

September 2004  
Invitation to Comment

---

Response Due Date  
6 December 2004

*IAASB Exposure Draft*

---

Proposed Policy Statement,  
“Clarifying Professional  
Requirements in International  
Standards Issued by the IAASB ”

*IAASB Consultation Paper*

---

Improving the Clarity and Structure  
of IAASB Standards and Related  
Considerations for Practice  
Statements



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

## CONTENTS

---

	Page
Hong Kong Institute of CPAs Invitation to Comment .....	3
IAASB Exposure Draft on Proposed Policy Statement “Clarifying Professional Requirements in International Standards Issued by the IAASB” .....	9 – 18
IAASB Consultation Paper on “Improving the Clarity and Structure of IAASB Standards and related Considerations for Practice Statements” .....	19 – 85
IAASB Press Release .....	86 – 88

This Invitation to Comment may be filed in the “Exposure Drafts, Invitations to Comment” section of Volume III of the Institute Members’ Handbook.

A copy of the Invitation to Comment can also be found on the Institute’s website at:  
<http://www.hkicpa.org.hk/professionaltechnical/assurance/exposedraft/>



## INVITATION TO COMMENT

The International Auditing and Assurance Standards Board (IAASB) is seeking comments on the attached Exposure Draft (ED) and Consultation Paper which have been posted on the Institute's website at <http://www.hkicpa.org.hk/professionaltechnical/assurance/exposedraft/>. They can also be found on-line at <http://www.ifac.org/IAASB/>.

In accordance with the Institute's ISA Convergence Due Process, the Institute's Auditing and Assurance Standards Committee (AASC) invites comments on the IAASB ED and Consultation Paper from any interested party and would like to hear from both those who do agree and those who do not agree with the proposals contained in the IAASB ED and Consultation Paper. Comments should be supported by specific reasoning and should preferably be submitted in written form.

To allow your comments on the IAASB ED and Consultation Paper to be considered and included in the Institute's submission to the IAASB, they are requested to be received by the Institute on or before **6 December 2004**. Comments may be sent by mail, fax or e-mail to:

**Stephen Chan**  
**Technical Director (Ethics & Assurance)**  
**Hong Kong Institute of Certified Public Accountants**  
**4th Floor, Tower Two, Lippo Centre**  
**89 Queensway**  
**Hong Kong**

**Fax number: 2865 6776**  
**E-mail: [commentletters@hkicpa.org.hk](mailto:commentletters@hkicpa.org.hk)**

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

Upon finalization of the IAASB ED and Consultation Paper, the AASC intends to adopt them as local standards so that Hong Kong Auditing and Assurance Standards maintain conformity with current International Auditing and Assurance Standards at all times.

**September 2004**

*Exposure Draft*

---

**Proposed Policy Statement,  
“ Clarifying Professional  
Requirements in International  
Standards Issued by the IAASB ”**

*Consultation Paper*

---

**Improving the Clarity and Structure  
of IAASB Standards and Related  
Considerations for Practice  
Statements**



## CONTENTS

---

	Page
Request for Comments.....	2
Exposure Draft	
Explanatory Memorandum .....	6
Proposed Policy Statement, “Clarifying Professional Requirements in International Standards Issued by the IAASB”.....	11
Consultation Paper	
Improving the Clarity and Structure of IAASB Standards and Related Considerations for Practice Statements .....	16
Supplement to the Exposure Draft and Consultation Paper: Illustrative Examples.....	37

## REQUEST FOR COMMENTS

The enclosed exposure draft, “Proposed Policy Statement, *Clarifying Professional Requirements in International Standards Issued by the IAASB*,” and consultation paper, “Improving the Clarity and Structure of IAASB Standards and Related Considerations for Practice Statements,” of the International Auditing and Assurance Standards Board (IAASB) were approved for publication in September 2004. The proposed Policy Statement may be modified in light of comments received before being issued in final form.

### Introduction

In serving the public interest, the IAASB aims to set high quality international auditing and assurance standards that are understandable, clear and capable of consistent application, thereby serving to enhance the quality and uniformity of practice worldwide. In doing so, the IAASB seeks to balance the needs of a wide range of users that operate in different legal, cultural and business environments.

In seeking continually to improve its standards, and in responding to developments affecting the demands and expectations of professional accountants, recent IAASB standards have included more specific essential procedures and detailed guidance on how to apply the basic principles and essential procedures in differing circumstances. This trend has arisen primarily from the need to increase the quality and consistency of auditor performance globally. A further factor is the increasing complexity of business and financial reporting. As a consequence, the standards are longer, and in some instances more prescriptive and more complex, than those issued in the past.

In 2003 the IAASB undertook a review of the drafting conventions used in its standards. The objective of the review was to identify ways to improve the clarity, and thereby the consistent application, of International Standards issued by the IAASB. In doing so, the IAASB initially considered three principal issues:

- Whether the distinction between bold type and plain type lettering was appropriate and helpful, and their respective authority sufficiently clear;
- The language used to describe the responsibilities of the professional accountant; and
- Whether actions expressed in the present tense contain obligations for professional accountants, and how to address the concern that some professional accountants may interpret this material as being optional while others may view it as being mandatory.

The IAASB has reached agreement on how to address the three issues identified above and has concluded that it should seek input on its proposal through the enclosed exposure draft.

During consideration of these issues, the IAASB also considered other wider aspects of clarity arising from concerns variously expressed by some IAASB members, national standard setters, and respondents to recent exposure drafts about the length and complexity of standards and the way in which they are structured.

Whether and how other aspects of IAASB standards might be improved as part of the clarity review has proved difficult to resolve. The IAASB concluded that this issue requires further

## REQUEST FOR COMMENTS

consultation and that additional information is needed to assist the IAASB in its deliberations. The IAASB has therefore issued a consultation paper seeking further input on this aspect of the project, on the concerns that have been raised on certain aspects of IAASB standards, and on the options that should be considered by the IAASB to respond to these concerns.

The language and structure of standards are viewed by some as interrelated aspects of clarity. The exposure draft and consultation paper have therefore been issued together, and the IAASB will consider comments received on both documents concurrently. The IAASB has determined, however, that a delay in resolving the issues addressed in the consultation paper should not preclude the adoption of the proposals in the exposure draft, subject to comments received on exposure.

### **Comments on the Exposure Draft and Consultation Paper**

The IAASB welcomes comments on the enclosed exposure draft and consultation paper. In responding, respondents are requested to refer to the relevant paragraphs within the exposure draft and consultation paper. The responses should include the reasons for the comments, and, in the case of the proposed Policy Statement, specific suggestions for any proposed changes to wording.

The IAASB is seeking comments on all matters addressed in the exposure draft and consultation paper. In particular, the IAASB is interested in comments on the questions contained in the explanatory memorandum to the exposure draft. Specific matters in the consultation paper on which the IAASB is seeking comment are highlighted therein.

### **Supplement to the Exposure Draft and Consultation Paper: Illustrative Examples**

For the purposes of encouraging debate and soliciting responses to the exposure draft and consultation paper, IAASB staff has prepared an illustration of how the proposals in the Policy Statement and the restructuring of an International Standard on Auditing (ISA) contemplated in the consultation paper might be applied to an ISA. This supplement does not form part of either the exposure draft or consultation paper nor does it represent actual or contemplated changes that might arise from their application. Comments on this material are welcome in so far as they relate to the proposed Policy Statement and the issues contained in the consultation paper for which the IAASB is seeking input. Since the changes contained therein do not reflect the views of, nor a proposal by, the IAASB, comments on the specific changes are not sought from respondents.

## REQUEST FOR COMMENTS

### **Response Due Date**

To be considered, comments on the exposure draft of the proposed Policy Statement and on the consultation paper should be submitted so as to be received by **December 31, 2004**, preferably by e-mail or on computer disk, or in writing. All comments will be considered a matter of public record. Comments should be addressed to:

Technical Director  
International Auditing and Assurance Standards Board  
545 5<sup>th</sup> Avenue, 14<sup>th</sup> Floor  
New York, New York 10017 USA  
Email responses should be sent to: [Edcomments@ifac.org](mailto:Edcomments@ifac.org)

The approved text of the exposure draft and consultation paper is published in the English language. In order to achieve maximum exposure and feedback, the International Federation of Accountants encourages the reproduction of this publication in any format.

Copyright © September 2004 by the International Federation of Accountants. All rights reserved.



**Response Due Date December 31, 2004**

**Proposed Policy Statement  
Clarifying Professional  
Requirements in International  
Standards Issued by the IAASB**

**Issued for Comment  
by the International  
Federation of  
Accountants**



## EXPLANATORY MEMORANDUM

### **Introduction**

This memorandum provides some background to, and explanation of, the proposed Policy Statement approved for exposure by the International Auditing and Assurance Standards Board (IAASB).

### **Background**

International standards that are clear and capable of consistent application should contain no ambiguity about the professional requirements a professional accountant must fulfill.

It has been suggested that there is some confusion over the authority of the plain type lettering (containing explanatory and other material), as compared with text presented in bold type. In particular, some constituents have questioned whether professional accountants are expected to perform the procedures described in the present tense, noting that the present tense may be interpreted as being more, or less, definitive than possibly intended by the IAASB.

The IAASB is proposing to reaffirm the responsibility of the professional accountant to consider all aspects of a standard, not just the bold type sentences, and to clarify the language used to describe the responsibilities of the professional accountant, including the use of the word “should,” and whether material presented in the present tense in fact contains a professional requirement.

### ***Proposed Changes***

#### **Categories of Professional Requirements**

The IAASB believes that the use of clear, concise, consistent and definitive imperatives is essential to the consistent application of International Standards. Accordingly, the proposed Policy Statement not only reaffirms the responsibility of the professional accountant to consider all aspects of a standard, but establishes that the obligations imposed on the professional accountant are to be communicated by the use of specific language. To achieve this, the Policy Statement proposes to clarify the professional requirements of a standard by specifying and defining two categories of professional requirements: *requirements* and *presumptive requirements*.

A *requirement*, identified by the use of the word “shall,” is a professional requirement to be fulfilled in all cases where the relevant circumstances apply. A *presumptive requirement*, identified by the word “should,” is a professional requirement to be fulfilled in all cases in which the circumstances exist to which the presumptive requirement applies; but, in rare circumstances, the professional accountant may depart from a presumptive requirement provided that the professional accountant documents why the professional accountant decided to do so and how the alternative procedure(s) performed in the circumstances were sufficient to achieve the objectives of the presumptive requirement.

The obligation imposed by a presumptive requirement differs from that imposed by use of the word “should” in existing standards. The latter permits departure only where a professional accountant judges it necessary to achieve more effectively the objective of the engagement. The IAASB believes that the proposed change reflects the establishment of an appropriate threshold for departure from a presumptive requirement in applying professional judgment.

The proposed documentation requirement in the case of a departure from a presumptive requirement is more rigorous than the present requirement for the professional accountant to “be prepared to justify the departure.” The IAASB believes the additional documentation requirement responds to the public interest and is appropriate for what should be a rare occurrence.

Subject to comments on exposure, it is proposed that the requirement for a professional accountant to document a departure from a presumptive requirement be effective for engagements conducted in accordance with IAASB’s International Standards for periods commencing on or after June 15, 2005. For this purpose only, the basic principles and essential procedures contained in existing standards will carry the status of presumptive requirements until such time as the relevant standards are revised in line with the proposed Policy Statement. The circumstances in which a professional accountant may depart from a basic principle or essential procedure remain unchanged.

### **Use of the Present Tense**

Under the current drafting convention, the formulation “the auditor should [do something]” is restricted to the basic principles and essential procedures set out in bold type. Explanatory material set out in plain type uses the present tense. This material includes definitions and explanations, but also refers to actions of the professional accountant (for example, “the auditor considers [this or that],” or “the auditor tests a control”). It is this latter type of statement over which there seems to be confusion – does it impose an obligation on the professional accountant, or is it in fact optional?

The IAASB proposes to discontinue the use of the present tense in relation to actions by the professional accountant. In future, such statements would be drafted so as to make any requirement clear (by using “shall” or “should”), or to make it clear that there is no intention to create a requirement, by using alternative language that appropriately explains the IAASB’s intentions.

### **Changes Consequent on the Above**

It follows from the above proposals that all professional requirements that a standard imposes on the professional accountant will be identifiable by the use of “shall” or “should” statements. The IAASB proposes to refer to these as the “professional requirements” of a standard, and to discontinue the use of the terms “basic principles and essential procedures” in future International Standards. The latter terms may have implied that there were other principles (possibly, but not necessarily, in the standards), and that other procedures (again, whether in the standards or not) might not be “essential.”

While the IAASB has not deliberated or otherwise agreed their content, the illustrative examples in the “Supplement to the Exposure Draft and Consultation Paper: Illustrative Examples” prepared by IAASB staff suggest there will be an increase in the number of bold type requirements in standards when drafted under the proposals as compared with the present drafting convention. Some believe that this increase will be significant.

### **Other Matters**

The IAASB considered whether it should discontinue the use of bold type. In doing so, it observed that respondents to the November 2002 draft Preface were overwhelmingly of the view that bold type should be retained. The IAASB has concluded that it should continue to use bold type as a convention to assist the professional accountant in identifying the requirements of a standard. The IAASB recognizes, however, that the proposals in the exposure draft differ from the circumstances in November 2002. It is therefore appropriate to ask respondents to give their views on the issue.

The exposure draft also clarifies the purpose and intended use of explanatory material contained in International Standards and the use of appendices.

### **Application of the Policy Statement**

Subject to comments on exposure, the IAASB intends to apply the provisions of the Policy Statement on a prospective basis to exposure drafts approved for issue by the IAASB after the final approval of the Policy Statement – which may possibly happen by June 2005. International Standards based on exposure drafts approved for issue before final approval of the Policy Statement would not be revised to adopt the conventions proposed in the Policy Statement without consideration of the need for re-exposure.

Once finalized, the provisions of the Policy Statement will be adopted through amendment to the Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance, and Related Services. Except as noted above with respect to the documentation of departures from existing basic principles and essential procedures, the existing description of the authority and conventions of International Standards contained in the Preface will remain applicable for existing International Standards until such time as they have been revised and drafted in accordance with the provisions of the Policy Statement.

### **Alternative Approaches to Implementation**

The IAASB considered implementing the proposed Policy Statement following three alternative approaches.

The first approach consisted of developing and issuing for exposure at a single point in time a complete package of all International Standards on Auditing (ISAs),<sup>1</sup> revised following the conventions proposed in the Policy Statement. This approach may avoid any suggestion of confusion that might arise during a transitional period when standards would exist in both the existing and new style of drafting.

---

<sup>1</sup> Although IAASB’s standards comprise more than ISAs, this proposal principally focuses on ISAs given their importance to the public interest. The concepts behind the proposal, however, can be equally applied in the future to other International Standards issued by the IAASB.

The second approach consisted of redrafting and issuing for exposure (but not otherwise revising), on a priority basis, the recently issued audit risk and fraud ISAs under the proposed conventions. This would reflect their central importance and the fact that they would not otherwise be expected to be revised in the short term. Applying the proposed categories of professional requirements to these ISAs would entail a determination by the IAASB whether each existing requirement identified in bold type lettering and using the word “should” represents: (a) a *requirement*, requiring a change to a “shall” statement; or (b) a *presumptive requirement*, requiring no drafting change. It would also entail a review of the use of the present tense in existing ISAs and a determination whether each procedure or action is necessary to achieve the objective of the specific ISA and therefore a professional requirement, or strictly explanatory in nature. In the latter case, the present tense might be modified or the sentence restructured to make it clear that there is no intention to create a professional requirement. Remaining International Standards would adopt the drafting conventions as they are updated and revised.

The IAASB concluded that the application of the Policy Statement following either of the above approaches would not be practicable, as both approaches would consume a significant amount of IAASB agenda time and require existing projects to be put on hold during that period. Recognizing the importance of completing projects currently underway, the IAASB has concluded that the most appropriate way forward is a prospective approach as described above.

