Guide to Using ISAs in the Audits of Small- and Medium-Sized Entities

Volume 2 — Practical Guidance

Third Edition

IFAC
International Federation of Accountants

Small and Medium Practices Committee
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, NY 10017 USA

This Implementation Guide was prepared by the Small and Medium Practices Committee of the International Federation of Accountants (IFAC). The committee represents the interests of professional accountants operating in small- and medium-sized practices and other professional accountants who provide services to small- and medium-sized entities.

This publication may be downloaded free of charge from the IFAC website: www.ifac.org. The approved text is published in the English language.

The mission of IFAC is to serve the public interest, strengthen the worldwide accountancy profession, and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards, and speaking out on public interest issues where the profession's expertise is most relevant.

For further information, please email paulthompson@ifac.org.

Copyright © November 2011 by the International Federation of Accountants (IFAC). All rights reserved. Permission is granted to make copies of this work provided that such copies are for use in academic classrooms or for personal use and are not sold or disseminated and provided that each copy bears the following credit line: "Copyright © November 2011 by the International Federation of Accountants (IFAC). All rights reserved. Used with permission of IFAC. Contact permissions@ifac.org for permission to reproduce, store, or transmit this document." Otherwise, written permission from IFAC is required to reproduce, store, or transmit, or make similar uses of, this document, except as permitted by law. Contact permissions@ifac.org.

ISBN: 978-1-60815-099-1

Contents

Volume 1	Primary ISA References	Page Number
Preface		5
Request for Comments		6
1. How to Use the Guide		8
2. The ISAs		13
Core Concepts		21
3. Ethics, ISAs, and Quality Control	ISQC 1, 200, 220	21
4. The Risk-Based Audit—Overview	Multiple	34
5. Internal Control—Purpose and Components	315	54
6. Financial Statement Assertions	315	80
7. Materiality and Audit Risk	320	87
8. Risk Assessment Procedures	240, 315	99
9. Responding to Assessed Risks	240, 300, 330, 500	109
10. Further Audit Procedures	330, 505, 520	120
11. Accounting Estimates	540	142
12. Related Parties	550	151
13. Subsequent Events	560	160
14. Going Concern	570	167
15. Summary of Other ISA Requirements	250, 402, 501, 510, 600, 610, 620, 720	177
16. Audit Documentation	ISQC 1, 220, 230, 240, 300, 315, 330	211
17. Forming an Opinion on Financial Statements	700	224

Volume 2	Primary ISA Reference	Page Number
Preface		5
Request for Comments		6
1. How to Use the Guide		8
2. Introduction to the Case Studies		13
PHASE 1: Risk Assessment		24
3. Risk Assessment—Overview		24
Preliminary Activities		27
4. Engagement Acceptance and Continuance	ISQC 1, 210, 220, 300	27
Planning the Audit		43
5. Overall Audit Strategy	300	43
6. Determining and Using Materiality	320, 450	54
7. Audit Team Discussions	240, 300, 315	70
Performing Risk Assessment Procedures		79
8. Inherent Risks—Identification	240, 315	79
9. Inherent Risks—Assessment	240, 315	107
10. Significant Risks	240, 315, 330	117
11. Understanding Internal Control	315	127
12. Evaluating Internal Control	315	141
13. Communicating Deficiencies in Internal Control	265	171
14. Concluding the Risk Assessment Phase	315	184
PHASE II: Risk Response		194
15. Risk Response—An Overview	–	194
16. The Responsive Audit Plan	260, 300, 330, 500	197
17. Determining the Extent of Testing	330, 500, 530	220
18. Documenting Work Performed	230	249
19. Written Representations	580	253
PHASE III: Reporting		266
20. Reporting—Overview	–	266
21. Evaluating Audit Evidence	220, 330, 450, 520, 540	269
22. Communicating with Those Charged With Governance	260, 265, 450	286
23. Modifications to the Auditor's Report	705	297
24. Emphasis of Matter and Other Matter Paragraphs	706	310
25. Comparative Information	710	316

Preface

Welcome to the third edition of the IFAC SMP Committee's Guide to Using International Standards on Auditing in the Audits of Small- and Medium-Sized Entities.

In this edition, we have taken the opportunity to refine some of the technical content and to make other minor presentational improvements. Mindful, however, that many users may be in the process of translating the Guide, we have endeavored to keep the revisions in this edition to a minimum.

First released in 2007 and developed with the Canadian Institute of Chartered Accountants (CICA), the Guide is intended to enable practitioners to develop a deeper understanding of an audit conducted in compliance with International Standards on Auditing (ISAs) through explanation and illustrative examples. It offers a practical "how-to" audit approach that practitioners may use when undertaking a risk-based audit of an SME. Ultimately, it should help practitioners conduct high-quality, cost-effective audits, enabling them to better serve SMEs and, in turn, the wider public interest.

The Guide provides non-authoritative guidance on applying ISAs. It is not to be used as a substitute for reading the ISAs, but rather as a supplement to support consistent implementation of these standards in the audits of SMEs. The Guide does not address all aspects of the ISAs, and should not be used for the purposes of determining or demonstrating compliance with the ISAs.

In order to help member bodies maximize the use of both this Guide and its sister publication, the Guide to Quality Control for Small- and Medium-Sized Practices, the SMP Committee is developing a companion guide, along with additional materials designed to support the use of the Guides for education and training purposes. The companion guide will include suggestions on how IFAC member bodies and firms may make best use of the Guides to suit their own needs and jurisdictions.

Finally, we welcome readers to visit the SMP area of the IFAC website at www.ifac.org/SMP for further details about the work of the IFAC SMP Committee and for access to a wide collection of additional free publications and resources.

Sylvie Voghel

Chair, IFAC SMP Committee
November 2011

Request for Comments

This is the third edition of the Guide. While we consider this Guide to be useful and of high quality, it can be improved. We are committed to updating this Guide on a regular basis so as to ensure that it reflects current standards and is as useful as possible.

We welcome comments from national standard setters, IFAC member bodies, practitioners, and others. In particular, we welcome views on the following questions.

1. How do you use the Guide? For example, do you use it as a basis for training and/or as a practical reference guide, or in some other way?
2. Do you consider the Guide to be sufficiently tailored to the audit of SMEs?
3. Do you find the Guide easy to navigate? If not, can you suggest how navigation can be improved?
4. In what other ways do you think the Guide can be made more useful?
5. Are you aware of any derivative products—such as training materials, forms, checklists, and programs—that have been developed based on the Guide? If so, please provide details.

Please submit your comments to Paul Thompson, Deputy Director at:

Email: paulthompson@ifac.org
Fax: +1 212-286-9570
Mail: Small and Medium Practices Committee
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, NY 10017, USA

Disclaimer

This Guide is designed to assist practitioners in the implementation of the International Standards of Auditing (ISAs) on the audit of small- and medium-sized entities, but is not intended to be a substitute for the ISAs themselves. Furthermore, a practitioner should utilize this Guide in light of his/her professional judgment and the facts and circumstances involved in each particular audit. IFAC disclaims any responsibility or liability that may occur, directly or indirectly, as a consequence of the use and application of this Guide.

