

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<sup>40</sup> ISA 701, paragraphs 9 and A14

<sup>41</sup> ISQM 2, *Engagement Quality Reviews*

<sup>42</sup> ISQM 1, paragraph 34(f)

<sup>43</sup> ISA 700 (Revised), paragraph 49

<sup>44</sup> ISQM 2, paragraph 26

an effective and timely engagement quality review. In addition to discussing significant matters with the engagement quality reviewer, the engagement partner may assign responsibility for coordinating requests from the engagement quality reviewer to another member of the engagement team.

*Differences of Opinion* (Ref: Para. 37–38)

A107. ISQM 1 requires the firm to establish a quality objective that addresses differences of opinion that arise within the engagement team, or between the engagement team and the engagement quality reviewer or individuals performing activities within the firm’s system of quality management. ISQM 1 also requires that differences of opinion are brought to the attention of the firm and resolved.

A108. In some circumstances, the engagement partner may not be satisfied with the resolution of the difference of opinion. In such circumstances, appropriate actions for the engagement partner may include, for example:

- Seeking legal advice; or
- Withdrawing from the audit engagement, when withdrawal is possible under applicable law or regulation.

**Monitoring and Remediation** (Ref: Para. 39)

A109. ISQM 1 sets out requirements for the firm’s monitoring and remediation process. ISQM 1 requires the firm to communicate to engagement teams information about the firm’s monitoring and remediation process to enable them to take prompt and appropriate action in accordance with their responsibilities.<sup>45</sup> Further, information provided by members of the engagement team may be used by the firm in the firm’s monitoring and remediation process, and exercising professional judgment and professional skepticism while conducting the audit may assist the members of the engagement team in remaining alert for information that may be relevant to that process.

A110. Information provided by the firm may be relevant to the audit engagement when, for example, it relates to findings on another engagement performed by the engagement partner or other members of the engagement team, findings from the local firm office or inspection results of previous audits of the entity.

A111. In considering information communicated by the firm through its monitoring and remediation process and how it may affect the audit engagement, the engagement partner may consider the remedial actions designed and implemented by the firm to address identified deficiencies and, to the extent relevant to the nature and circumstances of the engagement, communicate accordingly to the engagement team. The engagement partner may also determine whether additional remedial

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<sup>45</sup> ISQM 1, paragraph 47

actions are needed at the engagement level. For example, the engagement partner may determine that:

- An auditor's expert is needed; or
- The nature, timing and extent of direction, supervision and review needs to be enhanced in an area of the audit where deficiencies have been identified.

If an identified deficiency does not affect the quality of the audit (e.g., if it relates to a technological resource that the engagement team did not use) then no further action may be needed.

A112. An identified deficiency in the firm's system of quality management does not necessarily indicate that an audit engagement was not performed in accordance with professional standards and applicable legal and regulatory requirements, or that the auditor's report was not appropriate in the circumstances.

**Taking Overall Responsibility for Managing and Achieving Quality** (Ref: Para. 40)

A113. ISQM 1 requires the firm to establish a quality objective addressing the engagement team's understanding and fulfillment of their responsibilities in connection with the engagement. ISQM 1 further requires that the quality objective include the overall responsibility of engagement partners for managing and achieving quality on the engagement and being sufficiently and appropriately involved throughout the engagement.

A114. Relevant considerations in addressing paragraph 40 include determining how the engagement partner has complied with the requirements of this ISA, given the nature and circumstances of the audit engagement and how the audit documentation evidences the engagement partner's involvement throughout the audit engagement, as described in paragraph A118.

A115. Indicators that the engagement partner may not have been sufficiently and appropriately involved include, for example:

- Lack of timely review by the engagement partner of the audit engagement planning, including reviewing the assessment of risks of material misstatement and the design of those responses to those risks.
- Evidence that those to whom tasks, actions or procedures have been assigned were not adequately informed about the nature of their responsibilities and authority, the scope of the work being assigned and the objectives thereof; and were not provided other necessary instructions and relevant information.
- A lack of evidence of the engagement partner's direction and supervision of the other members of the engagement team and the review of their work.

A116. If the engagement partner's involvement does not provide the basis for determining that the significant judgments made and the conclusions reached are appropriate, the engagement partner will not be able to reach the determination required by paragraph 40. In addition to taking account of firm policies or procedures that may set forth the required actions to be taken in such circumstances, appropriate actions that the engagement partner may take, include, for example:

- Updating and changing the audit plan;
- Reevaluating the planned approach to the nature and extent of review and modifying the planned approach to increase the involvement of the engagement partner; or
- Consulting with personnel assigned operational responsibility for the relevant aspect of the firm's system of quality management.

#### **Documentation** (Ref: Para. 41)

A117. In accordance with ISA 230,<sup>46</sup> audit documentation provides evidence that the audit complies with the ISAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file.

A118. Documentation of the performance of the requirements of this ISA, including evidencing the involvement of the engagement partner and the engagement partner's determination in accordance with paragraph 40, may be accomplished in different ways depending on the nature and circumstances of the audit engagement. For example:

- Direction of the engagement team can be documented through signoffs of the audit plan and project management activities;
- Minutes from formal meetings of the engagement team may provide evidence of the clarity, consistency and effectiveness of the engagement partner's communications and other actions in respect of culture and expected behaviors that demonstrate the firm's commitment to quality;
- Agendas from discussions between the engagement partner and other members of the engagement team, and where applicable the engagement quality reviewer, and related signoffs and records of the time the engagement partner spent on the engagement, may provide evidence of the engagement partner's involvement throughout the audit engagement and supervision of other members of the engagement team; or
- Signoffs by the engagement partner and other members of the engagement team provide evidence that the working papers were reviewed.

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<sup>46</sup> ISA 230, paragraph A7

A119. When dealing with circumstances that may pose risks to achieving quality on the audit engagement, the exercise of professional skepticism, and the documentation of the auditor's consideration thereof, may be important. For example, if the engagement partner obtains information that may have caused the firm to decline the engagement (see paragraph 24), the documentation may include explanations of how the engagement team dealt with the circumstance.

A120. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The nature and scope of the issue on which consultation was sought; and
- The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

# CONFORMING AMENDMENTS TO INTERNATIONAL STANDARDS ON AUDITING (ISA) AND RELATED MATERIAL ARISING FROM THE QUALITY MANAGEMENT PROJECTS

*Preface to the International Quality ~~Control~~Management, Auditing, Review, Other Assurance, and Related Services Pronouncements*

## Introduction

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

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

10. International Standards on Quality ~~Control~~Management (ISQEMs) are to be applied for all services falling under the IAASB's Engagement Standards.