## Questions

**While the IAASB is seeking comments on all matters addressed in the exposure draft, the IAASB is interested in comments on the following issues:**

### Equal Authority

1. In developing the proposed Policy Statement, the IAASB considered the need to clarify the responsibility of the professional accountant to consider all aspects of a standard, not just the bold type sentences. It considered the option of stating that the entire text of an International Standard has “equal authority,” this term to be explained as meaning that there is no difference in the level of authority between the different paragraphs within an International Standard regardless of whether the paragraph is presented in plain type or bold type lettering. The IAASB found the term “equal authority” problematic and subject to differing interpretation. An alternative, more acceptable term, was not identified.

The IAASB believes that the proposed Policy Statement – which reaffirms the responsibility of the professional accountant to consider all aspects of a standard, and combines this with the use of clearly defined categories of professional requirements and the clarification of the use of the present tense and explanatory material – achieves the same effect as the concept of “equal authority,” but without the need to introduce a specific term. Accordingly, the IAASB believes that use of the term “equal authority” would not further enhance the effect of the intended changes and has not adopted it.

**Do respondents agree with the view of the IAASB, or would a statement of “equal authority” assist in clarifying the responsibilities of the professional accountant?**

### **Categories of Professional Requirements**

2. Do respondents agree with the proposed categories of professional requirements and the related obligations they would impose on professional accountants? Please state the reasons in support for your response.
3. Do respondents believe that the proposals will improve the quality and consistency of audits? Please state the reasons in support for your response.
4. Do respondents agree with the proposed requirement for the professional accountant, when departing from a presumptive requirement, to document why the professional accountant decided to depart, and how the alternative procedure(s) performed in the circumstances were sufficient to achieve the objectives of the presumptive requirement? Please state the reasons in support for your response.
5. Do respondents agree with the applicability of the proposed documentation requirement to departures from existing International Standards before they are revised? Please state the reasons in support for your response.
6. Will the proposed terms “shall” and “should” result in translation difficulties? The IAASB had considered the word “must” as an alternative to “shall” – would this alternative resolve any identified translation difficulties?
7. Does the anticipated increase in the number of bold type requirements that may arise by adopting the proposals raise concern over the specificity and level at which professional requirements are set? Please state the reasons in support for your response.

### **Bold Type Lettering**

8. Do respondents agree with the decision of the IAASB to retain the bold type convention?

### **Implementation of the Proposals**

9. Do respondents agree that the IAASB should apply the proposals on a prospective basis? Please state the reasons in support for your response.

**PROPOSED POLICY STATEMENT<sup>2</sup>**  
**CLARIFYING PROFESSIONAL REQUIREMENTS IN INTERNATIONAL**  
**STANDARDS ISSUED BY THE IAASB**

**CONTENTS**

---

	Paragraph
Introduction.....	1
Clarifying Professional Requirements in International Standards .....	2-9
Professional Requirements .....	2-6
Explanatory Material .....	7-8
Appendices.....	9
Applicability to Existing International Standards .....	10-11
Application .....	12

---

---

<sup>2</sup> Once finalized, the provisions of this Policy Statement will be adopted through amendment to the Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance, and Related Services (Preface).

## **Introduction**

- This Policy Statement, in conjunction with the Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance, and Related Services<sup>3</sup> (Preface), sets forth the meaning of certain terms and conventions used in International Standards issued by the IAASB in describing the professional requirements imposed on professional accountants.

## ***Clarifying Professional Requirements in International Standards***

### **Professional Requirements**

- International Standards contain professional requirements together with related guidance in the form of explanatory and other material, including appendices. The professional requirements contained in International Standards are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. Professional accountants have a responsibility to consider the entire text of an International Standard in carrying out their work on an engagement and in understanding and applying the professional requirements of the relevant International Standard(s).
- Not every paragraph of an International Standard carries a professional requirement that the professional accountant is expected to fulfill. Rather, the professional requirements are communicated by the language and the meaning of the words used in the International Standard and as described in this Policy Statement.
- International Standards use two categories of professional requirements, identified by specific terms, to describe the degree of responsibility that International Standards impose on professional accountants, as follows:

*Requirements* – The professional accountant is required to comply with a requirement in all cases in which the circumstances exist to which the requirement applies. International Standards use the word “shall” to indicate a requirement.

*Presumptive requirements* – The professional accountant is also required to comply with a presumptive requirement in all cases in which the circumstances exist to which the presumptive requirement applies; but, in rare circumstances, the professional accountant may depart from a presumptive requirement provided that the professional accountant documents why the professional accountant decided to do so and how the alternative procedure(s) performed in the circumstances were sufficient to achieve the objectives of the presumptive requirement. International Standards use the word “should” to indicate a presumptive requirement.

---

<sup>3</sup> The IAASB Exposure Draft, “Amendments to the Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services–IAASB Due Process and Working Procedures,” issued in July 2004 proposes that the title of the Preface be amended to “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance, and Related Services” to align it with the structure of the *Handbook of International Auditing, Assurance, and Ethics Pronouncements* adopted by the IAASB.



## CONSULTATION PAPER

If an International Standard provides that a procedure or action is one that the professional accountant “should consider,” the consideration of the procedure or action is presumptively required, while carrying out the procedure or action is not.

The professional requirements of an International Standard are to be understood and applied in the context of the explanatory and other material that provides guidance for their application.

- A professional accountant complies with the professional requirements of International Standards that are relevant to the engagement, that is, when material matters exist that make the professional requirements of the standard applicable. A professional accountant should represent compliance with International Standards only upon complying with all relevant professional requirements of the International Standards.
- Bold type lettering is used in paragraphs within an International Standard to identify professional requirements for purposes of aiding overall readability.

### **Explanatory Material**

- International Standards contain explanatory material that is intended to provide further explanation and guidance on the professional requirements. Such explanatory material is intended to be descriptive rather than imperative. That is, it explains the objective of the professional requirements (where not otherwise self-evident), why the professional accountant should consider or employ particular procedures, depending on the circumstances, and provides additional information for the professional accountant to consider in exercising professional judgment in performing the engagement.
- Explanatory material may also identify and describe other procedures or actions relating to the activities of the professional accountant. While a professional accountant has a responsibility to consider the whole text of an International Standard in carrying out the work on an engagement, such guidance is not intended to impose a professional requirement for the professional accountant to perform the suggested procedures or actions. Rather, these procedures or actions require the professional accountant’s attention and understanding; how and whether the professional accountant carries out such procedures or actions in the engagement will depend on the exercise of professional judgment in the circumstances consistent with the objective of the standard.

### **Appendices**

- Appendices are an integral part of an International Standard. The purpose and intended use of an appendix are clearly explained in the body of the related International Standard or within the title and introduction of the appendix itself. The use of appendices may vary depending on the subject of the International Standard.

### **Applicability to Existing International Standards**

- The IAASB did not previously expressly define certain of the terms and conventions as set out herein for use when drafting International Standards, which therefore may be subject to different interpretation. Accordingly, the existing description of the authority and

## CONSULTATION PAPER

conventions of International Standards contained in the Preface will remain applicable, except as noted below, to existing International Standards until such time as they have been revised and drafted in accordance with the provisions of this Policy Statement.

- The IAASB believes, however, that the requirement for the professional accountant to document a departure from a presumptive requirement, as set out above, responds to the public interest and is appropriate for what should be a rare occurrence. Accordingly, this documentation requirement will apply to departures from the basic principles and essential procedures of the existing International Standards. The requirement for a professional accountant to justify departure from a presumptive requirement (or a basic principle or essential procedure) in writing is effective for engagements for periods commencing on or after June 15, 2005.<sup>4</sup>

### **Application**

- Except for the requirement pertaining to the documentation of departures, as explained above, the IAASB will apply the provisions of this Policy Statement on a prospective basis to exposure drafts approved for issue after final approval of the Policy Statement.

---

<sup>4</sup> For assurance engagements where there is no such period, the requirement to document a departure from a presumptive requirement is effective for reports issued on or after December 15, 2005.

**IFAC  
International  
Auditing  
and Assurance  
Standards Board**

**September 2004  
Consultation Paper**

---

**Response Due Date December 31, 2004**

**Improving the Clarity and  
Structure of IAASB Standards  
and related Considerations for  
Practice Statements**

**Issued for Comment  
by the International  
Federation of  
Accountants**



**CONSULTATION PAPER**  
**IMPROVING THE CLARITY AND STRUCTURE OF IAASB STANDARDS AND**  
**RELATED CONSIDERATIONS FOR PRACTICE STATEMENTS**

**CONTENTS**

---

Section	Paragraph
I: Introduction .....	1
II: Background .....	2-7
III: Understandability of IAASB Standards .....	8-31
Present Situation .....	8-12
Viewpoints .....	13-15
Options for Consideration .....	16-22
Viewpoints on Possible Restructuring .....	23-29
Pursuing a Restructuring Approach .....	30-31
IV: Fundamental Principles Underlying an ISA Audit .....	32-42
Present Situation .....	32
Discussion .....	33-36
Possible Fundamental Principles Underlying an ISA Audit .....	37-42
V: Practice Statements .....	43-47
Present Situation .....	43-45
Matters for Further Consideration .....	46-47
Appendix 1: Characteristics of a Restructured ISA	
Appendix 2: International Auditing Practice Statements (IAPSs)	

---

## **I. Introduction**

1. This consultation paper has been issued by the International Auditing and Assurance Standards Board (IAASB) to seek input on improving the clarity and structure of IAASB standards. It also seeks input on related considerations for Practice Statements.

## **II. Background**

2. The objective of the IAASB is *“to serve the public interest by setting high quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.”* This objective means that the IAASB endeavours to issue standards that, among other things, are:
  - Understandable by those who perform the relevant engagements;
  - Clear and capable of consistent application;
  - Recognized by the various regulators around the world;
  - Accepted by the profession at the international and national levels; and
  - Applicable to and applied in practice by all professional accountants for all engagements, regardless of the size and structure of their firm or of the entity subject to the engagement.
3. In seeking continually to improve its standards, the IAASB undertook in 2003 a review of the drafting conventions used in its standards. The objective of the review was to identify ways to improve the clarity, and thereby the consistent application, of its standards. The review also reflected the continuing need for the IAASB to issue standards that are as comprehensive as appropriate and that promote effective audits, recognizing the need to strike a balance between detailed requirements and retaining the ability for auditors to apply professional judgment appropriately.
4. In carrying out the review, the IAASB considered the views expressed by the International Organization of Securities Commissions (IOSCO) and other stakeholders on the need to clarify certain aspects of its standards,<sup>5</sup> and consulted representatives of national auditing standard setters about how to improve the clarity of the standards. The IAASB also considered elements arising from a review of UK auditing standards commissioned by the UK Auditing Practices Board from the British Standards Institute and solicited preliminary views from other regulators, the IAASB’s Consultative Advisory Group and some IFAC committees, including the IFAC Small and Medium Practices Permanent Task Force.
5. The review identified several aspects of IAASB standards where possible improvement in clarity might be made. Of particular importance were issues related to bold type and plain type lettering and the drafting conventions followed by the IAASB. The IAASB’s proposals on these issues are set out in the exposure draft of the proposed Policy Statement, “Clarifying Professional Requirements in International Standards Issued by the IAASB”

---

<sup>5</sup> Based on responses to the IAASB’s November 2002 Exposure Draft, “Proposed Terms of Reference, Preface and Operations Policy No 1 – Bold Type Lettering.”

(Exposure Draft).

6. Other important aspects were also identified for consideration by the IAASB. These aspects relate primarily to the understandability of the IAASB's International Standards on Auditing (ISAs) in light of their increased length and perceived complexity. The identification of the principles of auditing upon which the professional requirements of ISAs are set was also identified for consideration. These matters are the subject of this consultation paper.
7. The issue of whether there is a need to change the way in which IAASB standards are drafted, and if so how, has proved difficult to resolve. Contrasting views have been expressed amongst members of the IAASB and amongst some national standard setters and members of the regulatory community. These views may represent the different objectives of the constituents, and thereby expectations of different outcomes; they may also reflect the differing environments in which they practise. They are nevertheless matters that the IAASB needs to weigh and consider. The IAASB therefore concluded that further consultation is warranted and that additional information is needed in order to assist the IAASB's deliberations.

### **III. Understandability of IAASB Standards**

#### **Present Situation**

8. Early international auditing and assurance standards were generally fairly brief documents, typically comprising 15-35 paragraphs. They included a limited number of basic principles and essential procedures, supplemented by explanatory material where considered necessary. This drafting style reflected the view that standards that contain high-level principles and procedures provide a sufficient framework for the auditor to understand, and apply professional judgment in determining, the essential procedures required in carrying out a high quality audit.
9. Over time, however, practitioners and regulators have called for the IAASB to issue standards that bring more specificity to the procedures expected and more guidance as to how they might be carried out. These demands have arisen primarily from the need to increase the quality and consistency of auditor performance globally.
10. In seeking to improve its standards, and in responding to developments affecting the demands and expectations of auditors, recent IAASB's standards have included more specific essential procedures, and more detailed guidance on how to apply the basic principles and essential procedures in differing circumstances. As a consequence, the resulting standards are longer, and in some instances are perceived as more prescriptive and more complex, than those issued in the past. The aim of the IAASB, however, has been to continue to focus on the principles and essential procedures (albeit that there may be more of them) necessary in carrying out a high quality audit and the application by professional accountants of appropriate professional judgment.
11. Some stakeholders have expressed support for the way IAASB's standards are drafted, observing that they are an appropriate reflection of today's business environment, with the

additional guidance now provided considered a useful, and indeed essential, characteristic of high quality standards. However, some respondents to exposure drafts, while recognizing the reasons for such a trend, requested the IAASB to consider how best this trend could be managed to avoid perceived difficulties with long and complex standards, especially amongst smaller accounting firms and those who audit small- and medium-sized entities.

12. More recently, the International Federation of Accountants has undertaken a study on the extent to which professional accountants and others have faced challenges and achieved successes in the adoption and implementation of both International Financial Reporting Standards (IFRSs) and ISAs within their national environments. The report on the findings from this study, *Challenges and Successes in Implementing International Standards: Achieving Convergence to IFRSs and ISAs*,<sup>6</sup> addresses, among others, the topic of the complexity and structure of international standards. The report states that “[p]articipants were of the view that international standards are increasingly becoming longer, more complex, and rules-based, and that the structure and complexity of the standards are affecting, largely in an adverse way, both their adoption and implementation,” but also states that “the [participating] international regulators... appeared to be supportive of the longer and more detailed ISAs issued recently.” From the perspective of the challenges for small- and medium-sized entities and accounting firms, the report states that “[v]irtually all participants raised issues concerning the relevancy and appropriateness of the international standards to small- and medium-sized entities and accounting firms.” In general, the report reflects many of the viewpoints outlined below.

### **Viewpoints**

13. The following outlines some of the views expressed by certain national standard setters, regulators, IFAC Committees and others to the IAASB on how to improve the clarity of other aspects of IAASB standards. The views expressed below are not necessarily shared by all members of a particular group, nor do they represent the views of IAASB; however, some IAASB members may agree with the observations being made.

### *Concerns*

14. Several national auditing standard setters and some others have expressed particular concern over the present trend towards longer, more detailed standards. To improve their understandability, they have urged changes to how standards are written (a) to help make it easier for auditors to identify and understand professional requirements or obligations; (b) to control their length and complexity; and (c) to assist in national adoption and implementation. In this regard, the following views have been expressed:
  - Lengthy and detailed standards may be acceptable in some jurisdictions where such standards are already accepted by auditors, and where they are appropriate to the legal environment. In other jurisdictions, however, length and detail may prove obstacles to their acceptance. This has created difficulty not only for some national standard setters who have to adopt the standards, or at least converge to them, but arguably also for practitioners who must implement them, and for quality or compliance bodies who

---

<sup>6</sup> The report, published in September 2004, is available on the IFAC website at [www.ifac.org](http://www.ifac.org).

must monitor their application.