The purpose of this Guide is to provide practical guidance to practitioners conducting audit engagements for small- and medium-sized entities (SMEs). However, no material in the Guide should be used as a substitute for:

- 3FBEJOH BOE VOEFSTUBOEJOH UIF *4"T
  It is assumed that practitioners have read the text of the International Standards on Auditing (ISAs) which are contained in the Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements, which can be downloaded free of charge from the IFAC online publications and resources site at www.ifac.org/publications-resources/2010-handbook-international-quality-control-auditing-review-other-assurance-a. ISA 200.19 states that the auditor shall have an understanding of the entire text of an ISA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. The ISAs, as well as frequently asked questions (FAQs) and other support materials, can also be obtained from the Clarity Center at www.ifac.org/auditing-assurance/clarity-center.
- 6TF PG QSPGFTTJPOBM KVEHNFOU
  In order to apply the ISAs effectively, professional judgment is required based on the particular facts and circumstances involved in the firm and each particular engagement.

While it is expected that small- and medium-sized practices (SMPs) will be a significant user group, this Guide is intended to help all practitioners to implement ISAs on SME audits.

This Guide can be used to:

- %FWFMPQ B EFFQFS VOEFSTUBOEJOH PG BO BVEJU DPOEVDU
- %FWFMPQ B TUBò NBOVBM TVQQMFNFOUFE BT OFDFTTBSZ GP VTFE GPS EBZ UP EBZ SFGFSFODF BOE BT B CBTJT GPS USBJC
- Help ensure that staff adopt a consistent approach to planning and performing an audit.

This Guide often refers to an audit team, which implies that more than one auditor is involved in conducting the audit engagement. However, the same general principles also apply to audit engagements performed exclusively by one person (the practitioner).

1.1 Reproduction, Translation, and Adaptation of the Guide

IFAC encourages and facilitates the reproduction, translation, and adaptation of its publications. Interested parties wishing to reproduce, translate, or adapt this Guide should contact permissions@ifac.org.

1.2 Chapter Content and Organization

Rather than just summarize each ISA in turn, the Guide has been organized into two volumes as follows:

- 7PMVNF ‰$PSF $PODFQUT
- 7PMVNF ‰1SBDUJDBM (VJEBODF

This is Volume 2 of the Guide, which focuses on how to apply the concepts outlined in Volume 1. It follows the typical stages involved in performing an audit, starting with client acceptance, planning, and risk assessment, and then the risk response, evaluating audit evidence obtained, and forming an appropriate audit opinion.

Summary of Organization

Each chapter in both volumes of this Guide has been organized in the following format:

- $IBQUFS 5JUMF
- "VEJU 1SPDFTT $IBSU‰&YUSBDU
  Most chapters contain an extract from the audit process chart (where applicable) to highlight the particular activities addressed in the chapter.
- $IBQUFS $POUFOU
  This outlines the content and purpose of the chapter.
- 3FMFWBOU *4"T
  Most chapters in this Guide begin with some extracts from the ISAs that are relevant to the chapter content. These extracts include relevant requirements and, in some cases, the objectives (sometimes highlighted separately if/when a chapter focuses primarily on one particular ISA), selected definitions, and application material. The inclusion of these extracts is not meant to imply that other material in the ISA not specifically mentioned, or other ISAs that relate to the subject matter do not need to be considered. The extracts in the Guide are based solely on the judgment of the authors as to what is relevant for the content of each particular chapter. For example, the requirements of ISAs 200, 220, and 300 apply throughout the audit process, but have only been addressed specifically in one or two chapters.
- 0WFSWJFX BOE $IBQUFS .BUFSJBM
  The overview in each chapter provides:
  - Extracts from applicable ISAs and
  - An overview of what is addressed in the chapter.

  The overview is followed by a more detailed discussion of the subject matter, and practical step-by-step guidance/methodology on how to implement the relevant ISAs. This can include some cross-references to the applicable ISAs. While the Guide focuses exclusively on the ISAs (other than the 800 series) that apply to audits of historical financial information, reference is also made to the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants (the IESBA Code), and the International Standard on Quality Control 1 (ISQC 1), Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements.
- $PO T1JE JFGS U
  A number of Consider Points are included throughout the Guide. These Consider Points provide practical guidance on audit matters that can easily be overlooked, or where practitioners may have difficulty understanding and implementing certain concepts.

- *MMVTUSBUJWF $BTF 4UVEJFT

  To demonstrate how the ISAs can be applied in practice, Volume 2 of the Guide includes two case studies. At the end of many chapters within Volume 2, two possible approaches to documenting the application of the ISA requirements are discussed. Please refer to Volume 2, Chapter 2 of this Guide for details about the case studies.

  The purpose of the case studies and the documentation presented are purely illustrative. The documentation provided is a small extract from a typical audit file, and it outlines just one possible way of complying with the ISA requirements. The data, analysis, and commentary provided represent only some of the circumstances and considerations that the auditor will need to address in a particular audit. As always, the auditor must exercise professional judgment.

  The first case study is based on a fictional entity called Dephta Furniture. This is a local, family-owned furniture manufacturer with 15 full-time employees. The entity has a simple governance structure, few levels of management, and straightforward transaction processing. The accounting function uses an off-the-shelf, standard software package. The second case study is based on another fictional entity called Kumar & Co. This is a micro-sized entity with two full-time staff plus the owner and one part-time bookkeeper.

Other IFAC Publications

This Guide may also be read in conjunction with The Guide to Quality Control for Small- and Medium-Sized Practices, which can be downloaded free of charge from the IFAC online publications and resources site at http://web.ifac.org/publications/small-and-medium-practices-committee/implementation-guides.

1.3 Glossary of Terms

The Guide uses many of the terms as defined in the IESBA Code, Glossary of Terms, and ISAs (as contained in the Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements). Both partners and staff must be aware of these definitions.

The (VJEF BMTP VTFT UIF GPMMPXJOH UFSNT

Anti-Fraud Controls

These are controls designed by management to prevent or detect misstatements resulting from fraud. With respect to management override, these controls may not prevent a fraud from occurring, but would act as a deterrent and make perpetrating a fraud more difficult to conceal. Typical examples are:

- 1PMJDJFT BOE QSPDFEVSFT UIBU QSPWJEF BEEJUJPOBM BDD FOUSJFT
- *NQSPWFE BDDFTT DPOUSPMT GPS TFOTJUJWF EBUB BOE US
- 4JNJMBS UP BCPWF
- %JTDSFQBODZ BOE FYDFQUJPO SFQPSUT
- "VEJU USBJMT
- 'SBVE DPOUJOHFODZ QMBOT
-)VNBO SFTPVSDF QSPDFEVSFT TVDI BT JEFOUJGZJOH NPOJU QPUFOUJBM GPS FYBNQMF BO FYDFTTJWFMZ MBWJTI MJGFT

t .FDIBOJTNT GPS SFQPSUJOH QPUFOUJBM GSBVET BOPOZNPV

Entity-Level Controls

Entity-level controls address pervasive risks. They contribute to the "tone at the top" of an organization and establish expectations for the control environment. They are often less tangible than controls that operate at the transaction level, but have a pervasive and significant impact and influence over all other internal controls. As such, they form the all-important foundation upon which other internal controls (if any) are built. Examples of entity-level controls include management's commitment to ethical behavior, attitudes toward internal control, hiring and competence of staff employed, and anti-fraud and period-end financial reporting. These controls will have an impact on all other business processes within the entity.