...

## International Standards on Quality ~~Control~~Management

12. ISQEMs are written to apply to firms in respect of all their services falling under the IAASB's Engagement Standards. The authority of ISQEMs is set out in the introduction to ~~the~~each ISQEM.<sup>1</sup>

...

## Applicability of the International Standards

19. International Standards are relevant to engagements in the public sector. When appropriate, additional considerations specific to public sector entities are included:
  - (a) Within the body of an International Standard in the case of ISAs and ISQEMs; or
  - (b) In a Public Sector Perspective (PSP) appearing at the end of other International Standards.

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<sup>1</sup> ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, paragraph 12 and ISQM 2, *Engagement Quality Reviews*, paragraph 10

## ***ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing***

### **Introduction**

...

### **Requirements**

#### **Ethical Requirements Relating to an Audit of Financial Statements**

14. The auditor shall comply with relevant ethical requirements, including those ~~pertaining~~related to independence, relating to financial statement audit engagements. (Ref: Para. A16–A19)

...

### **Application and Other Explanatory Material**

#### **Ethical Requirements Relating to an Audit of Financial Statements (Ref: Para. 14)**

- A19. International Standard on Quality ~~Control~~Management (ISQEM) 1,<sup>2</sup> or national requirements that are at least as demanding,<sup>3</sup> deal with the firm's responsibilities to ~~establish~~design, implement and maintain its~~operate~~ a system of quality ~~control~~ for audit engagements. ISQC 1 sets out the responsibilities ~~of management that provides the firm for establishing policies and procedures designed to provide it with~~ reasonable assurance that the firm and its personnel ~~comply~~fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements. As part of its system of quality management, ISQM 1 requires the firm to establish quality objectives that address the fulfillment of responsibilities in accordance with relevant ethical requirements, including those pertainingrelated to independence.<sup>4</sup> ISA 220 (Revised) sets out the engagement partner's responsibilities with respect to relevant ethical requirements, including those related to independence.<sup>5</sup> These ~~include remaining alert, through observation and making inquiries as necessary, for evidence of breaches of relevant ethical requirements by members of the engagement team, determining the appropriate action if matters come to the engagement partner's attention that indicate that members of the engagement team have breached relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit~~

<sup>2</sup> ISQEM 1, *Quality ~~Control~~Management for Firms that Perform Audits and/or Reviews of Financial Statements, and/or Other Assurance and/or Related Services Engagements*

<sup>3</sup> ISA 220 (Revised), *Quality ~~Control~~Management for an Audit of Financial Statements*, paragraph 23

<sup>4</sup> ISQEM 1, paragraphs 20–25~~29~~

<sup>5</sup> ISA 220 (Revised), paragraphs 16–21

engagement.<sup>6</sup> ISA 220 recognizes that the engagement team is entitled to rely on a firm's system of quality control in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise. ISA 220 (Revised) also describes when the engagement team may depend on the firm's policies or procedures in managing and achieving quality at the engagement level.<sup>7</sup>

...

### **Professional Judgment (Ref: Para. 16)**

A27. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by ISA 220 (Revised),<sup>8</sup> assist the auditor in making informed and reasonable judgments.

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### **Sufficient Appropriate Audit Evidence and Audit Risk (Ref: Para. 5 and 17)**

#### *Sufficiency and Appropriateness of Audit Evidence*

A30. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit<sup>9</sup>) or through the information obtained by the firm in the acceptance or continuance of the client relationship or engagement firm's quality control procedures for client acceptance or continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

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<sup>6</sup> ISA 220, paragraphs 9–12

<sup>7</sup> ISA 220 (Revised), paragraph A10

<sup>8</sup> ISA 220 (Revised), paragraph 1835

<sup>9</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 916

## Conduct of an Audit in Accordance with ISAs

*Contents of the ISAs* (Ref: Para. 19)

A64. An ISA may include, in a separate section under the heading “Definitions,” a description of the meanings attributed to certain terms for purposes of the ISAs. These are provided to assist in the consistent application and interpretation of the ISAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the ISAs. The Glossary of Terms relating to International Standards issued by the International Auditing and Assurance Standards Board in the *Handbook of International Quality Control Management, Auditing, Review, Other Assurance, and Related Services Pronouncements* published by IFAC contains a complete listing of terms defined in the ISAs. It also includes descriptions of other terms found in ISAs to assist in common and consistent interpretation and translation.

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## ISA 210, *Agreeing the Terms of Audit Engagements*

### Introduction

#### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor’s responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present. ISA 220 (Revised)<sup>10</sup> deals with those aspects of engagement acceptance that are within the control of the auditor. (Ref: Para. A1)

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### Requirements

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## Application and Other Explanatory Material

#### Scope of this ISA (Ref: Para. 1)

A1. ISQM 1<sup>11</sup> deals with the firm’s responsibilities regarding the acceptance and continuance of client relationships and specific engagements. Assurance engagements, which include audit engagements, may only be accepted when the practitioner considers that relevant ethical requirements such as independence

<sup>10</sup> ISA 220 (Revised), *Quality Control Management for an Audit of Financial Statements*

<sup>11</sup> International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, paragraph 30

and professional competence will be satisfied, and when the engagement exhibits certain characteristics.<sup>12</sup> The auditor's responsibilities in respect of relevant ethical requirements, including those related to independence, in the context of the acceptance of an audit engagement and ~~in so far insofar~~ as they are within the control of the auditor are dealt with in ISA 220 (Revised).<sup>13</sup> This ISA deals with those matters (or preconditions) that are within the control of the entity and upon which it is necessary for the auditor and the entity's management to agree.