- National standards setters must create standards that are appropriate for their own jurisdictions and capable of being effectively introduced. Some countries, for example, support ISAs by incorporating them into national law. Some national standard setters argue that the more explanatory text (not by nature suitable for inclusion in a legal instrument) that is included in international standards, the more difficult it will be to converge national standards with international standards. Consequently, there is a need to consider whether the current structure of an ISA, in its entirety, is suitable in such jurisdictions. The trend towards longer and more detailed ISAs may hinder their integration into national auditing standards, particularly where such characteristics are viewed as representing a procedural approach that may be thought to hinder the use of professional judgment.
- In those countries where IAASB standards must be translated into the national language before integration into, or adoption as, national standards, the longer and more detailed the standards, the greater the translation problems. This difficulty has led some countries to redraft the standards during translation for better understanding by their auditors. Accordingly, while it might be appropriate to require the adoption of all professional requirements (in translated form, where necessary), a certain amount of flexibility may be needed to assist in (a) adapting explanatory material to local circumstances, and (b) translating explanatory material. Specific issues raised in this context have included the need to accommodate references to different corporate governance structures and to permit the exclusion of material that is unquestionably not applicable to a particular jurisdiction and which, if included, may result in confusion.
- Some practitioners have raised concerns about the difficulty in trying to keep up with the unprecedented pace at which international standards are being issued. Some argue that this situation may be aggravated by the trend towards relatively lengthy and complex standards. Further, detailed requirements, which some may view as adding a layer of complexity, may result in a compliance mentality and in inconsistency in interpretation. Consequently, some believe that these factors may increase the risk that practitioners will not fully consider the standards and may not apply them consistently. This effect may be particularly acute for small- and medium-sized accounting firms (although not only for them) who may believe that complex IAASB standards are not relevant to them and their clients. These concerns seem to be prevalent in many countries where the majority of audits are of small- or medium-sized private companies.

#### *Support for the Present Style of IAASB Standards*

15. In contrast to the above views, some individuals and groups support the style in which recently issued ISAs are written. In their view, the ISAs are in fact quite readable and the more specific and expanded guidance contained therein is generally in line with what the regulators and others are seeking in standards. It is argued that the recently issued standards are not unduly complex or “rules-based,” and that length is not necessarily a negative characteristic. In this regard, the following views have been expressed:



- Today's ISAs are very understandable and their length is a reflection of the complexities of the business environment and higher expectations of auditors. In this regard, the last few years have resulted in significant changes in the financial reporting environment, and in the public expectations of companies and their auditors. In this environment, more detail is required in standards to make them effective in achieving consistently high quality audits.
- Accounting firms are responding to the new demands by increasing the guidance and training given to their staff, and developing specific firm-wide audit practices and quality control systems. Similar increases in the specificity and amount of guidance should therefore occur in audit standard setting. Auditor judgment will, and should, continue to be important, but it would seem that standards will need to include both general principles and specific application guidance to guide the exercise of sound professional judgment.
- Recent ISAs provide good guidance for small accounting firms. For example, the level of guidance in the audit risk standards makes it easier for small accounting firms to train their staff and to implement the standards.
- The issue of length is separate and distinct from the issue of clarity; it would be possible to make improvements in clarity without change to the style or structure of the standards affecting their overall length; it would also be possible to make standards shorter and more general, without achieving improvement in clarity. Accordingly, it is questionable whether the views that the length and complexity of standards hinder clarity and understandability are in fact valid or compelling enough to warrant a change to the style and structure of the standards.
- In response to the view that change to the structure, or reconsideration of the length and style of the standards, is necessitated by legal requirements in jurisdictions, it has been observed that some jurisdictions have two-level auditor guidance in place today to accommodate their particular legislative environments. In other jurisdictions, auditing and accounting standards are incorporated into law by reference. Accordingly, it is questioned whether such legislative or legal requirements in themselves warrant a change to the current structure of the standards. While the IAASB should remain cognizant of the manner in which the standards may be adopted by various jurisdictions, views on the real significance of national legislative approaches should be sought in the first instance before the IAASB agrees to changes in its practice. This is particularly important if such changes were in any way to affect the quality of its standards.

## **Questions**

Recently issued ISAs have addressed complex issues. In developing those standards, the IAASB has sought to create standards that are as comprehensive as possible and that promote effective audits, while striking a balance between detailed requirements and retaining the ability for auditors to apply professional judgment.

1. **Has the length and style of these standards aided or impaired their understandability and clarity? Please explain the reasons that are persuasive in reaching your view and provide examples that help illustrate your view.**
2. **If there is concern over the length of the standards, please also explain what is viewed as being problematic – the amount of explanatory guidance provided, the scope of matters addressed or other aspects of the standards. How do respondents consider such matters might be resolved?**
3. **Has the degree of detail provided in the standards aided or hindered their adoption or implementation? Please provide specific details of the circumstances that have arisen as a result of the style in which ISAs are written.**
4. **Are there other options for improvement in standards that should be considered by the IAASB?**

## **Options for Consideration**

16. As explained in paragraph 5, the IAASB has decided to revise the conventions used in drafting its standards in order to improve their clarity and the consistency of their application. If the responses to this consultation paper indicate that the other concerns expressed above about clarity are not shared by respondents, the IAASB will not pursue other options.
17. If, on the other hand, the responses to this consultation paper indicate that there is a need to take further action to improve the clarity of its standards, the IAASB will consider other options. Pending the results of this consultation, the IAASB has not reached a conclusion about what should be done in these circumstances. However, it is anticipated that any further changes would require a restructuring of the standards. In order to assist respondents, some options are presented below; they are not intended, however, to restrict the range of options that respondents might suggest.
18. Under the restructuring options discussed below, all professional requirements of ISAs (that is, those requirements that are identified in existing ISAs as well as those that would be identified through the application of the proposed Policy Statement in the accompanying Exposure Draft) would be retained. Restructuring would have the effect however of separating professional requirements from the related explanatory material. In considering the restructuring options, it is important to note that the IAASB would not allow any aspect of restructuring to weaken the requirements, or reduce the applicability, of its standards. On the contrary, any restructuring that seeks to respond to the concerns raised over the length and complexity of ISAs would be expected to strengthen the effect of the standards by more clearly expressing their requirements and improving the ability of practitioners to understand and implement them.

### *Restructuring Option A*

19. *Retain the present structure of an ISA (including all professional requirements contained therein), but move a large part of the explanatory material to a related International Auditing Practice Statement (IAPS).*

The resulting ISAs would be more concise as they would include mainly the professional requirements of the auditor. The related IAPS would include a large part of the explanatory material presently included in ISAs, and could also incorporate interpretive guidance, industry considerations, additional guidance for small- and medium-sized accounting firms, and public sector matters. The IAPSs could also be issued or revised to address emerging issues without the need to revise the related ISA.

The use of IAPSs for explanatory material related to ISAs would require a careful and systematic review of the existing IAPSs (which cover a broad range of topics), as well as a review of the authority, drafting conventions and future use of Practice Statements to ensure that they are considered and applied, where applicable, during an audit.<sup>7</sup>

This option would also require consideration of whether the bold type lettering convention should continue to be used in the ISAs.

### *Restructuring Option B*

20. *Retain both the professional requirements and explanatory material in one document, but separated into two distinct sections: the first section (the ‘standards section’) would set out the professional requirements of the ISA (again, all professional requirements contained therein); the second section (the ‘application material’ section) would contain explanatory material that supports proper application of the ISA. The need for the current bold type lettering convention would no longer exist and therefore its use would be discontinued.*

Consistent with the current authority attaching to ISAs, the auditor would be required to (a) comply with the standards section, and (b) consider the application material section as part of understanding and applying the professional requirements. This option would clearly distinguish professional requirements from explanatory material, but within one authoritative document.

Appendix 1 provides an outline of the type of material that would be included within the standards section and application material section of a restructured ISA following this approach. For the purposes of encouraging debate and soliciting responses to this paper, an illustration of how ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements” might have been issued under this option has been attached as a supplement to this paper (see Exhibit 2 of the document “Supplement to the Exposure Draft and Consultation Paper: Illustrative Examples”).

---

<sup>7</sup> There are some national regulators that are considering the adoption of ISAs, but not necessarily all IAPSs. In absence of assurance that IAPSs would be adopted also, greater use of IAPSs may be seen as a weakening of the standards issued by the IAASB. On the other hand, greater use of IAPSs as a means to issue guidance on the application of ISAs, together with appropriate adjustments to their authority, may serve to give them a higher profile and reduce the chance that guidance in an IAPS is overlooked, and could therefore have a double benefit.

21. Under either restructuring option above, the authority of the document used to communicate explanatory material – whether by the way of the use of IAPs or by way of a second section within an ISA – would be equivalent between the two options, and consistent with the authority presently attaching to explanatory material in ISAs.

*Related Alternative - Establishing an Explanatory Document*

22. In addition to the above restructuring options, an alternative way of enhancing the understandability of ISAs has been considered by the IAASB, as follows:

*Issue an ISA made up of two separate documents: (a) the first document would contain the professional requirements; and (b) the second document would contain the related explanatory material as well as additional background to, and explanation of, the IAASB's basis for its conclusions in developing the ISA.*

This model is different to the restructuring options above as it contemplates a document not currently being issued by the IAASB.

The second document would contain additional explanatory or application guidance that helps support the application of the professional requirements. It would also contain the IAASB's basis for the conclusions reached in formulating the professional requirements. These two documents would be closely aligned, exposed together and eventually presented together in the *Handbook of International Auditing, Assurance, and Ethics Pronouncements* with the same effective dates. The second document would be considered an integral part of the standard, with appropriate authority attaching thereto such that the auditor would be required to consider the explanatory material.

**Viewpoints on Possible Restructuring**

23. The following outlines some of the views that the IAASB has received from those national standard setters, regulators, IFAC Committees that have been consulted on their preliminary views of whether restructuring of IAASB standards is needed and, if so, the implications thereof.

*Support for Restructuring*

24. While some may argue that restructuring is little more than a reshuffling of material offering little benefit, it has several distinct advantages in relation to the users of the standards:
  - Professional requirements are clearly and unambiguously stated, separated from the more detailed guidance dealing with the implementation of the requirements. Auditors, particularly those dealing with smaller and less complex businesses, should therefore be able to focus on and understand the requirements more easily.
  - The requirements of the ISAs will be presented in a less intimidating, more concise and user-friendly manner.
  - Although the guidance in the application material is essential, many experienced auditors may find it familiar or self-evident. For them, and for those audit situations

for which more detailed guidance is not required, auditors can focus effort on the standards sections that identify their obligations, rather than searching for requirements in a long document.

- The format lends itself to further innovation that will assist the widespread adoption and use of international standards such as a web-based application with the ability to “drill-down” from the professional requirements to the application guidance.
  - Restructuring may further assist, and provide more flexibility, in national adoption or implementation of ISAs, providing national standard setters with scope to incorporate national requirements and guidance within the ISA framework. It would also enable their incorporation into legislation, where that is required. In this regard, national standard setters would be required to adopt the professional requirements in their entirety (the ISA in the case of option A, or the standards sections in the case of option B), translating if necessary. National standard setters might be allowed, however, to adapt the related material (the IAPS, or related explanatory or application material) to deal with translation difficulties or local circumstances so long as any change does not undermine or contradict the effect of the standards. In other words, adoption, translation, adaptation, or added guidance should not result in a loss of any content of a standard, although it may have the effect of interpreting the content in light of regulatory or other local circumstances.
25. In support of these benefits, some observers also note that audit failure occurs when auditors do not focus on what is important, rather than because the auditor overlooked some explanatory guidance. Restructuring ISAs therefore may help the auditor to focus on the principal things that the auditor needs to do and know, thereby enhancing the quality of audits.
26. It has also been observed that the process of applying the proposed categories of professional requirements outlined in the accompanying Exposure Draft may increase the number of professional requirements included in standards. As a result, such professional requirements may become so deeply embedded within the document (especially in the longer ISAs) that they could be overlooked. The effective application of that Policy Statement would therefore require consideration of the style and structure of ISAs; that is, the issue of clarity of language cannot be addressed in isolation, but in tandem with the reconsideration of the structure of the ISAs.

#### *Concerns Over Restructuring*

27. Of particular concern to some over restructuring is that by separating professional requirements and explanatory material (either by way of two sections within one document or two separate documents), overall clarity may in fact be reduced because the auditor may overlook or ignore explanatory material. This would be true particularly if the standards omitted context-sensitive material provided by the related explanatory material such that they could not be interpreted and understood on a stand-alone basis. In this regard, the ISAs need to explain both what the auditor is required to do, and why, as such explanations are integral to the auditor’s undertaking of a “shall” or “should” requirement; one cannot gain a full understanding of the standard without such explanations.

28. It has been further noted that the objective to accommodate legislative options whereby the standards sections only are to be included in legislation may provide even more reason to expect that practitioners may overlook or ignore the explanatory material. The possible perception that the explanatory and guidance document or section is of lesser authority than the “standards” may be considered unacceptable. This risk may exist irrespective of how well the authority of the explanatory material is described.
29. The practicalities and consequences of implementation have also been questioned. ISAs are being translated and are embedded in training and audit methodologies. In particular, the revised European Commission 8<sup>th</sup> Directive<sup>8</sup> is expected to require the use of ISAs throughout the European Union for statutory audit. The concern is that restructuring may entail a major translation effort and that the impact on standard setters, firms, educators and practitioners would be significant. This concern is one of the major factors that suggest that any change of this nature should be implemented on a prospective basis.

### **Questions**

5. **Do respondents believe that the IAASB should continue with its present style of ISAs, or is there a need for ISAs to be restructured? What are the reasons that are persuasive in reaching your view?**
6. **If ISAs are to be restructured, which option should be pursued and why? Are there other options that the IAASB should consider, particularly in helping with the ability for auditors of both large and small- and medium-sized entities to implement ISAs?**

### **Pursuing a Restructuring Approach**

30. The IAASB has proposed that the Policy Statement in the accompanying Exposure Draft be applied on a prospective basis, because this approach would not disrupt the IAASB’s work on other important projects.
31. Should a restructuring occur (that option may be pursued if the comments received on this consultation paper support a move in that direction), for practical reasons, the restructuring of ISAs would also need to be carried out on a prospective basis, concurrently with the application of the proposed Policy Statement. The revision to an ISA, to accomplish both the clarification of language and a restructuring, would therefore only be done once.

---

<sup>8</sup> Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC (March 16, 2004).

## **Questions**

7. **Notwithstanding the decisions of the IAASB regarding the proposed Policy Statement (see accompanying Exposure Draft), in the event there is strong support for the restructuring of ISAs, do respondents agree that any such restructuring should be applied on a prospective basis? Or should restructuring be applied prospectively, but on a priority basis first to a limited number of ISAs that have attracted concerns about their length and complexity, namely the IAASB’s recently issued audit risk and fraud ISAs? If so, what are the reasons that are persuasive in reaching your view?**

## **IV. Fundamental Principles Underlying an ISA Audit**

### **Present Situation**

32. IAASB’s standards are said to be “principles-based,” but although they contain “basic principles and essential procedures,” the distinction between the two has never been made. Accordingly, the principles upon which ISAs are based have never been separately enunciated.

### **Discussion**

#### *Support for Identifying Fundamental Principles Underlying an ISA Audit*

33. To continue to support a “principles-based” approach to standards and to assist auditors in using professional judgment in following an ISA’s requirements, it may be desirable for the IAASB to articulate what those principles are, and to demonstrate their linkage with the standards that are issued. Accordingly, one possibility would be for the IAASB to identify and communicate the “fundamental principles underlying an ISA audit,” and to align the professional requirements of ISAs more closely with those principles.
34. The advantages of codifying the “fundamental principles underlying an ISA audit” include more clearly identifying and communicating the principles that underlie the professional requirements contained in ISAs and that ultimately drive the auditor’s professional judgment. Absent a professional requirement within an ISA guiding the auditor’s conduct in a specific circumstance or in relation to a specific matter, the auditor might be able to refer to and work from the principles in guiding professional judgment and in determining an appropriate course of action.
35. The identification of the “fundamental principles underlying an ISA audit” would also create a framework to assist the IAASB in determining the professional requirements to be established in ISAs, particularly in relation to the determination of whether a procedure is to be considered a mandatory requirement (a “shall” statement) or a presumptively mandatory requirement (a “should” statement) as proposed in the accompanying Exposure Draft.

## Concerns

36. Although there may be some support conceptually for identifying and communicating “fundamental principles underlying an ISA audit,” some question the practicality of attempting to identify and reach agreement on them at an international level, the manner in which they should be expressed, and the ultimate value to be derived therefrom. In regard to their development, some argue that a theoretical basis supported by research is needed to determine such principles. The development of, and agreement on (if indeed possible), fundamental principles may therefore require significant resources that otherwise may better serve the public interest if applied to the development of high quality ISAs. In addition, while the principles may be of assistance to the IAASB and standard setters, they may not be useful to practitioners.