Management

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

Those Charged With Governance (TCWG)

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

Owner-Manager

This refers to the proprietor of an entity involved in the running of the entity on a day-to-day basis. In most instances, the owner-manager will also be the person charged with governance of the entity.

Small- and Medium-Sized Practice (SMP)

An accounting practice/firm that exhibits the following characteristics:

t *UT DMJFOUT BSF NPTUMZ TNBMM BOE NFEJVN TJ[FE FOUJUJ

t &YUFSOBM TPVSDFT BSF VTFE UP TVQQMFNFOU MJNJUFE JO I

t It employs a limited number of professional staff.

What constitutes an SMP will vary from one jurisdiction to another.

1.4 Acronyms Used in the Guide

AR	Accounts receivable
Assertions (combined)	C= Completeness E = Existence A = Accuracy and cutoff V = Valuation
CAATs	Computer-assisted audit techniques
CU	Currency units (standard currency unit is referred to as "€")
F/S	Financial statements
HR	Human resources
IAASB	International Auditing and Assurance Standards Board
IC	Internal Control. The five major components of internal control are as follows: CA = Control activities CE = Control environment IS = Information systems MO= Monitoring RA = Risk assessment
IESBA Code	IESBA Code of Ethics for Professional Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
ISAs	International Standards on Auditing
ISAEs	International Standards on Assurance Engagements
IAPSs	International Auditing Practice Statements
ISQC	International Standard on Quality Control
ISREs	International Standards on Review Engagements
ISRSs	International Standards on Related Services
IT	Information technology
PC	Personal computer
R&D	Research and development
RMM	Risks of material misstatement
RAPs	Risk assessment procedures
SME	Small- and medium-sized entity
SMP	Small- and medium-sized practice
TOC	Tests of controls
TCWG	Those charged with governance
WP	Work papers, working papers

To illustrate how the various aspects of the audit process can be documented in practice, two case studies have been developed based on one fictional medium-sized entity and one fictional entity that is very small. The first scenario (Case Study A) is a furniture company called Dephta Furniture, Inc. that employs 15 people. The second scenario (Case Study B) is Kumar & Co., a small entity with two people. Kumar & Co. primarily supplies goods to Dephta Furniture, Inc. Both organizations have decided to use the IFRS reporting framework.

3FBEFST BSF DBVUJPOFE UIBU UIFTF DBTF TUVEJFT BSF QVSFM
JT B TNBMM FYUSBDU GSPN B UZQJDBM BVEJU öMF BOE JU JM
UIF *4" SFRVJSFNFOUT 5IF EBUB BOBMZTJT BOE DPNNFOUBS
DJSDVNTUBODFT BOE DPOTJEFSBUJPOT UIBU UIF BVEJUPS XJM
BMXBZT UIF BVEJUPS NVTU FYFSDJTF QSPGFTTJPOBM KVEHNF

$BTF 4UVEZ "‰%FQIUB 'VSOJUVSF *OD

Background

Dephta Furniture, Inc. is a family-owned furniture manufacturing company. It produces various kinds of wooden household furniture, both ready-made and custom-built. Dephta has an excellent reputation for producing quality products.

The company has three major product lines: bedroom sets, dining-room sets, and tables of all sorts. Standard pieces of furniture can also be customized for specific needs. To tap into the power of the Internet, the company recently set up a web site where people can buy furniture directly and pay by credit card. During the last period, the company shipped custom orders as far as 900 kilometers away.

The manufacturing facility is located on an acre of land adjacent to Suraj Dephta's house. An addition on the west side of Suraj's home acts as Dephta Furniture's shop. Major decisions are often made around the dining room table (which is the first table Suraj and his father built together). He likes the symbolism of sharing a meal on the product that produces his family's money for food.

Industry Trends

Until recently, Dephta had been growing rapidly. However, the furniture industry is currently experiencing challenging times due to:

t " EFDMJOJOH FDPOPNZ EVF UP B XPSME XJEF SFDFTTJPO

- 1PUFOUJBM DVTUPNFST MJNJUJOH UIFJS TQFOEJOH PO EJTD
- $PNQFUJUJPO
- 1SFTTVSF UP SFEVDF QSJDFT UP BUUSBDU TBMFT BOE
- 4PNF GVSOJUVSF QBSUT NBOVGBDUVSFST HPJOH PVU PG CV

Governance

The company was started in 1952 by Suraj's father, Jeewan Dephta. Jeewan first made wooden spindles and banisters with one lathe in a small workshop next to the family home.

The company does not have a formal governance structure. Jeewan and Suraj prepare a business plan each period, then meet once a month with a successful local businessman, Ravi Jain, to review their progress against the plan. They also pay Ravi to comment on the practicality of their new dreams and ideas for the business, review the operating results, and provide advice on how to deal with any specific issues that have arisen.

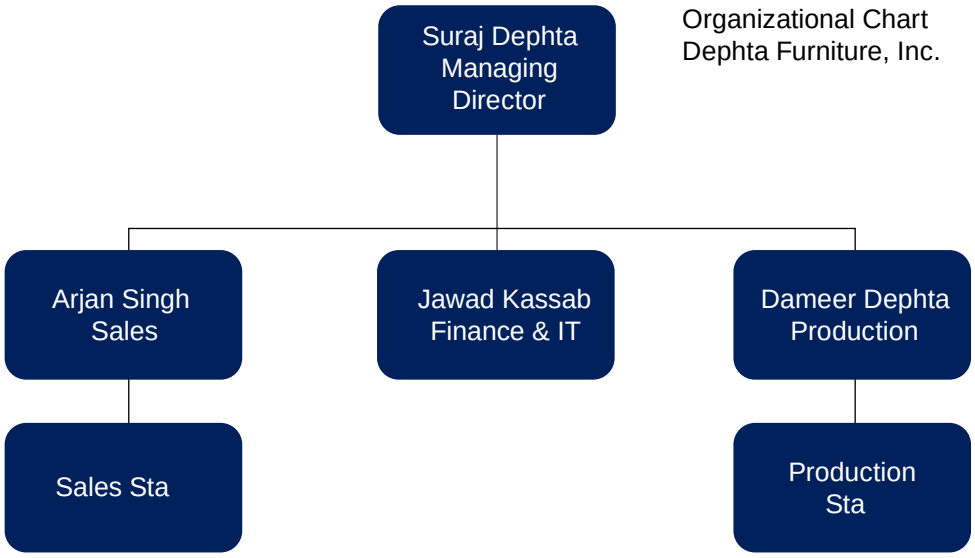
Ravi's daughter, Parvin (a lawyer by training), usually accompanies her father to the meetings with Suraj and Jeewan. Parvin offers some legal advice, but her true passion lies in marketing and promotion. It was Parvin's idea that Dephta Furniture should expand its boundaries and start selling its products on the Internet. She also pushed for expansion outside their local region and even to neighboring countries. Perhaps by accessing additional markets, sales levels can be maintained despite the current economic downturn.