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## ISA 230, *Audit Documentation*

### Introduction

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### Nature and Purposes of Audit Documentation

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3. Audit documentation serves a number of additional purposes, including the following:
  - Assisting the engagement team to plan and perform the audit.
  - Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA 220 (Revised).<sup>14</sup>
  - Enabling the engagement team to be accountable for its work.
  - Retaining a record of matters of continuing significance to future audits.
  - Enabling the conduct of engagement quality control reviews,<sup>15</sup> other types of engagement reviews<sup>16</sup> and monitoring activities under the firm's system of quality management inspections in accordance with ISQC 1<sup>17</sup> or national requirements that are at least as demanding.<sup>18</sup>
  - Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

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<sup>12</sup> *International Framework for Assurance Engagements*, paragraph 17

<sup>13</sup> ISA 220 (Revised), paragraphs 9–11, 16–21

<sup>14</sup> ISA 220 (Revised), *Quality Control/Management for an Audit of Financial Statements*, paragraphs 15–17, 29–34

<sup>15</sup> *International Standard on Quality Management (ISQM) 2, Engagement Quality Reviews*

<sup>16</sup> *ISQM 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, paragraph A135

<sup>17</sup> *ISQC 1, Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraphs 32–33, 35–38, and 48

<sup>18</sup> ISA 220, paragraph 2

## Requirements

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### Application and Other Explanatory Material

#### Documentation of the Audit Procedures Performed and Audit Evidence Obtained

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*Form, Content and Extent of Audit Documentation* (Ref: Para. 8)

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Documentation of Compliance with ISAs (Ref: Para. 8(a))

...

- A7. Audit documentation provides evidence that the audit complies with the ISAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:
- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
  - The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management or, where appropriate, those charged with governance.
  - An auditor's report containing an appropriately qualified opinion on the financial statements demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the ISAs.
  - In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
    - For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with the ISAs. For example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management's assertions, documenting how the auditor evaluated that evidence, including the professional judgments made in forming a conclusion as to the sufficiency and appropriateness of the audit evidence obtained.

- Similarly, that the engagement partner has taken responsibility for the direction, and supervision and performance of the audit in compliance with engagement team and the ISAs review of their work<sup>19</sup>—may be evidenced in a number of ways within the audit documentation. This may include documentation of ~~that evidences~~ the engagement partner’s timely sufficient and appropriate involvement in aspects of the audit, such as participation in the engagement team discussions required by ISA 315 (Revised 2019).<sup>20</sup>

...

A13. ISA 220 (Revised) contains requirements and guidance on the auditor to review the audit work performed through review of the audit documentation.<sup>21</sup> The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

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*Matters Arising after the Date of the Auditor’s Report* (Ref: Para. 13)

A20. Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor’s report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor’s report.<sup>22</sup> The resulting changes to the audit documentation are reviewed in accordance with the review responsibilities set out in ISA 220 (Revised),<sup>23</sup> ~~with the engagement partner taking final responsibility for the changes.~~

**Assembly of the Final Audit File** (Ref: Para. 14–16)

A21. ISQM 1 (or national requirements that are at least as demanding) requires firms’ systems of quality management to establish a quality objective that addresses the assembly of engagement documentation on a timely basis after the date of the engagement reports, policies and procedures for the timely completion of the assembly of audit files.<sup>24</sup> An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor’s report.<sup>25</sup>

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<sup>19</sup> ISA 220 (Revised), paragraph 29

<sup>20</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*, paragraph 17

<sup>21</sup> ISA 220 (Revised), paragraphs 1729–34

<sup>22</sup> ISA 560, *Subsequent Events*, paragraph 14

<sup>23</sup> ISA 220 (Revised), paragraphs 1629–34

<sup>24</sup> ISQM 1, paragraph 4531(f)

<sup>25</sup> ISQM 1, paragraph A54A83

- A23. ISQEM 1 (or national requirements that are at least as demanding) requires firms' systems of quality management to establish a quality objective to address the appropriate maintenance and policies and procedures for the retention of engagement documentation to meet the needs of the firm and to comply with law, regulation, relevant ethical requirements, or professional standards.<sup>26</sup> The retention period for audit engagements ordinarily is no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report on the group financial statements, when applicable.<sup>27</sup>
- A24. An example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after file assembly has been completed is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal activities or external parties inspections.

## Appendix (Ref: Para. 1)

### Specific Audit Documentation Requirements in Other ISAs

This appendix identifies paragraphs in other ISAs that contain specific documentation requirements. The list is not a substitute for considering the requirements and related application and other explanatory material in ISAs.

- ISA 210, *Agreeing the Terms of Audit Engagements* – paragraphs 10–12
- ISA 220 (Revised), *Quality Control/Management for an Audit of Financial Statements* – paragraphs 24–41

## ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*

### Introduction

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### Requirements

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### Application and Other Explanatory Material

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<sup>26</sup> ISQEM 1, paragraph 4731(f)

<sup>27</sup> ISQEM 1, paragraph A6+A85

*Evaluating the Implications of Identified or Suspected Non-Compliance*  
(Ref: Para. 22)

...

A25. In certain circumstances, the auditor may consider withdrawing from the engagement, where permitted by law or regulation, for example when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances or the identified or suspected non-compliance raises questions regarding the integrity of management or those charged with governance, even when the non-compliance is not material to the financial statements. The auditor may consider it appropriate to obtain legal advice to determine whether withdrawal from the engagement is appropriate. When the auditor determines that withdrawing from the engagement would be appropriate, doing so would not be a substitute for complying with other responsibilities under law, regulation or relevant ethical requirements to respond to identified or suspected non-compliance. Furthermore, paragraph A9A55 of ISA 220 (Revised)<sup>28</sup> indicates that some ethical requirements may require the predecessor auditor, upon request by the proposed successor auditor, to provide information regarding noncompliance with laws and regulations to the successor auditor.

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**ISA 260 (Revised), *Communication with Those Charged with Governance***

**Introduction**

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**Requirements**

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**Application and Other Explanatory Material**

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**Matters to Be Communicated**

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*Significant Findings from the Audit* (Ref: Para. 16)

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<sup>28</sup> ISA 220 (Revised), *Quality Control/Management for an Audit of Financial Statements*

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 16(e))

A28. To the extent not already addressed by the requirements in paragraphs 16(a)–(d) and related application material, the auditor may consider communicating about other matters discussed with, or considered by, the engagement quality control reviewer, if one has been appointed, ~~in accordance with ISA 220.~~<sup>29</sup>

*Auditor Independence* (Ref: Para. 17)

A29. The auditor is required to comply with relevant ethical requirements, including those ~~pertain~~ing~~related~~ to independence, relating to financial statement audit engagements.<sup>30</sup>

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<sup>29</sup> See ~~paragraphs 19–22 and A23–A33 of ISA 220, *Quality Control for an Audit of Financial Statements*~~.

<sup>30</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 14

## Appendix 1

(Ref: Para. 3)

### Specific Requirements in ISQEM 1 and Other ISAs that Refer to Communications with Those Charged With Governance

This appendix identifies paragraphs in ISQEM 1<sup>31</sup> and other ISAs that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in ISAs.