## Possible Fundamental Principles Underlying an ISA Audit

37. To assist in the consideration of whether “fundamental principles underlying an ISA audit” should be identified and communicated, the IAASB has formulated a general working framework for the development and codification of such principles and a preliminary list of possible principles.
38. In drafting the principles, the IAASB has considered the International Framework for Assurance Engagements, the basic principles and essential procedures within existing ISAs and principles or similar statements in a number of national auditing standards. It is important to note that the following “fundamental principles underlying an ISA audit” are based on the preliminary view of the IAASB and may not represent the final set of principles that ultimately might be adopted.
39. The following is not intended to suggest that the IAASB will pursue the development of a final set of principles; that decision will be taken in light of the comments received.

### *Working Framework*

40. Fundamental principles may be described as comprising the essential qualities underpinning every ISA audit. Conceptually, fundamental principles should:
- Underlie the objective(s) of an audit, and help drive the behavior of the auditor in using professional judgment to fulfill the professional requirements of the ISAs.
  - Be easily understood both by professional accountants and other readers of ISAs.
  - Be universally applicable to all audits.
  - Represent those expectations which auditors are not expected to depart from or override.
41. To reinforce the importance of the principles and the expectation that auditors will not depart from or override the principles, the principles would need to be positioned within a document having an appropriate level of authority (that is, an ISA, for example ISA 200, “Objectives and General Principles Governing an Audit of Financial Statements”), with the requirement to comply with these principles clearly communicated.



42. Based on above working framework, a proposed statement of authority and a set of “fundamental principles underlying an ISA audit,” are presented below:

***Authority of Fundamental Principles Underlying an ISA Audit***

*In carrying out an audit of financial statements and in complying with ISAs, the auditor shall comply with the fundamental principles underlying an ISA audit. They comprise (i) the fundamental principles of professional ethics established by Part B of the IFAC Code of Ethics for Professional Accountants (the IFAC Code) and the related requirement for independence, and (ii) those fundamental principles that underlie the objective of an ISA audit, as follows.*

***Fundamental Principles of Professional Ethics***

- (a) ***Integrity***  
*A professional accountant should<sup>9</sup> be straightforward and honest in all professional and business relationships.*
- (b) ***Objectivity***  
*A professional accountant should not allow prejudices or bias, conflict of interest or undue influence of others to override professional or business judgment.<sup>10</sup>*
- (c) ***Professional Competence and Due Care***  
*A professional accountant has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of the provision of competent professional service based on current developments in practice, legislation, and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards in all professional and business relationships.*
- (d) ***Confidentiality***  
*A professional accountant should respect the confidentiality of information acquired as a result of professional or business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.*
- (e) ***Professional Behavior***  
*A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.*

---

<sup>9</sup> These principles have been taken verbatim from the IFAC Ethics Committee’s Exposure Draft, “Proposed Revised Code of Ethics for Professional Accountants,” issued July 2003. Subject to the comments on the accompanying Exposure Draft, the IAASB would encourage the IFAC Ethics Committee to adopt the word “shall” in place of the word “should.”

<sup>10</sup> In addition, as required by Section 8 of Part B of the IFAC Code, the members of the assurance team, the firm and network firms should be independent of the client.

### ***Fundamental Principles Underlying the Objective of an ISA Audit***

- (f) ***Knowledge of the Entity***  
*The auditor shall possess a sufficient understanding of the entity and its environment to appropriately plan and perform the audit, interpret audit findings, and report on the financial statements.*
- (g) ***Responsibility***  
*The auditor shall take responsibility for the audit opinion, maintaining an adequate level of involvement in the audit engagement, properly supervising any assistants, and evaluating the work of experts or others upon whom reliance is placed.*
- (h) ***Quality Control***  
*The auditor shall follow quality control procedures, including consultation with others as necessary, that support the issuance of an auditor's report that is appropriate in the circumstances.*
- (i) ***Rigor and Skepticism***  
*The auditor shall plan and perform an audit with thoroughness and with an attitude of professional skepticism, critically assessing with a questioning mind the validity and reliability of evidence, and recognizing that circumstances may cause the financial statement to be materially misstated.*
- (j) ***Professional Judgment***  
*The auditor shall exercise professional judgment in fulfilling the auditor's responsibilities.*
- (k) ***Evidence***  
*The auditor shall obtain sufficient appropriate evidence to afford a reasonable basis for expressing an opinion on the financial statements.*
- (l) ***Documentation***  
*The auditor shall document matters that form the basis for the audit opinion.*
- (m) ***Communication***  
*The auditor shall communicate significant matters affecting the entity's financial statements to management, to those charged with governance, and, while respecting the confidentiality of information, to others where compliance with local laws and regulations require additional communication in the wider public interest.*
- (n) ***Association***  
*The auditor shall not be associated with, or allow the use of the auditor's name or report to be associated with, information known by the auditor to be misleading, unless the auditor reports on the information and how it is misleading.*
- (o) ***Reporting***  
*The auditor's report shall contain a clear expression of opinion in writing, and set out information necessary for a proper understanding of that opinion.*

## **Questions**

8. **Do respondents believe that identifying “fundamental principles underlying an ISA audit” would aid in communicating the principles that underlie the professional requirements in ISAs and ultimately help drive the auditor’s professional judgment? Please give reasons for your answer.**
9. **Should the establishment of such principles be considered a high, medium, or low priority of the IAASB for the immediate future?**
10. **Do respondents consider the proposed fundamental principles to be complete and appropriate, and do respondents believe the method by which they have been derived to be appropriate? If not, what matters do respondents believe should be considered in development of the fundamental principles?**
11. **Do respondents believe that the fundamental principles should be expanded to serve as a basis for all assurance engagements?**
12. **Do respondents agree with the proposed authority to be afforded the fundamental principles?**

## **V. Practice Statements**

### **Present Situation**

43. Paragraphs 20 and 21 of the Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance, and Related Services describe Practice Statements and the authority attaching thereto as follows:

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

*Professional accountants should be aware of and consider Practice Statements applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Practice Statement should be prepared to explain how the basic principles and essential procedures<sup>11</sup> in the IAASB’s Engagement Standard(s) addressed by the Practice Statement have been complied with.*

44. Practice Statements are developed and approved following the same due process afforded International Standards issued by the IAASB, unless the IAASB considers in a specific case that exposure of a draft IAPS is not required.

---

<sup>11</sup> The phrase “basic principles and essential procedures” would be changed to “professional requirements” under the proposed Policy Statement in the accompanying Exposure Draft, subject to comments received on exposure.

45. Appendix 2 summarises the existing IAPSs. There are three main types of IAPS:
- IAPSs that provide detailed guidance on information technology. These are not closely related to any specific ISA.
  - IAPSs that deal with particular issues such as derivatives, electronic commerce and reporting on compliance with IFRSs.
  - IAPSs that seek to interpret the application of ISAs across groups of auditors (e.g., the auditors of banks, auditors of small entities, and, under exposure, group auditors).

### **Matters for Further Consideration**

46. The IAASB recognizes that adopting the proposals contained in the accompanying Exposure Draft or in this consultation paper may affect future Practice Statements issued by the IAASB (in particular, IAPSs which cover a broad range of topics). The IAASB may therefore need to reconsider the purposes, authority, drafting conventions (and in particular, the use of the present tense in describing actions or procedures of the professional accountant), and future use of these Statements. The IAASB has concluded, however, that it must first focus on improving ISAs. Once a direction is clear, the IAASB can undertake a more systematic review of Practice Statements.
47. In exploring the future role of Practice Statements, notwithstanding the need to study the treatment of existing Practices Statements, there are several options which could be considered:
- Maintain the present system for, and authority of, Practice Statements.
  - Expand the use of Practice Statements to provide the vehicle whereby a large part of the explanatory material currently contained in ISAs would be communicated, (as envisioned by Restructuring Option A – see paragraph 19).
  - Use Practice Statements to extend the professional requirements of International Standards (e.g., ISAs), and explain how such requirements apply, to specific industries or circumstances. As more direct extensions of ISAs, such Practice Statements could carry equal authority to the International Standard(s) to which they relate and could contain interpretive professional requirements that would be directly derived from those contained in the related International Standard(s).
  - Modify the authority of Practice Statements such that they may be issued by the IAASB following an expedited approval process (for example, approval by a simple majority, rather than the present two-thirds majority requirement of the IAASB, or permit issue without public exposure in all cases), thereby allowing the IAASB to issue practical guidance to promote good practice in a more timely and flexible manner.
  - Discontinue their use.

## **Questions**

### *Existing Practice Statements and their Authority*

12. **Do respondents believe the present description of the authority of Practice Statements to be clear and understandable? If so, do respondents agree with the authority that is afforded them? If not, what should be the authority of Practice Statements?**
13. **Given the existing authority of Practice Statements and their use in providing additional guidance to International Standards, should the IAASB change the style in which Practice Statements are written? To the extent they are derived from professional requirements contained in an International Standard, should Practice Statements enunciate professional requirements?**

### *Future Role for Practice Statements*

14. **Taking account of the options identified above, what future role should the IAASB consider for Practice Statements? Are there other options that the IAASB should consider? Please explain why a particular option is being suggested and how it might be of benefit.**

### Characteristics of a Restructured ISA

This appendix provides an outline of the structure that an ISA might take following Restructuring Option B described in paragraph 20 of the consultation paper.

Restructuring Option B suggests a possible approach to restructuring an ISA whereby both the professional requirements and explanatory material would be retained in one document, but separated into two distinct sections: the first section (the ‘standards section’) would set out the professional requirements of the ISA; the second section (the ‘application material section’) would contain explanatory material that supports proper application of the ISA.

Following this approach, the standards section would contain:<sup>12</sup>

- The topic of the ISA and its purpose, including where practicable, reference to the fundamental principles underlying an ISA audit<sup>13</sup> to which the ISA relates and how the ISA is designed to achieve them.
- Definitions or explanation of specific terms and concepts introduced in that ISA.
- The professional requirements of the ISA.
- The effective date of the ISA.

The application material section would contain all other explanatory or application material, including:

- A fuller discussion of the objectives of the ISA and the context in which it is set.
- Explanation of the objective of the professional requirement(s) contained in the standards section above.
- The responsibilities of management and others.
- Auditor considerations when exercising professional judgment, including examples and suggested procedures.
- Public sector and small- and medium-sized accounting firms considerations.
- Appendices.

Descriptive headings and appropriate cross-references would link the professional requirements of the ISA and the related application material.

The separation of the professional requirements from explanatory material would make continued use of the current bold type lettering convention unnecessary. Its use would therefore be discontinued.

---

<sup>12</sup> This guide would be modified as more experience is gained.

<sup>13</sup> Such reference would be made if the IAASB determines that a final set of “fundamental principles underlying an ISA audit” are to be developed and published.

*International Auditing Practice Statements (IAPs)*

*As of September 2004*

- 1000 Inter-Bank Confirmation Procedures
- 1001 IT Environments—Stand-alone Personal Computers
- 1002 IT Environments—On-line Computer Systems
- 1003 IT Environments—Database Systems
- 1004 The Relationship Between Bank Supervisors and Banks' External Auditors
- 1005 The Special Considerations in the Audit of Small Entities
- 1006 Audits of the Financial Statements of Banks
- 1008 Risk Assessments and Internal Control—CIS Characteristics and Considerations
- 1009 Computer-assisted Audit Techniques
- 1010 The Consideration of Environmental Matters in the Audit of Financial Statements
- 1012 Auditing Derivative Financial Instruments
- 1013 Electronic Commerce—Effect on the Audit of Financial Statements
- 1014 Reporting by Auditors on Compliance With International Financial Reporting Standards

## **SUPPLEMENT TO THE EXPOSURE DRAFT AND CONSULTATION PAPER: ILLUSTRATIVE EXAMPLES**

This supplement to the IAASB exposure draft of a proposed Policy Statement, “Clarifying Professional Requirements in International Standards Issued by the IAASB,” and consultation paper, “Improving the Clarity and Structure of IAASB Standards and Related Considerations for Practice Statements,” has been prepared by IAASB staff to illustrate how the proposals in the exposure draft and the restructuring of an ISA contemplated in the consultation paper might be applied to an ISA.

The material included herein is provided only to assist readers of the exposure draft and consultation paper to understand their potential implications for the drafting of standards. It DOES NOT represent actual or contemplated changes that might arise from their application.

The application of the proposal of the exposure draft, or the manner in which an ISA might be restructured as contemplated in the consultation paper, will require consideration by the IAASB following its due process, which has not been done for the examples presented. Accordingly, the illustrative examples have not been approved, disapproved, or otherwise acted upon by the IAASB and are neither authoritative nor official pronouncements nor statements of the IAASB.

Readers of this supplement should therefore not use or act upon the material herein other than for the sole purpose of responding to the exposure draft and consultation paper.

Comments on this material are welcome in so far as they relate to the proposal of the exposure draft and the issues contained in the consultation paper for which the IAASB is seeking input. Since the changes contained herein do not reflect the views of, nor a proposal by, the IAASB, comments on the specific changes are not sought from respondents.

For the purposes of this supplement, ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,” has been selected as it typifies the general style in which recent ISAs are drafted.

### **Illustrative Application of the Exposure Draft**

Exhibit 1 contains a marked version of selected paragraphs from ISA 315 illustrating how the proposed categories of professional requirements might be applied to an existing ISA.

Readers are asked to note that staff has only redrafted the explanatory material as strictly necessary to change present tense statements into clearer expressions of obligation (i.e., into “should” statements), where appropriate. This approach may not be taken by the IAASB, as it may conclude a fuller redraft of an ISA is necessary to effect the proposed Policy Statement.

### **Illustrative Application of the Consultation Paper – Restructuring of an ISA**

Exhibit 2 contains an illustration of how ISA 315 might be restructured following Restructuring Option B as described in the consultation paper.



The illustration incorporates the proposed categories of professional requirements, and also links the ISA to the proposed “fundamental principles underlying an ISA audit.”

In restructuring ISA 315, staff endeavored to create an ISA that: (a) presents the professional requirements of the standard in a way that would be viewed as complete and understandable by an experienced professional auditor (i.e., understandable on their own, although related to the application material); and (b) includes within the standards section guidance found in current explanatory material that may be considered requirements an auditor is expected to fulfill. The new obligations to perform or consider audit procedures (now proposed to be included in “should” statements) have, of course, been drawn from the former explanatory material and re-characterized as part of the professional requirements of the auditor (as reflected in Exhibit 1).

In comparison to the example ISA in Exhibit 1 illustrating the exposure draft, more extensive editorial changes from the authoritative ISA have been made to effect the restructuring and to improve the overall flow of the ISA.

**ILLUSTRATIVE APPLICATION OF THE EXPOSURE DRAFT<sup>14</sup>**  
**INTERNATIONAL STANDARD ON AUDITING 315**  
**UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT**  
**AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT**

**Introduction**

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and to provide guidance on obtaining an understanding of the entity and its environment, including its internal control, and on assessing the risks of material misstatement in a financial statement audit. The importance of the auditor's risk assessment as a basis for further audit procedures is discussed in the explanation of audit risk in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements."
2. **The auditor ~~shall should~~ obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.** ISA 500, "Audit Evidence," requires the auditor to use assertions in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. This ISA requires the auditor to make risk assessments at the financial statement and assertion levels based on an appropriate understanding of the entity and its environment, including its internal control. ISA 330, "The Auditor's Procedures in Response to Assessed Risks" discusses the auditor's responsibility to determine overall responses and to design and perform further audit procedures whose nature, timing, and extent are responsive to the risk assessments. The requirements and guidance of this ISA are to be applied in conjunction with the requirements and guidance provided in other ISAs. In particular, further guidance in relation to the auditor's responsibility to assess the risks of material misstatement due to fraud is discussed in ISA 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements."
3. The following is an overview of the requirements of this standard:
  - *Risk assessment procedures and sources of information about the entity and its environment, including its internal control.* This section explains the audit procedures that the auditor is required to perform to obtain the understanding of the entity and its environment, including its internal control (risk assessment procedures). It also requires discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement.
  - *Understanding the entity and its environment, including its internal control.* This section requires the auditor to understand specified aspects of the entity and its environment, and components of its internal control, in order to identify and assess the risks of material misstatement.