Personnel

Dephta Furniture, Inc. has a full-time staff of 15 employees. Six of these employees are related in some way to the family. Most of the family members work in the production area (as needed) in addition to the roles outlined in the exhibit below. During busy periods, two to four temporary workers may be employed as necessary. A few of the temporary workers return regularly but, because of the lack of job security, turnover is quite high.

As managing director, Suraj Dephta oversees all aspects of the business. Arjan Singh is in charge of sales and he is assisted by two full-time salespeople. Dameer, Suraj's brother, looks after production, which includes ordering raw materials and managing the inventory. Because the facility's space is limited, Suraj and Dameer are never too far away from the production process, and they share the task of supervising the two staff members.

Jawad Kassab (a cousin of Suraj) is in charge of the finance function and information technology (IT), and has two staff in his group.



Organizational Chart
Dephta Furniture, Inc.

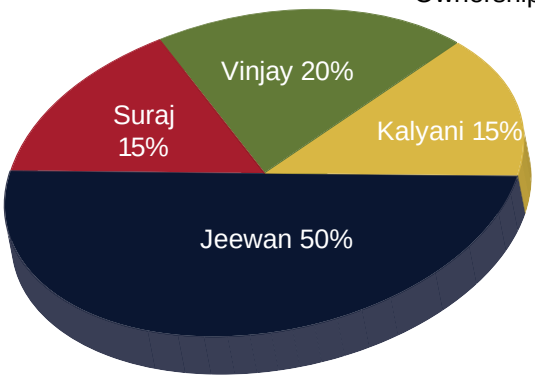
Ownership

Jeewan is the principal shareholder with a 50% interest in the company. He has plans to start transferring the shares to his son, Suraj, as long as Suraj continues to manage the company on a full-time basis and the company remains profitable as a result.

Suraj and his sister, Kalyani, each hold a 15% interest.

The remaining 20% is held by a family friend, Vinjay Sharma. Vinjay is a wealthy investor who has provided much of the capital needed to grow the company.

Ownership of Dephta Furniture, Inc.



Kalyani is a well-known singer who travels extensively. She is not involved in the operations of the company and totally relies on her father and brother to look after her interests.

In June of each period, Jeewan organizes a more formal business meeting. The shareholders meet in the morning (primarily to review the financial statements) and, later in the afternoon, hold a party for all staff. Suraj uses this occasion to tell the staff how well the business is doing and what the plans are for the future.

Operations

The company started out manufacturing chairs, tables, and spindles for railings and banisters, and has since expanded into making simple household furniture such as dressers, wardrobes, and cabinets. Dephta Furniture has grown considerably through strategies such as:

- 1SPWJEJOH RVBMJUZ QSPEVDUT BU GBJS QSJDFT UP MPDBM
- "DDFQUJOH MBSHFS GVSOJUVSF PSEFST GSPN OBUJPOBM SF deadline (there are major penalties for late delivery) and the profit margins are much tighter than those GPS DVTUPN NBEF GVSOJUVSF
- #FJOH UIF öSTU DPNQBOZ JO UIF SFHJPO UP TFMM MJNJUFE
- .BOVGBDUVSJOH QBSUT TVDI BT TQJOEMFT BOE SPVOE UBCM has enabled the company to purchase expensive lathes and specialized tools that other companies cannot afford.

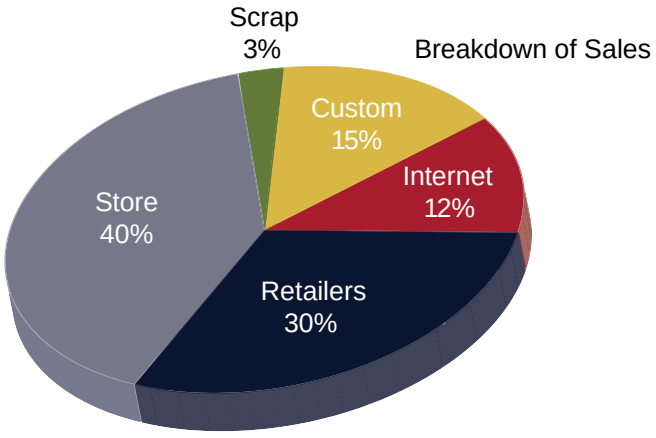
Dephta also sells scrap furniture and wood (pieces rejected in the quality control process) at the factory for cash only.

Exporting furniture to neighboring countries is also being considered. Suraj recognizes that this will mean higher shipping costs, dealing with customs, foreign currency exchange risk, and the potential for damage during transport. Although selling to neighboring countries means higher costs, it seems to be a small price to pay to access potential new customers. Also, Parvin knows many people in local government and thinks she can help to facilitate the extra paperwork involved.

Sales

The sales breakdown is approximately:

- 4UBOEBSE GVSOJUVSF GSPN DBUBMPH GSPN TBMFT UIBU B in person at the store: 40%
- 4BMFT UP GVSOJUVSF SFUBJMFST
- .BEF UP PSEFS DVTUPN CVJMU GVSOJUVSF
- *OUFSOFU TBMFT
- 4DSBQ TBMFT GSPN GBDUPSZ



Arjan Singh is a great dealmaker. He is very persistent when negotiating with customers and usually gets the sale, although the profit margins can be slim. Despite the economic downturn, he recently bought a beautiful family home overlooking the valley.

t /PUFT PO UIF TBMFT TZTUFN

- Sales contracts are prepared for retail and specialized orders. Deposits of 15% of the order are required on all custom orders, which are recorded as sales revenue when received. Two of the large retailers require Dephta to keep 30 days of inventory on hand so that orders can be shipped quickly to the stores when needed. These contracts also have provisions for inventory to be returned to Dephta if it doesn't sell within a specified time period.
- Sales orders are manually filled at the time of sale, except for furniture sold directly from the shop or other small items on hand. All orders over 500€ or where the sale price is below the minimum sale price must be approved by Arjan. Invoices are prepared when the items are shipped and sent to the customer.
- For all sales out of the shop, invoices are prepared at the time of sale and entered into the accounting system, which automatically numbers each sales transaction and provides an order receipt upon request.
- A summary of the day's Internet sales is downloaded from the web site. Details of the items ordered are prepared and given to the production department. An invoice is prepared at the same time and recorded into revenue, as the item has already been paid for on the customer's credit card. The invoice marked "paid in full" accompanies all Internet orders that have been shipped.
- Arjan rarely performs credit checks on customers. He knows most of them. In the past, customers QBJE DBTI VQPO EFMJWFSZ DVSSFOUMZ DSFEJU JT HSBO competitors are providing. As a result, Dephta Furniture requires a line of credit from the bank. Each period, the number of bad debts seems to be growing.
- At the end of each month, Suraj reviews the sales and accounts receivable listing. He ensures that there are no obvious mistakes, and personally calls every customer whose account is over 90 days.
- Each member of the sales staff (including Arjan) receives a commission of 15% on each sale in addition to a minimum base salary. To motivate the salespeople, their base salary is well below the salaries of most of the other employees. The computer system tracks sales made by each salesperson. Jawad prints a report each month and prepares a listing of commissions that will be paid on the following week's payroll. Either Suraj or Dameer reviews the listing of commissions and the sales to ensure that the staff are paid the correct amount. Arjan receives by far the most sales commissions.