- ISQEM 1, *Quality Control Management for Firms that Perform Audits and/or Reviews of Financial Statements, and/or Other Assurance and/or Related Services Engagements* – paragraph 30(a)34(c)

...

### ISA 300, *Planning an Audit of Financial Statements*

#### Introduction

#### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to plan an audit of financial statements. This ISA is written in the context of recurring audits. Additional considerations in an initial audit engagement are separately identified.

#### ~~The Role and Timing of Planning~~

2. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. ~~Adequate~~ Quality management at the engagement level in accordance with ISA 220 (Revised), in conjunction with adequate planning in accordance with this ISA, benefits the audit of financial statements in several ways, including the following: (Ref: Para. ~~A1~~A0–A3)
  - Helping the auditor to devote appropriate attention to important areas of the audit.
  - Helping the auditor identify and resolve potential problems on a timely basis.
  - Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
  - Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.

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<sup>31</sup> ISQEM 1, *Quality Control Management for Firms that Perform Audits and/or Reviews of Financial Statements, and/or Other Assurance and/or Related Services Engagements*

- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components and experts.

...

## Requirements

...

### Preliminary Engagement Activities

6. The auditor shall undertake the following activities at the beginning of the current audit engagement:
  - (a) Performing procedures required by ISA 220 (Revised) regarding the acceptance and continuance of the client relationship and the specific audit engagement;<sup>32</sup>
  - (b) Evaluating compliance with relevant ethical requirements, including those related to independence, in accordance with ISA 220 (Revised);<sup>33</sup> and
  - (c) Establishing an understanding of the terms of the engagement, as required by ISA 210.<sup>34</sup> (Ref: Para. A5–A7)

### Planning Activities

...

8. In establishing the overall audit strategy, the auditor shall consider the information obtained from complying with the requirements of ISA 220 (Revised) and:
  - (a) Identify the characteristics of the engagement that define its scope;
  - (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
  - (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
  - (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

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<sup>32</sup> ISA 220 (Revised), *Quality Control Management for an Audit of Financial Statements*, paragraphs 12–13 and 22–24

<sup>33</sup> ISA 220 (Revised), paragraphs 9–11 and 21

<sup>34</sup> ISA 210, *Agreeing the Terms of Audit Engagements*, paragraphs 9–13

- (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.<sup>35</sup> (Ref: Para. A8–A11)
9. The auditor shall develop an audit plan that shall include a description of:
- (a) The nature, timing and extent of the planned direction and supervision of engagement team members and the review of their work. (Ref: Para. A16–A17)
  - (ab) The nature, timing and extent of planned risk assessment procedures, as determined under ISA 315 (Revised 2019).<sup>36</sup>
  - (bc) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA 330.<sup>37</sup>
  - (ed) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs. (Ref: Para. A12-A14)
- ...
- ~~11. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A16–A17)~~

## Documentation

12. The auditor shall include in the audit documentation.<sup>38</sup>
- (a) The overall audit strategy;
  - (b) The audit plan; and
  - (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, including significant changes to the nature, timing and extent of the planned direction and supervision of engagement team members and the review of their work,<sup>39</sup> and the reasons for such changes. (Ref: Para. A18–A21)

## Additional Considerations in Initial Audit Engagements

13. The auditor shall undertake the following activities prior to starting an initial audit:
- (a) Performing procedures required by ISA 220 (Revised) regarding the acceptance of the client relationships and the specific audit engagements;<sup>40</sup> and

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<sup>35</sup> ISA 220 (Revised), paragraph 25

<sup>36</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*

<sup>37</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>38</sup> ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

<sup>39</sup> ISA 220 (Revised), paragraphs 30 and A91–A92

<sup>40</sup> ISA 220 (Revised), paragraphs 12–13, 22–24

- (b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A22)

...

## Application and Other Explanatory Material

A0. ISA 220 (Revised) deals with the specific responsibilities of the auditor regarding quality management at the engagement level for an audit of financial statements, and the related responsibilities of the engagement partner. Information obtained from complying with the requirements of ISA 220 (Revised) is relevant to this ISA. For example, in accordance with ISA 220 (Revised), the engagement partner is required to determine that sufficient and appropriate resources to perform the engagement have been assigned or made available to the engagement team, given taking into account the nature and circumstances of the audit engagement. Such a determination is directly relevant when ascertaining the nature, timing and extent of resources necessary to perform the engagement in the overall strategy, as required by paragraph 8 of this ISA.

### The Role and Timing of Planning (Ref: Para. 2)

A1. The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement. In planning the audit, the auditor may use project management techniques and tools. ISA 220 (Revised)<sup>41</sup> describes how such techniques and tools may support the engagement team in managing the quality of the engagement.

...

A3. The auditor may decide to discuss elements of planning with the entity's management to ~~facilitate the conduct and management of the audit engagement~~ help the auditor manage and achieve quality at the engagement level (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

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<sup>41</sup> ISA 220 (Revised), paragraphs A73–A74

## Preliminary Engagement Activities (Ref: Para. 6)

- A5. Performing the preliminary engagement activities specified in paragraph 6 at the beginning of the current audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to ~~plan and perform the audit engagement~~manage and achieve quality at the engagement level in accordance with ISA 220 (Revised).
- A6. Performing these preliminary engagement activities enables the auditor to plan an audit engagement ~~for which in order to~~, for example:
- ~~The auditor maintains~~Maintain the necessary independence and ability to perform the engagement.
  - ~~There~~Determine that there are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
  - ~~There~~Determine that there is no misunderstanding with the client as to the terms of the engagement.
- ~~A7. The auditor's consideration of client continuance and relevant ethical requirements, including independence, occurs throughout the audit engagement as conditions and changes in circumstances occur. Performing initial procedures on both client continuance and evaluation of relevant ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.~~

## Planning Activities

### *The Overall Audit Strategy* (Ref: Para. 7–8)

- A8. The process of establishing the overall audit strategy ~~assists the auditor to determine~~, subject to the completion of the auditor's risk assessment procedures, may include such matters as:
- The nature of resources (human, technological or intellectual) to deploy~~be deployed~~ for specific audit areas, ~~such as. For example, the use~~deployment of appropriately-experienced team members for high risk areas, or the involvement~~assignment~~ of experts onto ~~to~~ address complex matters;
  - The amount of resources to allocate~~be allocated~~ to specific audit areas, ~~such as. For example,~~ the number of team members assigned to observe~~attend~~ the physical inventory count at material~~multiple~~ locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
  - When these resources are to be deployed, such as whether at an interim audit stage or at key cutoff dates; and

- How such resources are ~~managed, directed and, supervised, such as or used.~~ For example, when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), ~~and whether to complete engagement quality reviews.~~

A8A. ISA 220 (Revised) contains requirements and guidance on engagement resources and engagement performance (including direction and supervision of the members of the engagement team and the review of their work).