---

<sup>14</sup> For purposes of the illustration, changes to the text of ISA 315 are shown in mark-up.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- *Assessing the risks of material misstatement.* This section requires the auditor to identify and assess the risks of material misstatement at the financial statement and assertion levels. The auditor:
  - Identifies risks by considering the entity and its environment, including relevant controls, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
  - Relates the identified risks to what can go wrong at the assertion level; and
  - Considers the significance and likelihood of the risks.

This section also requires the auditor to determine whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. The auditor is required to evaluate the design of the entity's controls, including relevant control activities, over such risks and determine whether they have been implemented.

- *Communicating with those charged with governance and management.* This section deals with matters relating to internal control that the auditor communicates to those charged with governance and management.
  - *Documentation.* This section establishes related documentation requirements.
4. Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with ISAs. In particular, that understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing risks of material misstatement of the financial statements and responding to those risks throughout the audit, for example when:
- Establishing materiality and evaluating whether the judgment about materiality remains appropriate as the audit progresses;
  - Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
  - Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
  - Developing expectations for use when performing analytical procedures;
  - Designing and performing further audit procedures to reduce audit risk to an acceptably low level; and
  - Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.
5. The auditor uses professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

assess the risks of material misstatement of the financial statements and to design and perform further audit procedures. The depth of the overall understanding that is required by the auditor in performing the audit is less than that possessed by management in managing the entity.

### **Risk Assessment Procedures and Sources of Information About the Entity and Its Environment, Including Its Internal Control**

6. Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. As described in ISA 500, audit procedures to obtain an understanding are referred to as “risk assessment procedures” because some of the information obtained by performing such procedures may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, in performing risk assessment procedures, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such audit procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

### **Risk Assessment Procedures**

7. ~~The auditor shall should perform the following~~ risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control.
- 8 **In order to do so, the auditor should perform the following procedures:**
  - (a) **Inquiries of management and others within the entity who may have information that helps in identifying risks of material misstatement;**
  - (b) **Analytical procedures; and**
  - (c) **Observation and inspection, including tracing transactions through the information systems relevant to financial reporting as considered appropriate.**

The auditor is not required to perform all the risk assessment procedures described above for each aspect of the understanding described in paragraph 20. However, ~~the above does require the auditor to perform~~ all the risk assessment procedures ~~are performed by the auditor~~ in the course of obtaining the required understanding.

98. ~~In addition,~~ **The auditor should consider performing other audit procedures where in the auditor’s judgment the information obtained may be helpful in identifying risks of material misstatement.** For example, the auditor may consider making inquiries of the entity’s external legal counsel or of valuation experts that the entity has used. Reviewing information obtained from external sources such as reports by analysts, banks, or rating agencies; trade and economic journals; or regulatory or financial publications may also be useful in obtaining information about the entity.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

109. Although much of the information the auditor obtains by inquiries can be obtained from management and those responsible for financial reporting, inquiries of others within the entity, such as production and internal audit personnel, and other employees with different levels of authority, may be useful in providing the auditor with a different perspective in identifying risks of material misstatement. ~~In determining others within the entity to whom inquiries may be directed, and the extent of those inquiries, the auditor considers what information may be obtained that helps the auditor in identifying risks of material misstatement.~~ For example:

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

1140. ~~The auditor should consider the results of analytical procedures along with other information gathered in identifying the risks of material misstatement.~~ Analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. ~~In performing analytical procedures as risk assessment procedures involves, the auditor develops expectations about plausible relationships that are reasonably expected to exist and comparing. When comparison of those expectations with recorded amounts or ratios developed from recorded amounts. yields unusual or unexpected relationships that are identified from the comparison may assist, the auditor considers those results~~ in identifying risks of material misstatement. However, when such analytical procedures use data aggregated at a high level (which is often the situation), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. ~~Accordingly, the auditor considers the results of such analytical procedures along with other information gathered in identifying the risks of material misstatement.~~ See ISA 520, "Analytical Procedures" for additional guidance on the use of analytical procedures.

1244. Observation and inspection may support inquiries of management and others, and also provide information about the entity and its environment. ~~Examples of such audit procedures ordinarily include observation or inspection of the following:~~

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- ~~Observation of e~~Entity activities and operations.
- ~~Inspection of d~~Documents (such as business plans and strategies), records, and internal control manuals.
- ~~Reading r~~eports 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).
- ~~T~~Visits to the entity's premises and plant facilities.
- ~~Tracing transactions through the information system relevant to financial reporting (walk-throughs).~~

**1312.** When the auditor intends to use information about the entity and its environment obtained in prior periods, the auditor should determine whether changes have occurred that may affect the relevance of such information in the current audit. For continuing engagements, the auditor's previous experience with the entity contributes to the understanding of the entity. For example, audit procedures performed in previous audits ordinarily provide audit evidence about the entity's organizational structure, business and controls, as well as information about past misstatements and whether or not they were corrected on a timely basis, which assists the auditor in assessing risks of material misstatement in the current audit. However, such information may have been rendered irrelevant by changes in the entity or its environment. The auditor **may** make inquiries and performs other appropriate audit procedures, such as walk-throughs of systems, to determine whether changes have occurred that may affect the relevance of such information.

**1413.** When relevant to the audit, the auditor **should also** considers whether other information **such as that** obtained from the auditor's client acceptance or continuance process or, where practicable, experience gained on other engagements performed for the entity **may be helpful in identifying risks of material misstatement**. Other engagements performed for the entity may include, for example, engagements to review interim financial information.

### Discussion Among the Engagement Team

**1514.** The members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements.

**1615.** The objective of this discussion is for members of the engagement team to gain a better understanding of the potential for material misstatements of the financial statements resulting from fraud or error in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures.

**1716.** The discussion provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

entity, and for the team members to exchange information about the business risks<sup>15</sup> to which the entity is subject, ~~and about~~ how and where the financial statements might be susceptible to material misstatement, ~~and the application of the applicable financial reporting framework to the entity's facts and circumstances.~~ As required by ISA 240, particular emphasis is<sup>16</sup> given to the susceptibility of the entity's financial statements to material misstatement due to fraud. ~~The discussion also addresses application of the applicable financial reporting framework to the entity's facts and circumstances.~~

~~1817.~~ Professional judgment is used to determine which members of the engagement team are included in the discussion, how and when it occurs, and the extent of the discussion. The key members of the engagement team are ordinarily involved in the discussion; however, it is not necessary for all team members to have a comprehensive knowledge of all aspects of the audit. The extent of the discussion is influenced by the roles, experience, and information needs of the engagement team members. In a multi-location audit, for example, there may be multiple discussions that involve the key members of the engagement team in each significant location. Another factor to consider in planning the discussions is whether to include experts assigned to the engagement team. For example, the auditor may determine that including a professional possessing specialist information technology (IT)<sup>17</sup> or other skills is needed on the engagement team and therefore includes that individual in the discussion.

~~1948.~~ As required by ISA 200, the auditor plans and performs the audit with an attitude of professional skepticism. ~~As required by ISA 240,~~ the discussion among the engagement team members emphasizes the need to maintain professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications.

~~2049.~~ Depending on the circumstances of the audit, there may be further discussions in order to facilitate the ongoing exchange of information between engagement team members regarding the susceptibility of the entity's financial statements to material misstatements. The purpose is for engagement team members to communicate and share information obtained throughout the audit that may affect the assessment of the risks of material misstatement due to fraud or error or the audit procedures performed to address the risks.

### **Understanding the Entity and Its Environment, Including Its Internal Control**

~~2120.~~ The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

---

<sup>15</sup> See paragraph 30.

<sup>16</sup> NOTE TO READERS: Where reference is made to a professional requirement that has been established in another ISA, the drafting convention applied is to make reference to the relevant ISA (as illustrated by the use of the phrase "As required by..."), but not to repeat the use of the "should" or to apply bold type lettering.

<sup>17</sup> Information technology (IT) encompasses automated means of originating, processing, storing and communicating information, and includes recording devices, communication systems, computer systems (including hardware and software components and data), and other electronic devices.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- (a) Industry, regulatory, and other external factors, including the applicable financial reporting framework.
- (b) Nature of the entity, including the entity's selection and application of accounting policies.
- (c) Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.
- (d) Measurement and review of the entity's financial performance.
- (e) Internal control.

Appendix 1 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (a) through (d) above. Appendix 2 contains a detailed explanation of the internal control components.

**2224.** The nature, timing, and extent of the risk assessment procedures performed depend on the circumstances of the engagement such as the size and complexity of the entity and the auditor's experience with it. In addition, identifying significant changes in any of the above aspects of the entity from prior periods is particularly important in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

### **Industry, Regulatory and Other External Factors, Including the Applicable Financial Reporting Framework**

**2322.** The auditor ~~shall~~ **should** obtain an understanding of relevant industry, regulatory, and other external factors including the applicable financial reporting framework. These factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments; the regulatory environment encompassing, among other matters, the applicable financial reporting framework, the legal and political environment, and environmental requirements affecting the industry and the entity; and other external factors such as general economic conditions. See ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" for additional requirements related to the legal and regulatory framework applicable to the entity and the industry.

**2423.** ~~Where 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, the auditor should consider whether the engagement team includes members with sufficient knowledge and experience. For example, long-term contracts, for example, may involve significant estimates of revenues and costs that give rise to risks of material misstatement. In such cases, the auditor considers whether the engagement team includes members with sufficient relevant knowledge and experience.~~

**2524.** The auditor should consider whether local regulations specify certain financial reporting requirements for the industry in which the entity operates. Legislative and regulatory requirements often determine the applicable financial reporting framework to be used by management in preparing the entity's financial statements. In most cases, the



## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

applicable financial reporting framework will be that of the jurisdiction in which the entity is registered or operates and the auditor is based, and the auditor and the entity will have a common understanding of that framework. In some cases there may be no local financial reporting framework, in which case the entity's choice will be governed by local practice, industry practice, user needs, or other factors. For example, the entity's competitors may apply International Financial Reporting Standards (IFRS) and the entity may determine that IFRS are also appropriate for its financial reporting requirements. ~~The auditor considers whether local regulations specify certain financial reporting requirements for the industry in which the entity operates~~ This consideration of whether local regulations specify certain financial reporting requirements is important, since the financial statements may be materially misstated in the context of the applicable financial reporting framework if management fails to prepare the financial statements in accordance with such regulations.

### Nature of the Entity

~~2625.~~ **The auditor shall ~~should~~ obtain an understanding of the nature of the entity.** The nature of an entity refers to the entity's operations, its ownership and governance, the types of investments that it is making and plans to make, the way that the entity is structured and how it is financed. An understanding of the nature of an entity enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

~~2726.~~ The entity may have a complex structure with subsidiaries or other components in multiple locations. In addition to the difficulties of consolidation in such cases, other issues with complex structures that may give rise to risks of material misstatement include: the allocation of goodwill to business segments, and its impairment; whether investments are joint ventures, subsidiaries, or investments accounted for using the equity method; and whether special-purpose entities are accounted for appropriately.

~~2827.~~ An understanding of the ownership and relations between owners and other people or entities is also important in determining whether related party transactions have been identified and accounted for appropriately. ISA 550, "Related Parties" provides additional guidance on the auditor's considerations relevant to related parties.

~~2928.~~ **The auditor shall ~~should~~ obtain an understanding of the entity's selection and application of accounting policies, including the reasons for changes thereto, and consider whether they are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.** The understanding encompasses the methods the entity uses to account for significant and unusual transactions; the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; and changes in the entity's accounting policies. ~~The understanding also includes the identification of~~ ~~auditor also identifies~~ financial reporting standards and regulations that are new to the entity, and ~~considers~~ when and how the entity will adopt such requirements. Where the entity has changed its selection of or method of applying a significant accounting policy, the ~~understanding also includes~~ ~~auditor considers~~ the reasons

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

for the change and whether it is appropriate and consistent with the requirements of the applicable financial reporting framework.

3029. The presentation of financial statements in conformity with the applicable financial reporting framework includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the basis of amounts set forth. ~~It also includes The auditor considers disclosure of whether the entity has disclosed~~ a particular matter that is appropriately in light of the circumstances and facts of ~~the entity which the auditor is aware at the time.~~

### Objectives and Strategies and Related Business Risks

3130. ~~The auditor shall should~~ **obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements.** The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the operational approaches by which management intends to achieve its objectives. Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic and the entity's strategies and objectives change over time.

3234. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk particularly may arise from change or complexity, though a failure to recognize the need for change may also give rise to risk. Change may arise, for example, from the development of new products that may fail; from an inadequate market, even if successfully developed; or from flaws that may result in liabilities and reputational risk. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks.

3332. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement. A business risk may have an immediate consequence for the risk of misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statements as a whole. For example, the business risk arising from a contracting customer base due to industry consolidation may increase the risk of misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which ~~may be relevant to assessing the auditor considers when assessing~~ the appropriateness of the going concern assumption. The auditor's consideration of whether a business risk may result in material misstatement is, therefore, made in light of the entity's

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

circumstances. Examples of conditions and events that may indicate risks of material misstatement are given in Appendix 3.

3433. Usually management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraphs 76 to 79.
3534. Smaller entities often do not set their objectives and strategies, or manage the related business risks, through formal plans or processes. In many cases there may be no documentation of such matters. In such entities, the auditor's understanding is ordinarily obtained through inquiries of management and observation of how the entity responds to such matters.

### Measurement and Review of the Entity's Financial Performance

3635. The auditor ~~shall should~~ obtain an understanding of the measurement and review of the entity's financial performance, including performance measures used by management and others to understand business performance. Performance measures and their review indicate to the auditor aspects of the entity's performance that management and others consider to be of importance. Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.
3736. Management's measurement and review of the entity's financial performance is to be distinguished from the monitoring of controls (discussed as a component of internal control in paragraphs 96-99), though their purposes may overlap. Monitoring of controls, however, is specifically concerned with the effective operation of internal control through consideration of information about the control. The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties), but in some cases performance indicators also provide information that enables management to identify deficiencies in internal control.
3837. Internally-generated information used by management for this purpose may include key performance indicators (financial and non-financial), budgets, variance analysis, segment information and divisional, departmental or other level performance reports, and comparisons of an entity's performance with that of competitors. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may provide information useful to the auditor's understanding of the entity and its environment. Such reports often are obtained from the entity being audited.
3938. Internal measures may highlight unexpected results or trends requiring management's inquiry of others in order to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

measures may also indicate to the auditor a risk of misstatement of related financial statement information. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

**4039.** Much of the information used in performance measurement may be produced by the entity's information system. If management assumes that data used for reviewing the entity's performance are accurate without having a basis for that assumption, errors may exist in the information, potentially leading management to incorrect conclusions about performance. **When the auditor intends to make use of the performance measures for the purpose of the audit (for example, for analytical procedures), the auditor should consider whether the information related to management's review of the entity's performance provides a reliable basis and is sufficiently precise for such a purpose. If making use of performance measures, the auditor should consider whether they are precise enough to detect material misstatements.**

**4140** Smaller entities ordinarily do not have formal processes to measure and review the entity's financial performance. Management nevertheless often relies on certain key indicators which knowledge and experience of the business suggest are reliable bases for evaluating financial performance and taking appropriate action.