Information Technology

The system consists of six PCs and a server used to host the Internet site. The internal system is mainly used for email, order taking, and accounting.

The company runs weekly back-ups of the accounting system on an external hard drive that is kept in the safe next to the computer room. Firewall protection and password protection have all been added in the last two periods. Last period, two PCs were stolen from the office. Access to the offices is now better secured, the PCs are chained to desks, and the server is locked in a separate and specially cooled office.

Internet sales are managed by Jawad. The company has an agreement with the bank to process the credit cards before any order is approved for shipping, and pays the bank 7% on each order processed. The application program for Internet sales provides the details of each sale, including the customer's name, address, and the items ordered. Internet transactions are downloaded daily from the website, and sales orders are prepared and forwarded to the production department.

Human Resources and Payroll

All hiring decisions are made by Dameer and Suraj. Like his father, Suraj is committed to hiring competent people and expects loyalty from his employees.

Employees are paid in cash at the beginning of each week. One of Jawad's staff, Karla Winston, is responsible for payroll. She has a list of employees, and calculates the payroll and deductions based on time-card summaries that Dameer provides to her. Suraj reviews payroll each Monday morning before instructing Karla to hand the envelopes to employees. All employees sign a list when they pick up their envelope. The company does not keep formal employee records.

Purchasing and Production

Dameer is responsible for purchasing and production. Because the inventory system is not very sophisticated, he tends to over-order some items, which often results in inventory sitting in the warehouse gathering dust. This is considered better than under-ordering supplies, which results in production delays.

t /PUFT PO UIF QVSDIBTJOH GVODUJPO

- At least two quotes must be obtained before purchases over 5,000 are approved. The exception is wood supplied by the local lumber mill, where Dephta has negotiated a five-year exclusive supply contract.
- The company prepares purchase orders for all inventory or capital purchases over 1,000 .
- Dameer approves all new vendors and supplies the details to Jawad. Jawad then sets up the vendors in the system and enters details of invoices received.

Accounting and Finance

Jawad studied accounting at university and is well versed in accounting and financial matters. When he joined Dephta two years ago, he quickly introduced the "Sound Accounting" software package by Onion Corp. with its integrated accounts payable, accounts receivable, and capital assets modules.

t /PUFT PO UIF BDDPVOUJOH BOE öOBODF GVODUJPO

- At present, the company does not have a perpetual inventory system. Inventory is counted twice a period, once at period end and once halfway through the period. This ensures that profit margins on sales can be accurately calculated at least twice a period.
- Jawad has been frustrated by the lack of controls over inventory. He had suggested to Suraj that inventory be counted at least four times per period to ensure that margins are reviewed throughout the period. Suraj had overridden his recommendation, stating that it would be too disruptive to count inventory so often and could cause the company to miss deadlines.
- Although Dephta has been profitable, the gross margins have been inconsistent. Jawad does not have an explanation as to why inventory costs are not tracked by product line.
- Suraj gets very annoyed at having to pay any form of income tax, and usually pressures Jawad to ensure that accruals are "more than adequate."

Note: The following income statement and balance sheet were prepared by management. Notes to the financial statements or a cash-flow statement have not been included.

"QQFOEJY "

%FQIUB 'VSOJUVSF *OD
Income Statement
JO $VSSFODZ 6OJUT k

	'PS UIF ZFBS FOEFE %FDFNCFS		
	20X2	20X1	20X0
Sales	1,437,317	1,034,322	857,400
Cost of goods sold	879,933	689,732	528,653
Gross profit	557,384	344,590	328,747
Distribution costs	64,657	41,351	39,450
Administrative expenses	323,283	206,754	197,248
Finance cost	19,471	19,279	15,829
Depreciation	23,499	21,054	10,343
	430,910	288,438	262,870
Profit before tax	126,474	56,152	65,877
Income taxes	31,619	14,038	16,469
Net income	94,855	42,114	49,408

"QQFOEJY #

%FQIUB 'VSOJUVSF *OD
#BMB4DIFFU
JO $VSSFODZ 6OJUT k

	"T BU %FDFNCFS		
	20X2	20X1	20X0
ASSETS			
Current assets			
Cash and cash equivalents	22,246	32,522	22,947
Trade and other receivables	177,203	110,517	82,216
Inventories	156,468	110,806	69,707
Prepayments and other	12,789	10,876	23,877
	368,706	264,721	198,747
Non-current assets			
Property, plant and equipment	195,821	175,450	103,430
	564,527	440,171	302,177
EQUITY AND LIABILITIES			
Current liabilities			
Bank indebtedness	123,016	107,549	55,876
Trade and other payables	113,641	107,188	50,549
Income tax payable	31,618	14,038	16,470
Current portion of interest-bearing loan	10,000	10,000	10,000
	278,275	238,775	132,895
Non-current liabilities			
Interest-bearing loan	70,000	80,000	90,000
Capital and reserves			
Issued capital	18,643	18,643	18,643
Accumulated profits	197,609	102,753	60,639
	564,527	440,171	302,177

$BTF 4UVEZ #‰,VNBS $P

Background

Kumar & Co. was started in 1990 by Rajesh (Raj) Kumar. It is an incorporated company, but consists of only two production personnel, Rajesh as the owner-manager, and some part-time bookkeeping assistance.

As a young boy, Raj learned the woodcrafting trade from his father, Sanjay. When Sanjay first took young Raj under his wing, he saw that Raj also had a natural talent for woodworking, and that made him proud.

After his father died in 1976, Raj decided to invest his small savings in opening his own furniture shop, which he called Kumar & Co.

Business Proposition

Raj's business was initially focused on producing small wooden household furniture. However, soon after starting the business, his cousin Suraj (of Dephta Furniture) approached him with a business proposition. Suraj asked that Raj dedicate most of his time and attention to creating spindles and table legs for furniture the Dephta factory produced. The price Dephta was willing to pay for his products allowed him a greater profit margin than he could get with any of his other handiwork. Raj agreed.

To encourage Raj to focus his business on serving Dephta's supply needs, Dephta purchased a 15% ownership stake in Kumar. This helped Kumar purchase new lathes and tools to improve production efficiency.

Industry Trends

The furniture industry is currently facing a challenging economy. Kumar & Co. has experienced healthy and steady growth, but if the demand for products from Dephta declines, Kumar's sales will also be hurt. Raj still takes some custom furniture orders, but Dephta constitutes approximately 90% of his business.

Production

Kumar & Co. is an owner-managed company, with Raj owning 85% of the shares. There are two full-time production personnel in addition to Raj. He is used to long workdays, and works most weekends, simply to keep up with the orders from Dephta.

In the current period, though, Raj is rarely in the office or workshop. He does the minimum required to meet demands, but has not been nearly as involved in approving orders, supply purchases, or record-keeping as he once was. Apparently he is dealing with some issues at home.

At the beginning of the period, Kumar obtained new bank financing to buy necessary raw materials and to replace some aging equipment. The loan came with bank covenants that must be maintained or the funds could be recalled.

Raj deals directly with Dephta personnel on orders and logs them in a notebook. The accountant then creates invoices and receives payments. He personally organizes shipping and maintains an order/shipping log.