...

*Direction, Supervision and Review* (Ref: Para. 11)

A16. ISA 220 (Revised) ~~deals with~~ establishes requirements and provides guidance on the engagement partner's responsibility for the nature, timing and extent of direction and supervision of the members of the engagement team and the review of their work.<sup>42</sup> ~~The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:~~

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

ISA 220 contains further guidance on the direction, supervision and review of audit work.<sup>43</sup>

#### Considerations Specific to Smaller Entities

A17. ~~If an audit is carried out entirely by the engagement partner, questions of direction and supervision of engagement team members and review of their work do not arise. In such cases, the engagement partner, having personally conducted all aspects of the work, will be aware of all material issues. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performs the entire audit. If particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably experienced auditors or the auditor's professional body.~~

<sup>42</sup> ISA 220 (Revised), paragraphs 29–31

<sup>43</sup> ISA 220, paragraphs 15–17

**Documentation** (Ref: Para. 12)

A18. The documentation of the overall audit strategy is a record of the key decisions ~~considered necessary to properly plan the audit and in managing quality at the engagement level and a means~~ to communicate significant matters to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

...

A20A. Documentation of the direction and supervision of engagement team members and the review of their work in accordance with ISA 220 (Revised) may also provide a record of significant changes to the planned nature, timing and extent of the direction, supervision and review.

...

**Additional Considerations in Initial Audit Engagements** (Ref: Para. 13)

A22. The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For an initial audit engagement, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances.<sup>44</sup>
- Other procedures required responses designed and implemented by the firm's system of quality control firm for initial audit engagements (for example, e.g., the firm's system of quality control management may include responses that require the involvement of another partner or senior individual with appropriate authority to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

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<sup>44</sup> ISA 510, *Initial Audit Engagements—Opening Balances*

## Appendix

(Ref: Para. 7–8, A8–A11)

### Considerations in Establishing the Overall Audit Strategy

This appendix provides examples of matters the auditor may consider in ~~establishing the overall audit strategy~~ managing quality at the engagement level. Many of these matters will ~~also~~ influence the auditor's overall audit strategy and detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required by other ISAs, not all matters are relevant to every audit engagement and the list is not necessarily complete.

#### Nature, Timing and Extent of Resources

- The ~~selection~~ human, technological and intellectual resources assigned or made available to the engagement (e.g., assignment of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement).
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

...

### ISA 315 (Revised 2019)

...

### Application and Other Explanatory Material

...

#### Risk Assessment Procedures and Related Activities

...

#### Other Relevant Sources

##### *Information from Other Sources*

A38. Other relevant sources of information include:

- The auditor's procedures regarding acceptance or continuance of the client relationship or the audit engagement in accordance with ISA 220 (Revised), including the conclusions reached thereon.<sup>45</sup>

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<sup>45</sup> ISA 220, Quality Control Management for an Audit of Financial Statements, paragraphs 1222–24

...

Industry, Regulatory and Other External Factors (Ref: Para. 19(a)(ii))

Industry Factors

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A69. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation.

**Example:**

In the construction industry, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience the appropriate competence and capabilities.<sup>46</sup>

**Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 28–37)**

*Assessing Risks of Material Misstatement at the Assertion Level*

Significant Risks (Ref: Para. 32)

Why significant risks are determined and the implications for the audit

A218. The determination of significant risks allows for the auditor to focus more attention on those risks that are on the upper end of the spectrum of inherent risk, through the performance of certain required responses, including:

- ...
- Timely review of audit documentation by the engagement partner at the appropriate stages during the audit allows significant matters, including significant risks, to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report.<sup>47</sup>

...

**ISA 500, *Audit Evidence***

...

**Application and Other Explanatory Material**

**Sufficient Appropriate Audit Evidence (Ref: Para. 6)**

...

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<sup>46</sup> ISA 220 (Revised), paragraphs 1425–28

<sup>47</sup> ISA 220 (Revised), paragraphs 1732 and A19A87–A89

A5. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has evaluated whether such information remains relevant and reliable as audit evidence for the current audit<sup>48</sup>) or ~~a firm's quality control procedures for client acceptance and continuance~~through the information obtained by the firm in the acceptance or continuance of the client relationship or engagement. In addition, the entity's accounting records and other sources internal to the entity are important sources of audit evidence. Information that may be used as audit evidence may have been prepared using the work of a management's expert or be obtained from an external information source. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

...

### **Information to Be Used as Audit Evidence**

*Relevance and Reliability* (Ref: Para. 7)

A30. As noted in paragraph A1, while audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources ~~such as~~, for example, previous audits, ~~in certain circumstances, a firm's quality control procedures for client acceptance and continuance and~~through the information obtained by the firm in the acceptance or continuance of the client relationship or engagement and in complying with certain additional responsibilities under law, regulation or relevant ethical requirements (e.g., regarding an entity's non-compliance with laws and regulations). The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

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## **ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures***

### **Introduction**

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### **Requirements**

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<sup>48</sup> ISA 315 (Revised 2019), paragraph 16

## Application and Other Explanatory Material

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### Risk Assessment Procedures and Related Activities

*Specialized Skills or Knowledge* (Ref: Para. 15)

A61. Matters that may affect the auditor's determination of whether the engagement team requires specialized skills or knowledge, include, for example:<sup>49</sup>

- The nature of the accounting estimates for a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments, insurance contract liabilities).

...

## ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

### Introduction

#### Scope of this ISA

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4. In accordance with ISA 220 (Revised),<sup>50</sup> the group engagement partner is required to ~~determine~~ be satisfied that those performing the group audit engagement, including component auditors, collectively have the appropriate competence and capabilities, including sufficient time. The group engagement partner is also responsible for the direction and supervision of members of the group engagement team and performance of the group audit engagement review of their work.<sup>51</sup>

5. The group engagement partner applies the requirements of ISA 220 (Revised) regardless of whether the group engagement team or a component auditor performs the work on the financial information of a component. This ISA assists the group engagement partner to meet the requirements of ISA 220 (Revised) where component auditors perform work on the financial information of components.