*[Paragraphs 41 through 124 and the appendices of ISA 315 have been excluded for purposes of this illustration.]*

**ILLUSTRATIVE APPLICATION OF THE CONSULTATION PAPER  
RESTRUCTURED INTERNATIONAL STANDARD ON AUDITING 315  
UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT  
AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT**

**CONTENTS**

<b>STANDARDS (or PROFESSIONAL REQUIREMENTS)</b>	Paragraph
Introduction.....	1-2
Risk Assessment Procedures and Activities and Sources of Information About the Entity and Its Environment, Including Its Internal Control .....	3-7
Understanding the Entity and Its Environment, Including Its Internal Control.....	8-16
Assessing the Risks of Material Misstatement .....	17-19
Significant Risks That Require Special Audit Consideration.....	20-23
Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence .....	24-25
Revision of Risk Assessment .....	26
Communicating With Those Charged With Governance and Management .....	27-28
Documentation.....	29-30
Effective Date .....	31
 <b>APPLICATION MATERIAL</b>	
Introduction.....	A1-A4
Risk Assessment Procedures and Activities and Sources of Information About the Entity and Its Environment, Including Its Internal Control .....	A5
Risk Assessment Procedures and Activities .....	A6-A15
Understanding the Entity and Its Environment, Including Its Internal Control.....	A16-A17
Industry, Regulatory and Other External Factors, Including the Applicable Financial Reporting Framework.....	A18-A20
Nature of the Entity .....	A21-A23
The Entity’s Selection and Application of Accounting Policies .....	A24-A25
Objectives and Strategies and Related Business Risks .....	A26-A30
Measurement and Review of the Entity’s Financial Performance .....	A31-A36
Internal Control.....	A37-A90
Assessing the Risks of Material Misstatement.....	A91-A96

SUPPLEMENT: ILLUSTRATIVE EXAMPLES

Significant Risks That Require Special Audit Consideration .....	A97-A103
Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence .....	A104-A107
Revision of Risk Assessment .....	A108
Documentation.....	A109

---

## ISA 315 Standards

### Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards on obtaining an understanding of the entity and its environment, including its internal control, and on assessing the risks of material misstatement in a financial statement audit. The fundamental principle of auditing – *Knowledge of the Entity* – underlies the need for, and the importance of, the auditor’s understanding of the entity and its environment, as identified in ISA 200, “Objective and General Principles Governing an Audit of Financial Statements.” The importance of the auditor’s risk assessment as a basis for further audit procedures is discussed in the explanation of audit risk in ISA 200. Guidance on the application of these standards is contained in the Application Material of this ISA.
2. The auditor shall obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

### **Risk Assessment Procedures and Activities and Sources of Information About the Entity and Its Environment, Including Its Internal Control**

3. The auditor shall perform risk assessment procedures and activities to obtain an understanding of the entity and its environment, including its internal control.
4. In order to do so, the auditor should perform the following procedures and activities:
  - (a) Inquiries of management and others within the entity who may have information that helps in identifying risks of material misstatement;
  - (b) Analytical procedures, including the consideration of the results of such analytical procedures along with other information gather in identifying the risks of material misstatement;
  - (c) Observation and inspection, including tracing transactions through the information systems relevant to financial reporting as considered appropriate; and
  - (d) Discussion with members of the engagement team about the susceptibility of the entity’s financial statements to material misstatements.
5. The auditor is not required to perform all the risk assessment procedures and activities described above for each aspect of the understanding described in paragraph 8. However, the above does require the auditor to perform all the risk assessment procedures in the course of obtaining the required understanding.
6. The auditor should consider whether information obtained from the auditor’s client acceptance or continuance process or, where practicable, experience gained on other engagements performed for the entity may be helpful in identifying risks of material misstatement. The auditor should also consider performing other audit procedures where in the auditor’s judgment the information obtained may be helpful in identifying risks of material misstatement.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

7. The information used to gain an understanding of the entity may be obtained in the current year or, for continuing engagements, from the auditor's previous experience with the entity and audit procedures performed in previous audits. When the auditor intends to use information about the entity and its environment obtained in prior periods, the auditor should determine whether changes have occurred that may affect the relevance of such information in the current audit.

### **Understanding the Entity and Its Environment, Including Its Internal Control**

8. The auditor shall obtain an understanding of the entity and its environment that consists of an understanding of the following aspects:
  - (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework, and any local regulations that specify certain financial reporting requirements for the industry in which the entity operates. In cases where the industry in which the entity operates or the degree of regulation may give rise to specific risks of material misstatement, the auditor should consider whether the engagement team includes members with sufficient relevant knowledge and experience.
  - (b) Nature of the entity. The nature of the entity refers to the entity's operations, its ownership and governance, the types of investments that it is making and plans to make, the way that the entity is structured and how it is financed.
  - (c) The entity's selection and application of accounting policies, including the reasons for changes thereto, and consider whether they are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
  - (d) The entity's objectives and strategies, and the related business risks that may result in a material misstatement of the financial statements.
  - (e) The measurement and review of the entity's financial performance, including performance measures used by management and others to understand business performance.
  - (f) Internal control relevant to the audit.
9. In obtaining an understanding of internal control relevant to the audit, the auditor should obtain an understanding of the following components of internal control<sup>18</sup>:
  - (a) The control environment, which sets the tone of an organization and is the foundation for effective internal control, providing discipline and structure.
  - (b) The entity's process for identifying business risks relevant to financial reporting objectives, estimating the significance of the risks, assessing the likelihood of their occurrence and deciding about actions to address those risks, and the results thereof. This process is described as the "entity's risk assessment process" and forms the basis for how management determines the risks to be managed.

---

<sup>18</sup> For the purposes of this ISA, the term "internal control" encompasses all five components of internal control stated below. In addition, the term "controls" refers to one or more of the components, or any aspect thereof.



## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- (c) The information system, including the related business processes, relevant to financial reporting.
  - (d) How the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including communications between management and those charged with governance as well as external communications such as those with regulatory authorities.
  - (e) Control activities, being those policies and procedures that help ensure that management directives are carried out and which prevent, or detect and correct, material misstatement, sufficient for the auditor to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks. In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from information technology (IT) or manual systems and whether the entity has responded adequately to the risks arising from IT by establishing effective general IT-controls and application controls.
  - (f) The major types of activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates corrective actions to its controls.
10. In obtaining an understanding of internal control relevant to the audit, the auditor should evaluate the design of a control and determine whether it has been implemented. The auditor should do so by performing procedures in addition to inquiry of the entity's personnel, as inquiry alone is not sufficient for such purposes.
11. In evaluating the design of the entity's control environment and determining whether it has been implemented, the auditor should consider the following elements and how they have been incorporated into the entity's processes:
- (a) Communication and enforcement of integrity and ethical values—essential elements which influence the effectiveness of the design, administration and monitoring of controls.
  - (b) Commitment to competence—management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
  - (c) Participation by those charged with governance—independence from management, their experience and stature, the extent of their involvement and scrutiny of activities, their ability to evaluate the actions of management, their understanding of the entity's business transactions and the information they receive, the degree to which difficult questions are raised and pursued with management, the extent of their evaluation of whether the financial statements give a true and fair view, and their interaction with internal and external auditors.
  - (d) Management's philosophy and operating style—management's approach to taking and managing business risks, and management's attitudes and actions toward financial reporting, including how they have established appropriate controls to prevent and detect fraud and error within the entity, information processing and accounting functions and personnel.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- (e) Organizational structure—the framework within which an entity’s activities for achieving its objectives are planned, executed, controlled and reviewed.
  - (f) Assignment of authority and responsibility—how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
  - (g) Human resource policies and practices—recruitment, orientation, training, evaluating, counseling, promoting, compensating and remedial actions.
12. In evaluating the design of the control environment and determining whether it has been implemented, the auditor should obtain an understanding of how management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior, and established appropriate controls to prevent and detect fraud and error within the entity.
13. The auditor’s understanding of the information system, including the related business processes, relevant to financial reporting, should include the following areas:
- The classes of transactions in the entity’s operations that are significant to the financial statements.
  - The procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements.
  - The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing, correcting as necessary, transferring to the general ledger and reporting transactions.
  - How the information system captures events and conditions, other than classes of transactions, that are significant to the financial statements.
  - The financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures.
14. In obtaining an understanding of the information system, including the related business processes, relevant to financial reporting, the auditor should consider risks of material misstatement associated with inappropriate override of controls over journal entries and the controls surrounding non-standard journal entries used to record non-recurring, unusual transactions or adjustments.
15. When the auditor intends to make use of the entity’s performance measures (as identified in paragraph 8(e)) or the entity’s information produced for monitoring activities (as identified in paragraph 9(f)) for the purpose of the audit, the auditor should consider whether the information provides a reliable basis and is sufficiently precise to detect material misstatements.
16. The auditor should inquire about business risks that management has identified and consider whether they may result in material misstatement.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

### **Assessing the Risks of Material Misstatement**

17. The auditor shall identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures.
18. In identifying and assessing the risks of material misstatement, the auditor should:
  - Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and consider the classes of transactions, account balances, and disclosures in the financial statements;
  - Relate the identified risks to what can go wrong at the assertion level;
  - Consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements; and
  - Consider the likelihood that the risks could result in a material misstatement of the financial statements.
19. The auditor should determine whether the identified risks of material misstatement relate to specific classes of transactions, account balances, and disclosures and related assertions, or whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions. The latter risks (risks at the financial statement level) may derive in particular from a weak control environment.

### **Significant Risks That Require Special Audit Consideration**

20. As part of the risk assessment as described in paragraph 17, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as "significant risks").
21. The determination of significant risks, which arise on most audits, is a matter for the auditor's professional judgment. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration.
22. In considering whether a risk is a significant risk, the auditor should consider the following:
  - Whether the risk is a risk of fraud.
  - Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.
  - The complexity of transactions.
  - Whether the risk involves significant transactions with related parties.
  - The degree of subjectivity in the measurement of financial information related to the risk especially those involving a wide range of measurement uncertainty.
  - Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

23. For significant risks, to the extent the auditor has not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented. An understanding of the entity's controls related to significant risks is required to provide the auditor with adequate information to develop an effective audit approach. Management ought to be aware of significant risks; however, risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls.

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

24. As part of the risk assessment as described in paragraph 17, the auditor should evaluate the design and determine the implementation of the entity's controls, including relevant control activities, over those risks for which, in the auditor's judgment, it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures.
25. The understanding of the entity's information system relevant to financial reporting enables the auditor to identify risks of material misstatement that relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements; these include risks of inaccurate or incomplete processing. Ordinarily, such risks relate to significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

### **Revision of Risk Assessment**

26. The auditor's assessment of the risk of material misstatement at the assertion level is based on available audit evidence and may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures that tends to contradict the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and modify the further planned audit procedures accordingly.

### **Communicating With Those Charged With Governance and Management**

27. The auditor should make those charged with governance or management aware, as soon as practicable, and at an appropriate level of responsibility, of material weaknesses in the design or implementation of internal control which have come to the auditor's attention.
28. If the auditor identifies risks of material misstatement which the entity has either not controlled, or for which the relevant control is inadequate, or if in the auditor's judgment there is a material weakness in the entity's risk assessment process, then the auditor includes such internal control weaknesses in the communication of audit matters of governance interest. See ISA 260, "Communications of Audit Matters with Those Charged with Governance."

### **Documentation**

29. The auditor should document:

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- (a) The discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, and the significant decisions reached;
  - (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment identified in paragraph 8, including each of the internal control components identified in paragraph 9, to assess the risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures;
  - (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 17; and
  - (d) The risks identified and related controls evaluated as a result of the requirements in paragraphs 23 and 24.
30. The manner in which these matters are documented is for the auditor to determine using professional judgment.

### **Effective Date**

31. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

### ISA 315 Application Material

#### Introduction

- A1. The purpose of this application material is to provide guidance on the application of the standards of ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.”
- A2. The standards of ISA 315 require the auditor to obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures. ISA 500, “Audit Evidence,” requires the auditor to use assertions in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The standards of ISA 315 also require the auditor to make risk assessments at the financial statement and assertion levels based on an appropriate understanding of the entity and its environment, including its internal control. ISA 330, “The Auditor’s Procedures in Response to Assessed Risks” establishes the standards for the auditor’s responsibility to determine overall responses and to design and perform further audit procedures whose nature, timing, and extent are responsive to the risk assessments. The standards and application material of this ISA are to be applied in conjunction with the standards and application material provided in other ISAs. In particular, further standards in relation to the auditor’s responsibility to assess the risks of material misstatement due to fraud is discussed in ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements.”
- A3. Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with ISAs. In particular, that understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing risks of material misstatement of the financial statements and responding to those risks throughout the audit, for example when:
- Establishing materiality and evaluating whether the judgment about materiality remains appropriate as the audit progresses;
  - Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
  - Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management’s use of the going concern assumption, or considering the business purpose of transactions;
  - Developing expectations for use when performing analytical procedures;
  - Designing and performing further audit procedures to reduce audit risk to an acceptably low level; and
  - Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management’s oral and written representations.
- A4. The auditor uses professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor’s

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

primary consideration is whether the understanding that has been obtained is sufficient to assess the risks of material misstatement of the financial statements and to design and perform further audit procedures. The depth of the overall understanding that is required by the auditor in performing the audit is less than that possessed by management in managing the entity.

### **Risk Assessment Procedures and Activities and Sources of Information About the Entity and Its Environment, Including Its Internal Control (Ref. ISA 315, 3-7)**

A5. Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. As described in ISA 500, audit procedures to obtain an understanding are referred to as “risk assessment procedures” because some of the information obtained by performing such procedures may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, in performing risk assessment procedures, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such audit procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

### **Risk Assessment Procedures and Activities**

#### *Inquiries of Management and Others Within the Entity (Ref. ISA 315, 4(a))*

A6. Although much of the information the auditor obtains by inquiries can be obtained from management and those responsible for financial reporting, inquiries of others within the entity, such as production and internal audit personnel, and other employees with different levels of authority, may be useful in providing the auditor with a different perspective in identifying risks of material misstatement. As required by ISA 315, in determining others within the entity to whom inquiries may be directed, and the extent of those inquiries, the auditor considers what information in the auditor’s judgment may be obtained that helps the auditor in identifying risks of material misstatement. For example:

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

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- Inquiries directed towards marketing or sales personnel may relate to changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

### *Analytical Procedures (Ref. ISA 315, 4(b))*

A7. Analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. Performing analytical procedures as risk assessment procedures involves the auditor developing expectations about plausible relationships that are reasonably expected to exist and comparing those expectations with recorded amounts or ratios developed from recorded amounts. Unusual or unexpected relationships that are identified from the comparison may assist the auditor in identifying risks of material misstatement. However, when such analytical procedures use data aggregated at a high level (which is often the situation), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, as required by ISA 315, the auditor considers the results of such analytical procedures along with other information gathered in identifying the risks of material misstatement. See ISA 520, "Analytical Procedures" for additional standards and application material on the use of analytical procedures.

### *Observation and Inspection (Ref. ISA 315, 4(c))*

- A8. Observation and inspection may support inquiries of management and others, and also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:
- Entity activities and operations.
  - Documents (such as business plans and strategies), records, and internal control manuals.
  - Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
  - The entity's premises and plant facilities.

### *Discussion Among the Engagement Team (Ref. ISA 315, 4(d))*

A9. The objective of this discussion is for members of the engagement team to gain a better understanding of the potential for material misstatements of the financial statements resulting from fraud or error in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures. The engagement partner considers which matters are to be communicated to members of the engagement team not involved in the discussion. All of the members of the engagement team do not necessarily need to be informed of all of the decisions reached in the discussion. For example, a member of the engagement team involved in audit of a component of the entity may not need to know the decisions reached regarding another component of the entity.



## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- A10. The discussion provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity, and for the team members to exchange information about the business risks<sup>19</sup> to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement. As required by paragraph 13 of ISA 240, particular emphasis is given to the susceptibility of the entity's financial statements to material misstatement due to fraud. The discussion also addresses application of the applicable financial reporting framework to the entity's facts and circumstances.
- A11. Professional judgment is used to determine which members of the engagement team are included in the discussion, how and when it occurs, and the extent of the discussion. The key members of the engagement team are ordinarily involved in the discussion; however, it is not necessary for all team members to have a comprehensive knowledge of all aspects of the audit. The extent of the discussion is influenced by the roles, experience, and information needs of the engagement team members. In a multi-location audit, for example, there may be multiple discussions that involve the key members of the engagement team in each significant location. Another factor to consider in planning the discussions is whether to include experts assigned to the engagement team. For example, the auditor may determine that including a professional possessing specialist information technology (IT)<sup>20</sup> or other skills is needed on the engagement team and therefore includes that individual in the discussion.
- A12. As required by ISA 200, the auditor plans and performs the audit with an attitude of professional skepticism. As required by ISA 240, the discussion among the engagement team members emphasizes the need to maintain professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications.
- A13. Depending on the circumstances of the audit, there may be further discussions in order to facilitate the ongoing exchange of information between engagement team members regarding the susceptibility of the entity's financial statements to material misstatements. The purpose is for engagement team members to communicate and share information obtained throughout the audit that may affect the assessment of the risks of material misstatement due to fraud or error or the audit procedures performed to address the risks.