Raj maintains good records and keeps the following information updated:

t 0SEFS TIJQQJOH MPH EBUF PSEFS XBT QMBDFE BNPVOU UZ
RVBOUJUZ TPME TIJQQFE EBUF TIJQQFE BOE JG QBJE

t 4BMFT MPH DVTUPNFS OBNF EBUF TIJQQFE PSEFS EFUBJM

SFRVFTUT FUD QSJDF BNPVOU QBJE BOE

t 1VSDIBTFT MPH TFHSFHBUFE CFUXFFO NBUFSJBMT BOE PUI

Raj matches the shipping log to the sales log each week to ensure that no shipments are missed.

Accounting

Kumar & Co.'s part-time bookkeeper, Ruby, has been working with Raj for over 10 years and is very competent. She maintains the accounting records and creates the monthly and annual financial statements. However, she feels that Raj takes her services for granted. He has not increased her salary in the last three years. Ruby has two children whom she wants to go to college, but is worried about how the tuition will be paid.

"QQFOEJY "

,VNBS $P

*ODPNF 4UBUFNFOU‰1SFQBSFE CZ .BOBHFNFOU

'PS UIF ZFBS FOEFE %FDFNCFS

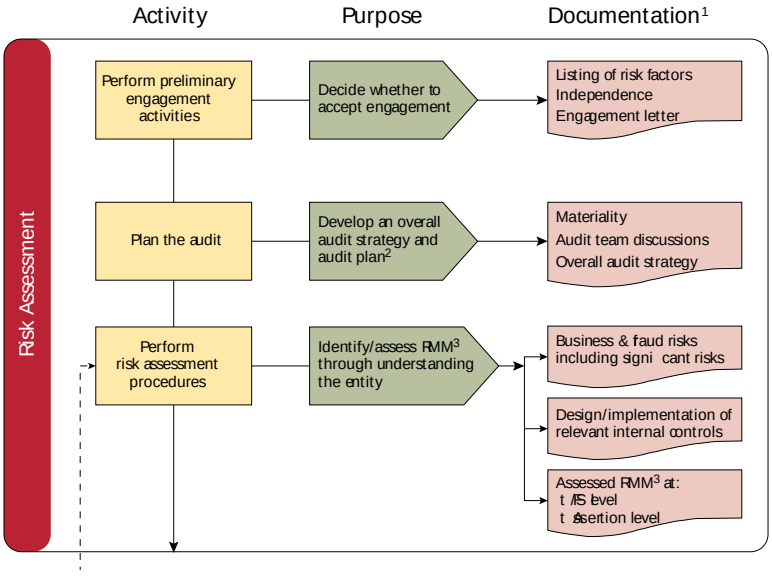
	20X2	20X1	20X0
Sales	231,540	263,430	212,818
Cost of goods sold	118,600	122,732	100,220
Gross profit	112,940	140,698	112,598
Distribution costs	13,002	19,450	12,890
Administrative expenses	71,532	91,318	68,101
Finance cost	6,480	0	0
Depreciation	11,541	6,871	5,020
	102,555	117,639	86,011
Profit before tax	10,385	23,059	26,587
Income taxes	5,765	6,420	8,988
Net income	4,620	16,639	17,599

"QQFOEJY #

,VNBS $P

#BMBODF 4IFFU‰1SFQBSFE CZ .BOBHFNFOU

	"T BU %FDFNCFS		
	20X2	20X1	20X0
ASSETS			
Current assets			
Cash and cash equivalents	1,255	10,822	6,455
Trade and other receivables	67,750	65,110	34,100
Inventories	34,613	15,445	12,607
	103,618	91,377	53,162
Property, plant and equipment	54,430	22,468	20,216
	158,048	113,845	73,378
EQUITY AND LIABILITIES			
Current liabilities			
Trade and other payables	53,100	48,820	36,500
Current portion of interest-bearing loan	4,000	0	0
	57,100	48,820	36,500
Non-current liabilities			
Interest-bearing loan	31,000	0	0
Capital and reserves			
Issued capital	10,580	10,580	10,580
Accumulated profits	59,368	54,445	26,298
	158,048	113,845	73,378



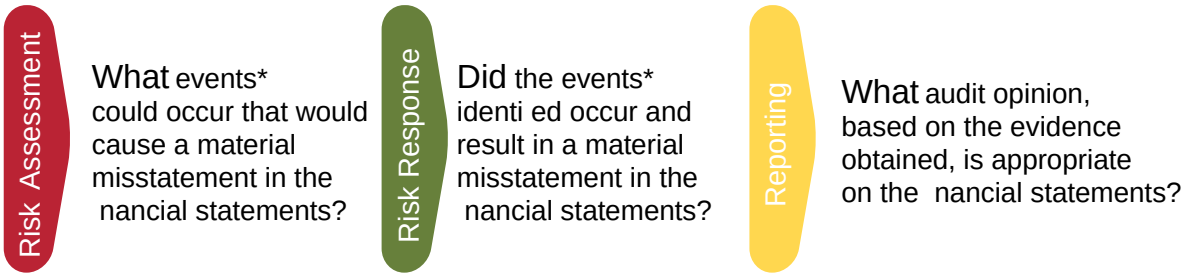
Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

For the purposes of this Guide the audit approach has been divided into three distinct phases—risk assessment, risk response, and reporting. The exhibit on the previous page summarizes the major activities involved in the risk assessment phase, along with their purpose and the resulting documentation. Additional information on each of these activities is outlined in the following chapters.

Paragraph #	* 4 " 0 C K F D U J W F T
315.3	The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

A simpler way of describing the three elements is illustrated below.