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### Requirements

12. In applying ISA 220 (Revised), the group engagement partner shall determine whether sufficient appropriate audit evidence can reasonably be expected to be

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<sup>49</sup> ISA 220 (Revised), *Quality Control/Management for an Audit of Financial Statements*, paragraphs 1425–26 and ISA 300, *Planning an Audit of Financial Statements*, paragraph 8(e)

<sup>50</sup> ISA 220 (Revised), *Quality Control/Management for an Audit of Financial Statements*, paragraphs 14–1525–26

<sup>51</sup> ISA 220 (Revised), paragraphs 29–31

obtained in relation to the consolidation process and the financial information of the components on which to base the group audit opinion. For this purpose, the group engagement team shall obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components. Where component auditors will perform work on the financial information of such components, the group engagement partner shall evaluate whether the group engagement team will be able to be involved in the work of those component auditors to the extent necessary to obtain sufficient appropriate audit evidence. (Ref: Para. A10–A12)

...

## ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

...

### Requirements

...

#### Using Internal Auditors to Provide Direct Assistance

...

34. The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with ISA 220 (Revised).<sup>52</sup> In so doing:
- (a) The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the factors in paragraph 29 of this ISA; and
  - (b) The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.

The direction, supervision and review by the external auditor of the work performed by the internal auditors shall be sufficient in order for the external auditor to determine ~~be satisfied~~ that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work. (Ref: Para. A40–A41)

### Application and Other Explanatory Material

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<sup>52</sup> ISA 220 (Revised), *Quality Control/Management for an Audit of Financial Statements*

## **Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used**

### *Evaluating the Internal Audit Function*

...

#### Application of a Systematic and Disciplined Approach (Ref: Para. 15(c))

...

A11. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

- The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
- Whether the internal audit function has appropriate quality control policies and procedures, for example, ~~such as those policies and procedures in ISQC 1<sup>53</sup>~~ that would be applicable to an internal audit function (such as those relating to leadership, human resources and engagement performance) or quality control requirements in standards set by the relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements such as conducting periodic external quality assessments.

## **ISA 620, *Using the Work of an Auditor's Expert***

### **Introduction**

#### **Scope of this ISA**

...

2. This ISA does not deal with:
  - (a) Situations where the engagement team includes a member, or consults an individual or organization, with expertise in a specialized area of accounting or auditing, which are dealt with in ISA 220 (Revised);<sup>54</sup> or
  - (b) The auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that

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<sup>53</sup> International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

<sup>54</sup> ISA 220 (Revised), *Quality Control Management for an Audit of Financial Statements*, paragraphs A11, A21–A23 A19

field is used by the entity to assist the entity in preparing the financial statements (a management's expert), which is dealt with in ISA 500.<sup>55</sup>

...

## Requirements

...

### Nature, Timing and Extent of Audit Procedures

8. The nature, timing and extent of the auditor's procedures with respect to the requirements in paragraphs 9–13 of this ISA will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including: (Ref: Para. A10)
- (a) The nature of the matter to which that expert's work relates;
  - (b) The risks of material misstatement in the matter to which that expert's work relates;
  - (c) The significance of that expert's work in the context of the audit;
  - (d) The auditor's knowledge of and experience with previous work performed by that expert; and
  - (e) Whether that expert is subject to the auditor's firm's system of quality control policies and procedures management. (Ref: Para. A11–A13)

...

## Application and Other Explanatory Material

### Determining the Need for an Auditor's Expert (Ref: Para. 7)

...

- A6. If the preparation of the financial statements involves the use of expertise in a field other than accounting, the auditor, who is skilled in accounting and auditing, may not possess the necessary expertise to audit those financial statements. The engagement partner is required to determine ~~be satisfied~~ that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities, including sufficient time, to perform the audit engagement.<sup>56</sup> Further, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the engagement.<sup>57</sup> The auditor's determination of whether to use the work of an auditor's expert, and if so when and to what extent, assists the auditor

<sup>55</sup> ISA 500, *Audit Evidence*, paragraphs A45–A59

<sup>56</sup> ISA 220 (Revised), paragraph 425–28

<sup>57</sup> ISA 300, *Planning an Audit of Financial Statements*, paragraph 8(e)

in meeting these requirements. As the audit progresses, or as circumstances change, the auditor may need to revise earlier decisions about using the work of an auditor's expert.

- A7. An auditor who is not an expert in a relevant field other than accounting or auditing may nevertheless be able to obtain a sufficient understanding of that field to perform the audit without an auditor's expert. This understanding may be obtained through, for example:

...

- Education or professional development in the particular field. This may include formal courses, or discussion with individuals possessing expertise in the relevant field for the purpose of enhancing the auditor's own capacity to deal with matters in that field. Such discussion differs from consultation with an auditor's expert regarding a specific set of circumstances encountered on the engagement where that expert is given all the relevant facts that will enable the expert to provide informed advice about the particular matter.<sup>58</sup>

...

#### **Nature, Timing and Extent of Audit Procedures (Ref: Para. 8)**

- A10. The nature, timing and extent of audit procedures with respect to the requirements in paragraphs 9–13 of this ISA will vary depending on the circumstances. For example, the following factors may suggest the need for different or more extensive procedures than would otherwise be the case:

- The work of the auditor's expert relates to a significant matter that involves subjective and complex judgments.
- The auditor has not previously used the work of the auditor's expert, and has no prior knowledge of that expert's competence, capabilities and objectivity.
- The auditor's expert is performing procedures that are integral to the audit, rather than being consulted to provide advice on an individual matter.
- The expert is an auditor's external expert and is not, therefore, subject to the firm's system of quality control policies and procedures management.