### *Other Information and Audit Procedures (Ref. ISA 315, 6)*

- A14. As required by paragraph 6 of ISA 315, the auditor considers other information obtained from the auditor's client acceptance or continuance process or, where practicable, experienced gained on other engagements performed for the entity, for example, engagements to review interim financial information, and to consider performing other audit procedures where the information obtained may be helpful in identifying risks of material misstatement. For example, the auditor may consider making inquiries of the

---

<sup>19</sup> See paragraph A26.

<sup>20</sup> Information technology (IT) encompasses automated means of originating, processing, storing and communicating information, and includes recording devices, communication systems, computer systems (including hardware and software components and data), and other electronic devices.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

entity's external legal counsel or of valuation experts that the entity has used. Reviewing information obtained from external sources such as reports by analysts, banks, or rating agencies; trade and economic journals; or regulatory or financial publications may also be useful in obtaining information about the entity.

### *Information Obtained in Prior Periods (Ref. ISA 315, 7)*

A15. For continuing engagements, the auditor's previous experience with the entity contributes to the understanding of the entity. For example, audit procedures performed in previous audits ordinarily provide audit evidence about the entity's organizational structure, business and controls, as well as information about past misstatements and whether or not they were corrected on a timely basis, which assists the auditor in assessing risks of material misstatement in the current audit. However, such information may have been rendered irrelevant by changes in the entity or its environment. The auditor makes inquiries and performs other appropriate audit procedures, such as walk-throughs of systems, to determine whether changes have occurred that may affect the relevance of such information, as required by paragraph 7 of ISA 315.

### **Understanding the Entity and Its Environment, Including Its Internal Control (Ref. ISA 315, 8)**

A16. As required by paragraph 8 of ISA 315, the auditor obtains an understanding of the following aspects of the entity and its environment:

- (a) Industry, regulatory, and other external factors, including the applicable financial reporting framework.
- (b) Nature of the entity.
- (c) The entity's selection and application of accounting policies.
- (d) Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.
- (e) Measurement and review of the entity's financial performance.
- (f) Internal control.

Appendix 1 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (a) through (e) above. Appendix 2 contains a detailed explanation of the internal control components.

A17. The nature, timing, and extent of the risk assessment procedures performed depend on the circumstances of the engagement such as the size and complexity of the entity and the auditor's experience with it. In addition, identifying significant changes in any of the above aspects of the entity from prior periods is particularly important in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

### **Industry, Regulatory and Other External Factors, Including the Applicable Financial Reporting Framework (Ref. ISA 315, 8(A))**

- A18. Relevant industry, regulatory, and other external factors including the applicable financial reporting framework include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments; the regulatory environment encompassing, among other matters, the applicable financial reporting framework, the legal and political environment, and environmental requirements affecting the industry and the entity; and other external factors such as general economic conditions. See ISA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements” for additional requirements related to the legal and regulatory framework applicable to the entity and the industry.
- A19. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and costs that give rise to risks of material misstatement. In such cases, as required by ISA 315, the auditor should consider whether the engagement team includes members with sufficient relevant knowledge and experience.
- A20. Legislative and regulatory requirements often determine the applicable financial reporting framework to be used by management in preparing the entity’s financial statements. In most cases, the applicable financial reporting framework will be that of the jurisdiction in which the entity is registered or operates and the auditor is based, and the auditor and the entity will have a common understanding of that framework. In some cases there may be no local financial reporting framework, in which case the entity’s choice will be governed by local practice, industry practice, user needs, or other factors. For example, the entity’s competitors may apply International Financial Reporting Standards (IFRS) and the entity may determine that IFRS are also appropriate for its financial reporting requirements. As required by paragraph 8(a) of ISA 315, the auditor considers whether local regulations specify certain financial reporting requirements for the industry in which the entity operates, since the financial statements may be materially misstated in the context of the applicable financial reporting framework if management fails to prepare the financial statements in accordance with such regulations.

### **Nature of the Entity (Ref. ISA 315, 8(B))**

- A21. The nature of an entity refers to the entity’s operations, its ownership and governance, the types of investments that it is making and plans to make, the way that the entity is structured and how it is financed. An understanding of the nature of an entity enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
- A22. The entity may have a complex structure with subsidiaries or other components in multiple locations. In addition to the difficulties of consolidation in such cases, other issues with complex structures that may give rise to risks of material misstatement include: the allocation of goodwill to business segments, and its impairment; whether investments are joint ventures, subsidiaries, or investments accounted for using the equity method; and whether special-purpose entities are accounted for appropriately.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

A23. An understanding of the ownership and relations between owners and other people or entities is also important in determining whether related party transactions have been identified and accounted for appropriately. ISA 550, “Related Parties” provides additional requirements on the auditor’s considerations relevant to related parties.

### **The Entity’s Selection and Application of Accounting Policies (Ref. ISA 315, 8(C))**

A24. The auditor’s understanding of the entity’s selection and application of accounting policies encompasses the methods the entity uses to account for significant and unusual transactions; the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; and changes in the entity’s accounting policies. As required by paragraph 8(c) of ISA 315, the auditor also identifies financial reporting standards and regulations that are new to the entity and considers when and how the entity will adopt such requirements, and where the entity has changed its selection of or method of applying a significant accounting policy, the auditor considers the reasons for the change and whether it is appropriate and consistent with the requirements of the applicable financial reporting framework.

A25. The presentation of financial statements in conformity with the applicable financial reporting framework includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the basis of amounts set forth. It also includes disclosure of a particular matter that is appropriate in light of the circumstances and facts of the entity.

### **Objectives and Strategies and Related Business Risks (Ref. ISA 315, 8(D))**

A26. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity’s management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the operational approaches by which management intends to achieve its objectives. Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity’s business is also dynamic and the entity’s strategies and objectives change over time.

A27. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk particularly may arise from change or complexity, though a failure to recognize the need for change may also give rise to risk. Change may arise, for example, from the development of new products that may fail; from an inadequate market, even if successfully developed; or from flaws that may result in liabilities and reputational risk. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks.

A28. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement. A business risk may have an immediate consequence for the risk of

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statements as a whole. For example, the business risk arising from a contracting customer base due to industry consolidation may increase the risk of misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which may be relevant to assessing the appropriateness of the going concern assumption. The auditor's consideration of whether a business risk may result in material misstatement is, therefore, made in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are given in Appendix 3.

- A29. Usually management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 9(b) of ISA 315 and paragraphs A70 to A72.
- A30. Smaller entities often do not set their objectives and strategies, or manage the related business risks, through formal plans or processes. In many cases there may be no documentation of such matters. In such entities, the auditor's understanding is ordinarily obtained through inquiries of management and observation of how the entity responds to such matters.

### **Measurement and Review of the Entity's Financial Performance (Ref. ISA 315, 8(E))**

- A31. Performance measures and their review indicate to the auditor aspects of the entity's performance that management and others consider to be of importance. Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.
- A32. Management's measurement and review of the entity's financial performance is to be distinguished from the monitoring of controls (discussed as a component of internal control in paragraphs A88-A90), though their purposes may overlap. Monitoring of controls, however, is specifically concerned with the effective operation of internal control through consideration of information about the control. The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties), but in some cases performance indicators also provide information that enables management to identify deficiencies in internal control.
- A33. Internally-generated information used by management for this purpose may include key performance indicators (financial and non-financial), budgets, variance analysis, segment information and divisional, departmental or other level performance reports, and comparisons of an entity's performance with that of competitors. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may provide information useful to the auditor's understanding of the entity and its environment. Such reports often are obtained from the entity being audited.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- A34. Internal measures may highlight unexpected results or trends requiring management's inquiry of others in order to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor a risk of misstatement of related financial statement information. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.
- A35. Much of the information used in performance measurement may be produced by the entity's information system. If management assumes that data used for reviewing the entity's performance are accurate without having a basis for that assumption, errors may exist in the information, potentially leading management to incorrect conclusions about performance. As required by paragraph 15 of ISA 315, when the auditor intends to make use of the performance measures for the purpose of the audit (for example, for analytical procedures), the auditor considers whether the information related to management's review of the entity's performance provides a reliable basis and is sufficiently precise for such a purpose; if making use of performance measures, the auditor considers whether they are precise enough to detect material misstatements.
- A36. Smaller entities ordinarily do not have formal processes to measure and review the entity's financial performance. Management nevertheless often relies on certain key indicators which knowledge and experience of the business suggest are reliable bases for evaluating financial performance and taking appropriate action.

### **Internal Control (Ref. ISA 315 8(f), 9 and 10)**

- A37. The auditor uses the understanding of internal control to identify types of potential misstatements, consider factors that affect the risks of material misstatement, and design the nature, timing, and extent of further audit procedures. Internal control relevant to the audit is discussed in paragraphs A42-A48 below. In addition, the depth of the understanding is discussed in paragraphs A49-A53 below.
- A38. Internal control is the process designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. It follows that internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives.
- A39. Internal control, as described in paragraph 9 of ISA 315, consists of the following components:
- (a) The control environment.
  - (b) The entity's risk assessment process.
  - (c) The information system, including the related business processes, relevant to financial reporting, and communication.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- (d) Control activities.
- (e) Monitoring of controls.

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

- A40. The division of internal control into the five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. The division does not necessarily reflect how an entity considers and implements internal control. Also, the auditor's primary consideration is whether, and how, a specific control prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures, and their related assertions, rather than its classification into any particular component. Accordingly, auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this ISA, provided all the components described in the standards of ISA 315 are addressed.
- A41. The way in which internal control is designed and implemented varies with an entity's size and complexity. Specifically, smaller entities may use less formal means and simpler processes and procedures to achieve their objectives. For example, smaller entities with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures or detailed written policies. For some entities, in particular very small entities, the owner-manager<sup>21</sup> may perform functions which in a larger entity would be regarded as belonging to several of the components of internal control. Therefore, the components of internal control may not be clearly distinguished within smaller entities, but their underlying purposes are equally valid.

### *Controls Relevant to the Audit*

- A42. 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.
- A43. Ordinarily, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements for external purposes that give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework and the management of risk that may give rise to a material misstatement in those financial statements. It is a matter of the auditor's professional judgment, subject to the requirements of ISA 315, whether a control, individually or in combination with others, is relevant to the auditor's considerations in assessing the risks of material misstatement and designing and performing further procedures in response to assessed risks. In exercising that judgment, the auditor considers the circumstances, the applicable component and factors such as the following:
- The auditor's judgment about materiality.
  - The size of the entity.

---

<sup>21</sup> This ISA uses the term "owner-manager" to indicate the proprietors of entities who are involved in the running of the entity on a day-to-day basis.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

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

A44. Controls over the completeness and accuracy of information produced by the entity may also be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. The auditor's previous experience with the entity and information obtained in understanding the entity and its environment and throughout the audit assists the auditor in identifying controls relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

A45. Controls relating to operations and compliance objectives may, however, be relevant to an audit if they pertain to data the auditor evaluates or uses in applying audit procedures. For example, controls pertaining to non-financial data that the auditor uses in analytical procedures, such as production statistics, or controls pertaining to detecting non-compliance with laws and regulations that may have a direct and material effect on the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

A46. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as a commercial airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit.

A47. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. In obtaining an understanding of each of the components of internal control, the auditor's consideration of safeguarding controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, controls to prevent the excessive use of materials in production generally are not relevant to a financial statement audit.

A48. Controls relevant to the audit may exist in any of the components of internal control and a further discussion of controls relevant to the audit is included under the heading of each internal control component below. In addition, paragraphs 23 and 24 in ISA 315 identify certain risks for which the auditor is required to evaluate the design of the entity's controls over such risks and determine whether they have been implemented.



## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

### *Depth of Understanding of Internal Control*

- A49. Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Further explanation is contained in the discussion of each internal control component below. Implementation of a control means that the control exists and that the entity is using it. As required by paragraph 10 of ISA 315, the auditor considers the design of a control in determining whether to consider its implementation. An improperly designed control may represent a material weakness<sup>22</sup> in the entity's internal control and the auditor considers whether to communicate this to those charged with governance and management as required by paragraph 25 of ISA 315.
- A50. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include inquiring of entity personnel, observing the application of specific controls, inspecting documents and reports, and tracing transactions through the information system relevant to financial reporting. Inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented.
- A51. Obtaining an understanding of an entity's controls is not sufficient to serve as testing the operating effectiveness of controls, unless there is some automation that provides for the consistent application of the operation of the control (manual and automated elements of internal control relevant to the audit are further described below). For example, obtaining audit evidence about the implementation of a manually operated control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, IT enables an entity to process large volumes of data consistently and enhances the entity's ability to monitor the performance of control activities and to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems. Therefore, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Standards for, and further explanation of, tests of the operating effectiveness of controls are contained in ISA 330 and the application material therein, respectively.

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

- A52. Most entities make use of IT systems for financial reporting and operational purposes. However, even when IT is extensively used, there will be manual elements to the systems. The balance between manual and automated elements varies. In certain cases, particularly smaller, less complex entities, the systems may be primarily manual. In other cases, the extent of automation may vary with some systems substantially automated with few related manual elements and others, even within the same entity, predominantly manual. As a result,

---

<sup>22</sup> A material weakness in internal control is one that could have a material effect on the financial statements.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

an entity's system of internal control is likely to contain manual and automated elements, the characteristics of which are relevant to the auditor's risk assessment and further audit procedures based thereon.

A53. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported.<sup>23</sup> Controls in a manual system may include such procedures as approvals and reviews of activities, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace such paper documents as purchase orders, invoices, shipping documents, and related accounting records. Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT. An entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT.

A54. Generally, IT provides potential benefits of effectiveness and efficiency for an entity's internal control because it enables an entity to:

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

A55. IT also poses specific risks to an entity's internal control, including the following:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.

---

<sup>23</sup> Paragraph 9 of Appendix 2 defines initiation, recording, processing, and reporting as used throughout ISA 315 and this application material

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- 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.

A56. Manual aspects of systems may be more suitable where judgment and discretion are required such as for the following circumstances:

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

A57. Manual controls are performed by people, and therefore pose specific risks to the entity's internal control. Manual controls may be less reliable than automated controls because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual systems may be less suitable for the following:

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented or detected by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

A58. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. Therefore in understanding internal control, and as required by paragraph 9(e) of ISA 315, the auditor considers whether the entity has responded adequately to the risks arising from the use of IT or manual systems by establishing effective controls.

### *Limitations of Internal Control*

A59. Internal control, no matter how well designed and operated, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human failures, such as simple errors or mistakes. For example, if an entity's information system personnel do not completely understand how an order entry system processes sales transactions, they may erroneously design changes to the system to process sales for a new line of products. On the other hand, such changes may be correctly designed but misunderstood by individuals who translate the design into program code. Errors also may occur in the use of information produced by IT.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

For example, automated controls may be designed to report transactions over a specified amount for management review, but individuals responsible for conducting the review may not understand the purpose of such reports and, accordingly, may fail to review them or investigate unusual items.

- A60. 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.
- A61. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, for key areas, even in a very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. The potential for override of controls by the owner-manager depends to a great extent on the control environment and in particular, the owner-manager's attitudes about the importance of internal control.

### *Control Environment (Ref. ISA 315, 9(a), 11 and 12)*

- A62. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure.
- A63. The primary responsibility for the prevention and detection of fraud and error rests with both those charged with governance and the management of an entity. As required by paragraph 12 of ISA 315, in evaluating the design of the control environment and determining whether it has been implemented, the auditor understands how management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior, and has established appropriate controls to prevent and detect fraud and error within the entity.
- A64. In understanding the control environment elements identified in paragraph 11 of ISA 315, the auditor also considers whether they have been implemented. Ordinarily, the auditor obtains relevant audit evidence through a combination of inquiries and other risk assessment procedures, for example, corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor determines whether controls have been implemented by considering, for example, whether management has established a formal code of conduct and whether it acts in a manner that supports the code or condones violations of, or authorizes exceptions to the code.
- A65. Audit evidence for elements of the control environment may not be available in documentary form, in particular for smaller entities where communication between management and other personnel may be informal, yet effective. For example,

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

management's commitment to ethical values and competence are often implemented through the behavior and attitude they demonstrate in managing the entity's business instead of in a written code of conduct. Consequently, management's attitudes, awareness and actions are of particular importance in the design of a smaller entity's control environment. In addition, the role of those charged with governance is often undertaken by the owner-manager where there are no other owners.