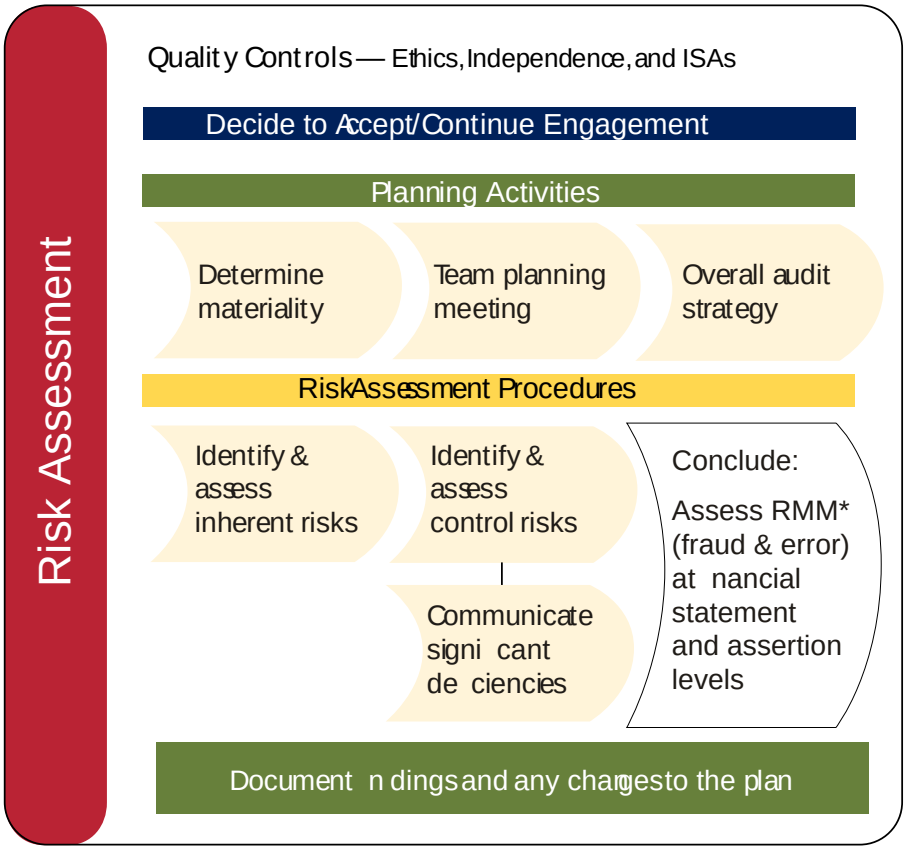
Exhibit 3.0-1



* An "event" is simply a business or fraud risk factor (see descriptions in Volume 1, Chapter 4, Exhibit 4.2-2) including those risk factors resulting from the absence of internal control to mitigate the potential for material misstatements in the financial statements.

The major steps involved in the risk assessment phase of the audit, in the order they would normally be performed, are outlined in the following exhibit.

Exhibit 3.0-2

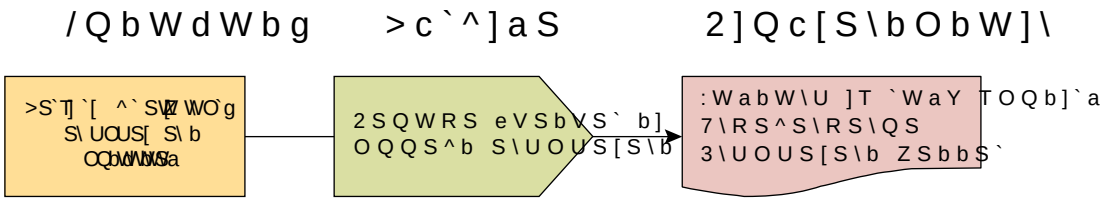


The core concepts that are addressed in the risk assessment phase are set out below.

Core Concepts Risk Assessment Phase	Volume and Chapters
Internal Control	V1 - 5
Financial Statement Assertions	V1 - 6
Materiality and Audit Risk	V1 - 7
Risk Assessment Procedures	V1 - 8

Chapter Content	Relevant ISAs/ISQC 1
Guidance on procedures required to: t Identify and assess risk factors relevant to deciding whether to B D D F Q U P S E F D M J O F U I F B V E J U F O H B H F N F O U B O E t Agree upon and document the terms of the engagement.	210, 220, 300 and ISQC 1

Exhibit 4.0-1



The major steps in the engagement acceptance/continuance process are outlined below.

Exhibit 4.0-2

Process to accept/continue with an audit engagement

1 For further information, refer to Volume 2, Chapter 4.3.

Paragraph #	*4" 0CKFDUJWF T
210.3	The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through: B &TUBCMJTIJOH XIFUIFS UIF QSFDPOEJUJPOT GPS BO BV (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T *42$
ISQC 1.26	The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm: (a) Is competent to perform the engagement and has the capabilities, including time and SFTPVSDFT UP EP TP 3FG 1BSB " " C $BO DPNQMZ XJUI SFMFWBOU FUIJDBM SFRVJSFNFOUT (c) Has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity. (Ref: Para. A19-A20, A23)
ISQC 1.27	Such policies and procedures shall require: (a) The firm to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. (Ref: Para. A21, A23) (b) If a potential conflict of interest is identified in accepting an engagement from a new or an existing client, the firm to determine whether it is appropriate to accept the engagement. (c) If issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, the firm to document how the issues were resolved.
ISQC 1.28	The firm shall establish policies and procedures on continuing an engagement and the client relationship, addressing the circumstances where the firm obtains information that would have caused it to decline the engagement had that information been available earlier. Such policies and procedures shall include consideration of: (a) The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made UIF BQQPJOUNFOU PS JO TPNF DBTFT UP SFHVMBUPSZ E (b) The possibility of withdrawing from the engagement or from both the engagement and the client relationship. (Ref: Para. A22-A23)
210.4	For purposes of the ISAs, the following term has the meaning attributed below: Preconditions for an audit %The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.
220.12	The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate. (Ref: Para. A8-A9)

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T *42$
220.13	If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A9)
300.13	The auditor shall undertake the following activities prior to starting an initial audit: (a) Performing procedures required by ISA 220 regarding the acceptance of the client SFMBUJPOTIJQ BOE UIF TQFDJöD BVEJU FOHBHFNFOU BO (b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A20)

4.1 Overview

One of the most important decisions that a firm can make is determining what engagements to accept or which client relationships to retain. A poor decision can lead to unbillable time, unpaid fees, additional stress on partners and staff, loss of reputation, and, worst of all, potential lawsuits.

ISQC 1 and ISA 220 require firms to develop, implement, and document their quality control procedures in regard to their client acceptance and retention policies. Ideally, these policies and procedures should address the level of risk (risk tolerance) and the client characteristics (such as poor management integrity, a high-risk industry, or a publicly-traded company) that would not be acceptable to the firm.

Before a firm decides to accept or retain an engagement, the auditor is required to:

- &TUBCMJTI UIF BDDFQUBCJMJUZ PG UIF QSPQPTFE öOBODJBI
- "TTFTT XIFUIFS UIF öSN DBO DPNQMZ XJUI SFMFWBOU FUIJD
- 0CUBJO UIF BHSFFNFOU PG NBOBHFNFOU UIBU JU BDLOPXMF
  - The preparation of the financial statements in accordance with the applicable financial reporting framework,
  - Such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and
  - To provide the auditor with access to all relevant information and any additional information that the auditor may request, plus unrestricted access to persons within the entity from whom the BVEJUPS EFUFSNJOFT JU OFDFTTBSZ UP PCUBJO BVEJU FW
- 1FSGPSN FOHBHFNFOU BDDFQUBODF PS DPOUJOVBODF QSPD

  risk assessment procedures outlined in Volume 1, Chapter 8. The results (assuming the engagement is accepted) can later be used as part of the risk assessment.

The initial and subsequent years' assessments of the engagement risk help to ensure that the firm is:

- *OEFQFOEFOU BOE UIBU OP DPOøJDUT PG JOUFSFTU FYJTU
- $PNQFUFOU UP QFSGPSN UIF XPSL XJUI UIF SFRVJSFE SFTPV
- 8JMMJOH UP BDDFQU UIF SJTLT JOWPMWFE JO QFSGPSNJOH management's integrity and attitudes toward internal control, industry trends, availability of appropriate BVEJU FWJEFODF BOE PUIFS GBDUPST TVDI BT UIF BCJMJUZ
- /PU BXBSF PG BOZ OFX JOGPSNBUJPO BCPVU BO FYJTUJOH D the engagement if it had been known earlier.

$0 / 4 * % &03* /15

There may be some very small entities requiring an audit where the owner-manager runs the entity, has few (if any) formal documented controls in place, and can therefore override just about everything. In these situations, the auditor has to determine whether the absence of control activities or of other components of control may make it impossible to obtain sufficient appropriate audit evidence. If this is the case, the auditor would exercise professional judgment in determining whether the engagement should be declined or a modified opinion provided.