#### *The Auditor's Firm's System of Quality Control Policies and Procedures Management* (Ref: Para. 8(e))

- A11. An auditor's internal expert may be a partner or staff (i.e., personnel), including temporary staff, of the auditor's firm, and therefore subject to the system of

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<sup>58</sup> ISA 220 (Revised), paragraphs A22A99–A102

~~quality control policies and procedures management~~ of that firm in accordance with ISQM 1<sup>59</sup> or national requirements that are at least as demanding.<sup>60</sup> ~~Alternatively, an~~ An auditor's internal expert may also be a partner or staff, including temporary staff, of a network firm, ~~and is subject to the firm's policies or procedures for network requirements and network services in accordance with ISQM 1. In some instances, the auditor's internal expert of a network firm may be subject to which may share common quality control management policies and/or procedures as the auditor's firm, given that they are part of the same network.~~

A12. ISQM 1 requires the firm to address the use of resources from a service provider, which includes the use of an external expert.<sup>61</sup> An auditor's external expert is not a member of the engagement team and ~~is~~ may not be subject to ~~quality control policies and procedures in accordance with ISQC 1.~~<sup>62</sup> In some jurisdictions, however, the firm's policies or procedures under its system of quality management.<sup>63</sup> Furthermore, the firm's policies or procedures for relevant ethical requirements may include policies or procedures that apply to the auditor's external expert.<sup>64</sup> In some cases, ~~R~~relevant ethical requirements or law or regulation may require that an auditor's external expert be:

- Treated as a member of the engagement team (i.e., the external expert may ~~therefore~~ be subject to relevant ethical requirements, including those ~~pertaining~~ related to independence); or
- Subject to other professional requirements, as determined by that law or regulation.

A13. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise.<sup>65</sup> The extent of that reliance will vary with the circumstances, and may affect the nature, timing and extent of the auditor's procedures with respect to such matters ~~as~~ described in ISA 220 (Revised), ~~quality management at the engagement level is supported by the firm's system of quality management and informed by the specific nature and circumstances of the audit engagement.~~<sup>66</sup> For example, the auditor may be able to depend on the firm's related policies or procedures in respect of:

- Competence and capabilities, through recruitment and training programs.
- Objectivity. Auditor's internal experts are subject to relevant ethical requirements, including those ~~pertaining~~ relating to independence.

<sup>59</sup> ISQM 1, *Quality Control Management for Firms that Perform Audits and/or Reviews of Financial Statements, and/or Other Assurance and/or Related Services Engagements*, paragraph 1216(w)

<sup>60</sup> ISA 220 (Revised), paragraph 23

<sup>61</sup> ISQM 1, paragraph 32

<sup>62</sup> ISQC 1, paragraph 12(f)

<sup>63</sup> ISQM 1, paragraph 16(f)

<sup>64</sup> ISQM 1, paragraph 29(b)

<sup>65</sup> ISA 220, paragraph 4

<sup>66</sup> ISA 220 (Revised), paragraph A4

- The auditor's evaluation of the adequacy of the auditor's expert's work. For example, the firm's training programs may provide auditor's internal experts with an appropriate understanding of the interrelationship of their expertise with the audit process. Reliance on such training ~~and other firm processes, such as protocols for scoping the work of auditor's internal experts,~~ may affect the nature, timing and extent of the auditor's procedures to evaluate the adequacy of the auditor's expert's work.
- Adherence to regulatory and legal requirements, through monitoring processes.
- Agreement with the auditor's expert.

~~Such reliance~~ Matters that the auditor may take into account when determining whether to depend on the firm's policies or procedures are described in ISA 220 (Revised).<sup>67</sup> Depending on the firm's policies or procedures does not reduce the auditor's responsibility to meet the requirements of this ISA.

#### **The Competence, Capabilities and Objectivity of the Auditor's Expert (Ref: Para. 9)**

...

A15. Information regarding the competence, capabilities and objectivity of an auditor's expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with other auditors or others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.
- The auditor's firm's system of quality control policies and procedures management (see paragraphs A11–A13).

...

#### **Agreement with the Auditor's Expert (Ref: Para. 11)**

...

A26. When there is no written agreement between the auditor and the auditor's expert, evidence of the agreement may be included in, for example:

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<sup>67</sup> ISA 220 (Revised), paragraphs 4(b) and A10

- Planning memoranda, or related working papers such as the audit program.
- The policies ~~and~~ procedures of the auditor's firm's system of quality management. In the case of an auditor's internal expert, the ~~established policies and procedures to which that expert is subject~~ firm's system of quality management may include ~~particular policies and~~ procedures in relation relating to that the expert's work. The extent of documentation in the auditor's working papers depends on the nature of such policies ~~and~~ procedures. For example, no documentation may be required in the auditor's working papers if the auditor's firm has detailed protocols covering the circumstances in which the work of such an expert is used.

## ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

...

### Application and Other Explanatory Material

...

#### Auditor's Report (Ref: Para. 20)

...

#### *Auditor's Report for Audits Conducted in Accordance with International Standards on Auditing*

...

#### Relevant Ethical Requirements

A36. Law or regulation, national auditing standards or the terms of an audit engagement may require the auditor to provide in the auditor's report more specific information about the sources of the relevant ethical requirements, including those pertaining related to independence, that applied to the audit of the financial statements.

#### Name of the Engagement Partner (Ref: Para. 46)

A61. ISQC 1<sup>68</sup> ~~requires that~~ The objective of the firm establish policies in ISQM 1<sup>69</sup> is to design, implement and procedures to provide operate a system of quality management that provides the firm with reasonable assurance that engagements are performed:

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<sup>68</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraph 32

<sup>69</sup> ISQM 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, paragraph 14

- The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and
- Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.

Notwithstanding ~~these~~ the objective of ISQEM 1 requirements, naming the engagement partner in the auditor's report is intended to provide further transparency to the users of the auditor's report on financial statements of a listed entity.

## ***ISA 701, Communicating Key Audit Matters in the Independent Auditor's Report***

...

### **Application and Other Explanatory Material**

...

#### **Determining Key Audit Matters (Ref: Para. 9–10)**

...

#### *Matters that Required Significant Auditor Attention (Ref: Para. 9)*

...

A15. Various ISAs require specific communications with those charged with governance and others that may relate to areas of significant auditor attention. For example:

- ISA 260 (Revised) requires the auditor to communicate significant difficulties, if any, encountered during the audit with those charged with governance.<sup>70</sup> The ISAs acknowledge potential difficulties in relation to, for example:
  - Related party transactions,<sup>71</sup> in particular limitations on the auditor's ability to obtain audit evidence that all other aspects of a related party transaction (other than price) are equivalent to those of a similar arm's length transaction.
  - Limitations on the group audit, for example, where the group engagement team's access to information may have been restricted.<sup>72</sup>

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<sup>70</sup> ISA 260 (Revised), paragraphs 16(b) and A21

<sup>71</sup> ISA 550, *Related Parties*, paragraph A42

<sup>72</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph 49(d)

- ISA 220 (Revised) establishes requirements for the engagement partner in relation to undertaking appropriate consultation on difficult or contentious matters, matters on which the firm's policies or procedures require consultation,<sup>73</sup> and other matters that in the engagement partner's professional judgment, require consultation. For example, the auditor may have consulted with others within the firm or outside the firm on a significant technical matter, which may be an indicator that it is a key audit matter. The engagement partner is also required to discuss, among other things, significant matters and significant judgments arising during the audit engagement with the engagement quality ~~control~~-reviewer.<sup>74</sup>

...