- A66. The overall responsibilities of those charged with governance are recognized in codes of practice and other regulations or guidance produced for the benefit of those charged with governance. It is one, but not the only, role of those charged with governance to counterbalance pressures on management in relation to financial reporting. For example, the basis for management remuneration may place stress on management arising from the conflicting demands of fair reporting and the perceived benefits of improved results. In understanding the design of the control environment, the auditor considers such matters as the independence of the directors and their ability to evaluate the actions of management. The auditor also considers whether there is an audit committee that understands the entity's business transactions and evaluates whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework.
- A67. The nature of an entity's control environment is such that it has a pervasive effect on assessing the risks of material misstatement. For example, owner-manager controls may mitigate a lack of segregation of duties in a small business, or an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities. The auditor's evaluation of the design of the entity's control environment includes considering whether the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and are not undermined by control environment weaknesses. For example, human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may not mitigate a strong bias by top management to overstate earnings. Changes in the control environment may affect the relevance of information obtained in prior audits. For example, management's decision to commit additional resources for training and awareness of financial reporting activities may reduce the risk of errors in processing financial information. Alternatively, management's failure to commit sufficient resources to address security risks presented by IT may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or by allowing unauthorized transactions to be processed.
- A68. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement and as explained in paragraph 5 of ISA 330, influences the nature, timing, and extent of the auditor's further procedures. In particular, it may help reduce the risk of fraud, although a satisfactory control environment is not an absolute deterrent to fraud. Conversely, weaknesses in the control environment may undermine the effectiveness of controls and therefore be negative factors in the auditor's assessment of the risks of material misstatement, in particular in relation to fraud.
- A69. The control environment in itself does not prevent, or detect and correct, a material misstatement in classes of transactions, account balances, and disclosures and related

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

assertions. The auditor, therefore, ordinarily considers the effect of other components along with the control environment when assessing the risks of material misstatement; for example, the monitoring of controls and the operation of specific control activities.

### *The Entity's Risk Assessment Process (Ref. ISA 315, 9(b) and 16)*

A70. As required by paragraph 9(b) of ISA 315, in evaluating the design and implementation of the entity's risk assessment process, the auditor determines how management identifies business risks relevant to financial reporting, estimates the significance of the risks, assesses the likelihood of their occurrence, and decides upon actions to manage them. If the entity's risk assessment process is appropriate to the circumstances, it assists the auditor in identifying risks of material misstatement.

A71. As required by paragraph 16 of ISA 315, the auditor inquires about business risks that management has identified and considers whether they may result in material misstatement. During the audit, the auditor may identify risks of material misstatement that management failed to identify. In such cases, the auditor considers whether there was an underlying risk of a kind that should have been identified by the entity's risk assessment process, and if so, why that process failed to do so and whether the process is appropriate to its circumstances. If, as a result, the auditor judges that there is a material weakness in the entity's risk assessment process, the auditor communicates to those charged with governance as required by paragraph 25 of ISA 315.

A72. In a smaller entity, management may not have a formal risk assessment process as identified in paragraph 9(b) of ISA 315. For such entities, the auditor discusses with management how risks to the business are identified by management and how they are addressed.

### *Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication (Ref. ISA 315, 9(c), 13 and 14, and 9(d), respectively)*

A73. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity.

A74. As required by paragraph 13 of ISA 315, in obtaining an understanding of the information system, including the related business processes, relevant to financial reporting, the auditor considers the procedures used to transfer information from transaction processing systems to general ledger or financial reporting systems. The auditor also understands the entity's procedures to capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables.

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

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- A76. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as an asset impairment. In manual, paper-based general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. However, when automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may be more easily identified through the use of computer-assisted audit techniques.
- A77. Preparation of the entity's financial statements include procedures that are designed to ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.
- A78. In obtaining an understanding, ISA 315 paragraph 14 requires the auditor to consider risks of material misstatement associated with inappropriate override of controls over journal entries and the controls surrounding non-standard journal entries. For example, automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or financial reporting system. Furthermore, the auditor maintains an awareness that when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.
- A79. As required by paragraph 13 of ISA 315, the auditor also understands how the incorrect processing of transactions is resolved, for example, whether there is an automated suspense file and how it is used by the entity to ensure that suspense items are cleared out on a timely basis, and how system overrides or bypasses to controls are processed and accounted for.
- A80. The auditor obtains an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances. This includes obtaining an understanding of how transactions originate within the entity's business processes. An entity's business processes are the activities designed to develop, purchase, produce, sell and distribute an entity's products and services; ensure compliance with laws and regulations; and record information, including accounting and financial reporting information.
- A81. 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 and may take such forms as policy manuals and financial reporting manuals. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on. As required by paragraph 9(d) of ISA 315, the auditor's understanding of communication pertaining to financial reporting matters also includes communications between management and those charged with governance,

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

particularly the audit committee, as well as external communications such as those with regulatory authorities.

### *Control Activities (Ref. ISA 315, 9(e))*

A82. Control activities are the policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:

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

A83. In obtaining an understanding of control activities, the auditor's primary consideration is whether, and how, a specific control activity, individually or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures. Control activities relevant to the audit are those for which the auditor considers it necessary to obtain an understanding in order to assess risks of material misstatement at the assertion level and to design and perform further audit procedures responsive to the assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. The auditor's emphasis is on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that material misstatements are more likely to occur. When multiple control activities achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A84. The auditor considers the knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. In considering whether control activities are relevant to the audit, the auditor considers the risks the auditor has identified that may give rise to material misstatement. Also, control activities are relevant to the audit if the auditor is required to evaluate them as discussed in paragraphs 23 and 24 of ISA 315.

A85. The use of IT affects the way that control activities are implemented. As required by paragraph 9(e) of ISA 315, the auditor considers whether the entity has responded adequately to the risks arising from IT by establishing effective general IT-controls and application controls. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process.



## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

A86. General IT-controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:

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

They are generally implemented to deal with the risks referred to in paragraph 55 above.

A87. Application controls are manual or automated procedures that typically operate at a business process level. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

### *Monitoring of Controls (Ref. ISA 315, 9(f))*

A88. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A89. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. See ISA 610, "Considering the Work of Internal Auditing" for additional guidance. Management's monitoring activities may also include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

A90. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors may exist in the information, potentially leading management to incorrect conclusions from its monitoring activities. The auditor obtains an understanding of the sources of the information related to the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. As required by paragraph 15 of ISA 315, when the auditor intends to make use of the entity's information produced for monitoring activities, such as internal auditor's reports, the auditor considers whether the information provides a reliable basis and is sufficiently detailed for the auditor's purpose.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

### **Assessing the Risks of Material Misstatement (Ref. ISA 315, 17-19)**

- A91. The auditor uses information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor uses the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.
- A92. The nature of the risks arising from a weak control environment is such that they are not likely to be confined to specific individual risks of material misstatement in particular classes of transactions, account balances, and disclosures. Rather, weaknesses such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.
- A93. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, the auditor gains an understanding of controls and relates them to assertions in the context of processes and systems in which they exist. Doing so is useful because individual control activities often do not in themselves address a risk. Often only multiple control activities, together with other elements of internal control, will be sufficient to address a risk.
- A94. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.
- A95. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.
- A96. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. Also, concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements. ISA 701 establishes standards in determining whether there is a need for the auditor to consider a qualification or disclaimer of opinion or, as may be required in some cases, to withdraw from the engagement.

### **Significant Risks That Require Special Audit Consideration (Ref. ISA 315, 20-23)**

- A97. ISA 330, paragraphs 44 and 51 describe the consequences for further audit procedures of identifying a risk as significant.

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

- A98. The determination of significant risks, which arise on most audits, is a matter for the auditor's professional judgment. As required by paragraph 21 of ISA 315, in exercising this judgment, the auditor excludes the effect of identified controls related to the risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because they have lower inherent risks. On the other hand, significant risks are often derived from business risks that may result in a material misstatement.
- A99. Significant risks often relate to significant non-routine transactions and judgmental matters. Non-routine transactions are transactions that are unusual, either due to size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.
- A100. Risks of material misstatement may be greater for risks relating to significant non-routine transactions arising from matters such as the following:
- Greater management intervention to specify the accounting treatment.
  - Greater manual intervention for data collection and processing.
  - Complex calculations or accounting principles.
  - The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.
- A101. Risks of material misstatement may be greater for risks relating to significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:
- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
  - Required judgment may be subjective, complex or require assumptions about the effects of future events, for example, judgment about fair value.
- A102. As required by paragraph 23 of ISA 315, for significant risks, to the extent the auditor has not already done so, the auditor evaluates the design of the entity's related controls, including relevant control activities, and determines whether they have been implemented. An understanding of the entity's controls related to significant risks is required to provide the auditor with adequate information to develop an effective audit approach. Management ought to be aware of significant risks; however, risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls. Therefore, the auditor's understanding of whether the entity has designed and implemented controls for such significant risks includes whether and how management responds to the risks and whether control activities such as a review of assumptions by senior management or experts, formal processes for estimations or approval by those charged with governance have been implemented to address the risks. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response will include such matters as whether it has been referred to appropriate experts (such as internal or

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

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.

A103. If management has not appropriately responded by implementing controls over significant risks and if, as a result, the auditor judges that there is a material weakness in the entity's internal control, the auditor communicates this matter to those charged with governance as required by paragraph 27 of ISA 315. In these circumstances, the auditor also considers the implications for the auditor's risk assessment.

### **Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref. ISA 315, 24-25)**

A104. The consequences for further audit procedures of identifying such risks are described in paragraph 25 of ISA 330.

A105. The understanding of the entity's information system relevant to financial reporting enables the auditor to identify risks of material misstatement that relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements; these include risks of inaccurate or incomplete processing. Ordinarily, such risks relate to significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A106. The characteristics of routine day-to-day business transactions often permit highly automated processing with little or no manual intervention. In such circumstances, it may not be possible to perform only substantive procedures in relation to the risk. For example, in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported electronically such as in an integrated system, the auditor may determine that it is not possible to design effective substantive procedures that by themselves would provide sufficient appropriate audit evidence that relevant classes of transactions or account balances, are not materially misstated. In such cases, audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed or reported only in electronic form and appropriate controls are not operating effectively.

A107. Examples of situations where the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence that certain assertions are not materially misstated include the following:

- An entity that conducts its business using IT to initiate orders for the purchase and delivery of goods based on predetermined rules of what to order and in what quantities and to pay the related accounts payable based on system-generated decisions initiated upon the confirmed receipt of goods and terms of payment. No other documentation of orders placed or goods received is produced or maintained, other than through the IT system.
- An entity that provides services to customers via electronic media (for example, an Internet service provider or a telecommunications company) and uses IT to create a

## SUPPLEMENT: ILLUSTRATIVE EXAMPLES

log of the services provided to its customers, initiate and process its billings for the services and automatically record such amounts in electronic accounting records that are part of the system used to produce the entity's financial statements.

### **Revision of Risk Assessment (Ref. ISA 315, 26)**

A108. As discussed in ISA 315, the auditor's assessment of the risks of material misstatement at the assertion level is based on available audit evidence and may change during the course of the audit as additional audit evidence is obtained. In particular, the risk assessment may be based on an expectation that controls are operating effectively to prevent, or detect and correct, a material misstatement at the assertion level. In performing tests of controls to obtain audit evidence about their operating effectiveness, the auditor may obtain audit evidence that controls are not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. As required by paragraph 26 of ISA 315, in circumstances where the auditor obtains audit evidence from performing further audit procedures that tends to contradict the audit evidence on which the auditor originally based the assessment, the auditor revises the assessment and modifies the further planned audit procedures accordingly. See paragraphs 66 and 70 of ISA 330 for further guidance.

### **Documentation (Ref. ISA 315, 29)**

A109. ISA 315 requires the auditor to document specific matters arising from the conduct of the auditor's work. In particular, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures (see paragraph 73 of ISA 330 for additional guidance). Examples of common techniques, used alone or in combination include narrative descriptions, questionnaires, check lists and flow charts. Such techniques may also be useful in documenting the auditor's assessment of the risks of material misstatement at the overall financial statement and assertions level. The form and extent of this documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the specific audit methodology and technology used in the course of the audit. For example, documentation of the understanding of a complex information system in which a large volume of transactions are electronically initiated, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an information system making limited or no use of IT or for which few transactions are processed (for example, long-term debt), documentation in the form of a memorandum may be sufficient. Ordinarily, the more complex the entity and the more extensive the audit procedures performed by the auditor, the more extensive the auditor's documentation will be. ISA 230, "Documentation" provides guidance regarding documentation in the context of the audit of financial statements.

*[No changes would be made to the content or structure of Appendix 1, 2 or 3 of ISA 315. Accordingly, the appendices have not been reproduced for purposes of this illustration.]*



**International Federation of Accountants**

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA  
Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 [www.ifac.org](http://www.ifac.org)

**FOR IMMEDIATE RELEASE**

**Contacts:**

**Bryan Hall (212) 286-9568**

[bryanhall@ifac.org](mailto:bryanhall@ifac.org)

**Helene Kennedy (212) 471-8707**

[hkennedy@kennedycomm.com](mailto:hkennedy@kennedycomm.com)

**NEW IAASB EXPOSURE DRAFTS FOCUS ON CLARIFYING PROFESSIONAL STANDARDS AND IMPROVING AUDIT DOCUMENTATION**

*(New York/September 23, 2004)* — At its meeting last week, the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) approved two new exposure drafts (EDs) for release: *Proposed Policy Statement on Clarifying Professional Requirements in International Standards*, and a revision to International Standard on Auditing (ISA) 230, *Audit Documentation*. Both documents recommend changes that will contribute to the improved quality and consistency of audits.

***Clarifying Professional Standards***

The ED on *Clarifying Professional Requirements in International Standards* reaffirms the IAASB's belief that the use of clear, concise, consistent, and definitive imperatives is essential to the consistent application of international standards. It does this by defining two categories of professional requirements – “requirements” and “presumptive requirements” – and the corresponding language to be used in pronouncements. A requirement, to be fulfilled in all cases, would be identified by the word “shall” and a presumptive requirement by the word “should.”

(more)

In addition, the IAASB recommends that the use of the present tense be discontinued when referring to actions by the professional accountant.

“International standards that are clear and capable of consistent application should contain no ambiguity about the professional requirements that a professional accountant must fulfill,” states John Kellas, chair of the IAASB. “The proposed changes are designed to achieve this goal.”

In addition to the ED, the IAASB has issued a consultation paper, *Improving the Clarity and Structure of IAASB Standards and Related Considerations for Practice Statements*, which seeks feedback on whether there is a need to change the way IAASB standards are drafted. Comments on the exposure draft and related consultation paper are requested by December 31, 2004.

### ***Audit Documentation***

The proposed revisions to ISA 230, *Audit Documentation*, include clarification on the form, content, and extent of audit documentation, guidance on changes to audit documentation after the date of the auditor’s report, and matters to be considered in connection with confidentiality, safe custody, and retention of audit documentation. These proposed changes provide for greater rigor in documentation of key audit matters, which the IAASB believes will ultimately drive improved auditor performance.

An appendix to the exposure draft identifies additional specific audit documentation requirements set out in other ISAs. Comments on this exposure draft are requested by January 31, 2005.

(more)

### *Submitting Comments*

All of the above-mentioned documents may be downloaded from the IFAC website ([www.ifac.org](http://www.ifac.org)) Comments may be submitted electronically to [EDComments@ifac.org](mailto:EDComments@ifac.org).

IFAC is dedicated to serving the public interest, strengthening the worldwide accountancy profession, and contributing to the development of strong international economies. Its current membership consists of 157 professional accountancy bodies in 118 countries, representing more than 2.5 million accountants in public practice, education, government service, industry and commerce.

The IAASB's role is to improve auditing and assurance standards and the quality and uniformity of practice throughout the world, thereby strengthening public confidence in the global auditing profession.

# # #