### Communication with Those Charged with Governance

...

- A63. The requirement in paragraph 17(b) to communicate with those charged with governance when the auditor has determined there are no key audit matters to communicate in the auditor's report may provide an opportunity for the auditor to have further discussion with others who are familiar with the audit and the significant matters that may have arisen (including the engagement quality ~~control~~-reviewer, where one has been appointed). These discussions may cause the auditor to re-evaluate the auditor's determination that there are no key audit matters.

## ISA 720 (Revised), The Auditor's Responsibilities Relating to Other Information

...

### Application and Other Explanatory Material

...

#### Reading and Considering the Other Information (Ref: Para. 14–15)

...

- A24. In accordance with ISA 220 (Revised),<sup>75</sup> the engagement partner is required to take responsibility for the ~~direction, supervision and performance of the audit engagement~~ direction and supervision of the members of the engagement team and the review of their work,<sup>76</sup> and determine that the nature, timing and extent

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<sup>73</sup> ISA 220 (Revised), *Quality Control Management for an Audit of Financial Statements*, paragraph 4835

<sup>74</sup> ISA 220 (Revised), paragraph 4936

<sup>75</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 15(a)

<sup>76</sup> ISA 220 (Revised), *Quality Management for an Audit of Financial Statements*, paragraphs 29–30

of direction, supervision and review is planned and performed in compliance accordance with the firm's policies or procedures, professional standards and applicable legal and regulatory requirements.<sup>77</sup> In the context of this ISA, factors that may be taken into account when determining the appropriate engagement team members to address the requirements of paragraphs 14–15, include:

- The relative experience of engagement team members.
- Whether the engagement team members to be assigned the tasks have the relevant knowledge obtained in the audit to identify inconsistencies between the other information and that knowledge.
- The degree of judgment involved in addressing the requirements of paragraph 14–15. For example, performing procedures to evaluate the consistency of amounts in the other information that are intended to be the same as amounts in the financial statements may be carried out by less experienced engagement team members.
- Whether, in the case of a group audit, it is necessary to make inquiries of a component auditor in addressing the other information related to that component.

### ***ISA 805 (Revised), Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement***

...

#### **Application and Other Explanatory Material**

...

#### **Considerations When Accepting the Engagement**

*Application of ISAs* (Ref: Para. 7)

- A5. ISA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining related to independence, relating to financial statement audit engagements, and (b) all ISAs relevant to the audit. It also requires the auditor to comply with each requirement of an ISA unless, in the circumstances of the audit, the entire ISA is not relevant or the requirement is not relevant because it is conditional and the condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an ISA by performing alternative audit procedures to achieve the aim of that requirement.

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<sup>77</sup> ISA 220 (Revised), *Quality Control for an Audit of Financial Statements*, paragraph 1530(a)

## IAPN 1000, *Special Considerations in Auditing Financial Instruments*

### Contents

International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*, should be read in conjunction with the *Preface to the International Quality Control Management, Auditing, Review, Other Assurance, and Related Services Pronouncements*. IAPNs do not impose additional requirements on auditors beyond those included in the International Standards on Auditing (ISAs), nor do they change the auditor's responsibility to comply with all ISAs relevant to the audit. IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance.

...

### Section II—Audit Considerations Relating to Financial Instruments

#### Planning Considerations<sup>78</sup>

##### *Using Those with Specialized Skills and Knowledge in the Audit*<sup>79</sup>

78. A key consideration in audits involving financial instruments, particularly complex financial instruments, is the competence of the auditor. ISA 220 (Revised)<sup>80</sup> requires the engagement partner to determine ~~be satisfied~~ that members of the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate ~~competence~~ and capabilities, including sufficient time, to perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements and to enable an auditor's report that is appropriate in the circumstances to be issued. Further, relevant ethical requirements<sup>81</sup> require the auditor to determine whether acceptance of the engagement would create

<sup>78</sup> ISA 300, *Planning an Audit of Financial Statements*, deals with the auditor's responsibility to plan an audit of financial statements

<sup>79</sup> When such a person's expertise is in auditing and accounting, regardless of whether the person is from within or external to the firm, this person is considered to be part of the engagement team and is subject to the requirements of ISA 220 (Revised), *Quality Control Management for an Audit of Financial Statements*. When such a person's expertise is in a field other than accounting or auditing, such person is considered to be an auditor's expert, and the provisions of ISA 620, *Using the Work of an Auditor's Expert*, apply. ISA 620 explains that distinguishing between specialized areas of accounting or auditing, and expertise in another field, will be a matter of professional judgment, but notes the distinction may be made between expertise in methods of accounting for financial instruments (accounting and auditing expertise) and expertise in complex valuation techniques for financial instruments (expertise in a field other than accounting or auditing).

<sup>80</sup> ISA 220 (Revised), paragraph 1426

<sup>81</sup> International Ethics Standards Board of Accountants' (IESBA) *International Code of Ethics for Professional Accountants (including International Independence Standards)* paragraphs 320.1-320.10A†

any threats to compliance with the fundamental principles, including the professional competence and due care. Paragraph 79 below provides examples of the types of matters that may be relevant to the auditor's considerations in the context of financial instruments.

...

80. The nature and use of particular types of financial instruments, the complexities associated with accounting requirements, and market conditions may lead to a need for the engagement team to consult<sup>82</sup> with other accounting and audit professionals, from within or outside the firm, with relevant technical accounting or auditing expertise and experience, taking into account factors such as:

- The capabilities and competence of the engagement team, including the experience of the members of the engagement team.
- The attributes of the financial instruments used by the entity.
- The identification of unusual circumstances or risks in the engagement, as well as the need for professional judgment, particularly with respect to materiality and significant risks.
- Market conditions.

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<sup>82</sup> ISA 220 (Revised), paragraph 18(b)35, requires the engagement partner to ~~be satisfied~~ determine that members of the engagement team have undertaken appropriate consultation during the course of the audit engagement, both within the engagement team, and between the engagement team and others at the appropriate level within or outside the firm.

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