Factors to consider include:

- 5IF FOUJUZ T DPOUSPM FOWJSPONFOU 'PS FYBNQMF JT U does he/she have a good attitude toward internal control?
- *T JU QPTTJCMF UP EFWFMPQ BO PWFSBMM SFTQPOTF BOE appropriately to the assessed risk factors? For example, can substantive procedures be used to determine that all revenues and liabilities are properly recorded in the accounting records?

4.2 Engagement Acceptance

The first step in the client acceptance or continuance process is to assess the auditing firm's ability to perform the engagement, and the risks involved. The following exhibit outlines some possible lines of inquiry.

Exhibit 4.2-1

Consider	Line of Inquiry
5IF 'JSN T Quality Control Requirements	What policies and procedures are in place to provide reasonable assurance that the firm will only undertake or continue relationships where: - 5IF öSN DBO DPNQMZ XJUI UIF *4" SFRVJSFNFOU - 5IF FOHBHFNFOU SJTLT JOWPMWFE BSF XJUIJO
What Work Is Required?	- 8IBU JT UIF OBUVSF BOE TDPQF PG UIF BVEJU - 8IBU BDDPVOUJOH GSBNFXPSL XJMM CF VTFE -)PX XJMM UIF BVEJUPS T SFQPSU BOE öOBODJB - 8IBU JT UIF EFBEMJOF JG BOZ GPS DPNQMFUJ

Consider	Line of Inquiry
%PFT UIF 'JSN Have the $PNQFUFODF 3FTPVSDFT BOE 5JNF 3FRVJSFE	t %PFT UIF öSN IBWF TVóDJFOU QFSTPOOFM XJUI capabilities? t %P UIF TFMFDUFE öSN QFSTPOOFM IBWF – Knowledge of relevant industries or subject matters, – Experience with relevant regulatory or reporting requirements, or – Ability to gain the necessary skills and knowledge effectively? t "SF FYQFSUT BWBJMBCMF JG OFFEFE t 8IFSF BQQMJDBCMF BSF UIFSF RVBMJöFE QFST engagement quality control review? t $BO UIF öSN BOE UIF BWBJMBCMF TUBò JO MJH clients) complete the engagement within the reporting deadline?
*T UIF 'JSN Independent?	t $BO UIF öSN BOE UIF FOHBHFNFOU UFBN DPNQM requirements? t 8IFSF DPOøJDUT PG JOUFSFTU MBDL PG JOEFQ identified: – Has appropriate action been taken to eliminate those threats or reduce them to an acceptable level by applying safeguards, or – Have steps been taken to withdraw from the engagement? t *G UIF FOUJUZ CFJOH BVEJUFE JT B DPNQPOFO engagement team may request certain work to be performed on the financial information of the component. In such cases, the group engagement would first obtain an understanding of the following: – Whether the component auditor understands and will comply with the ethical (including independence) requirements that are relevant to the group audit, – The component auditor's professional competence, – Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence, and – Whether the component auditor operates in a regulatory environment that actively oversees auditors.

Consider	Line of Inquiry
Are the Risks Involved Acceptable?	t '(PS OFX FOHBHFNFOUT IBT UIF öSN DPNNVOJDB with the predecessor auditor to determine if there are any reasons for not accepting the engagement? t)BT UIF öSN DPOEVDUFE BO *OUFSOFU TFBSDI B personnel and other third parties (such as bankers) to identify any reasons why the firm should not accept the engagement? t 8IBU BSF UIF WBMVFT iUPOF BU UIF UPQw BOE t)PX DPNQFUFOU BSF UIF FOUJUZ T TFOJPS NBO t "SF UIFSF EJóDVMU PS UJNF DPOTVNJOH JTTVFT estimates, compliance with legislation, etc.)? t 8IBU DIBOHFT IBWF UBLFO QMBDF UIJT QFSJPE (business trends and initiatives, personnel changes, financial reporting, IT systems, purchase/sale of assets, regulations, etc.)? t *T UIFSF B IJHI MFWFM PG QVCMJD TDSVUJOZ B t *T UIF FOUJUZ JO HPPE öOBODJBM IFBMUI BOE professional fees? t 8JMM UIF FOUJUZ QSPWJEF IFMQ UP UIF öSN JO schedules, analysis of balances, providing data files, etc.?
$BO UIF $MJFOU"#E 5SVTUFE	t 5F UIFSF BOZ TDPQF MJNJUBUJPOT TVDI BT VC obtain the required audit evidence? t *T UIFSF BOZ SFBTPO PS SFDFOU FWFOU UIBU principal owners, senior management, and those charged with governance of the entity? Consider the entity's operations, including business practices, the business' reputation, and history of any ethical or regulatory infringements. t "SF UIFSF BOZ JOEJDBUJPOT UIBU UIF FOUJUZ N or other criminal activities? t 8IBU JT UIF JEFOUJUZ BOE CVTJOFTT SFQVUBUJ t %PFT NBOBHFNFOU IBWF B QPPS BUUJUVEF UPX aggressive attitude toward interpretation of accounting standards? Consider corporate culture, organizational structure, risk tolerance, complexity of transactions, etc.

Background Checks

To ensure that the information obtained from the entity is accurate, consider what third-party information could be obtained to validate key aspects of the risk assessment. This simple step could avert problems later on. Examples include information from sources such as previous financial statements, income tax returns, credit reports, and possibly (after receiving permission from the prospective client) discussions with key advisors such as bankers, etc.

$0 / 4 * % &03* /15

Before contacting third parties and collecting information on a prospective client, take steps to ensure that all partners and staff are aware of:

- 5IF öSN T QPMJDJFT UP QSPUFDU DPOöEFOUJBM JOGPSNBU
- 3FRVJSFNFOUT PG BOZ QSJWBDZ MFHJTMBUJPO BOE
- 3FRVJSFNFOUT PG UIF BQQMJDBCMF DPEF PG FUIJDT

Once a decision has been reached to accept or continue with the client engagement, the next step is to:

- &TUBCMJTI XIFUIFS UIF QSFDPOEJUJPOT GPS BO BVEJU BSF
- $POöSN B DPNNPO VOEFSTUBOEJOH CFUXFFO UIF BVEJUPS B those charged with governance) of the terms of the audit engagement.

4.3 Pre-Conditions for an Audit

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
210.6	In order to establish whether the preconditions for an audit are present, the auditor shall: (a) Determine whether the financial reporting framework to be applied in the preparation of UIF öOBODJBM TUBUFNFOUT JT BDDFQUBCMF BOE 3FG 1 (b) Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para A11-A14, A20) (i) For the preparation of the financial statements in accordance with the applicable öOBODJBM SFQPSUJOH GSBNFXPSL JODMVEJOH XIFSF Para. A15) (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether EVF UP GSBVE PS FSSPS BOE 3FG 1BSB " " (iii) To provide the auditor with: a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other NBUUFST b. Additional information that the auditor may request from management for the QVSQPTF PG UIF BVEJU BOE c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Exhibit 4.3-1

Consider	Line of Inquiry
Are the Audit Preconditions Present?	Is the financial reporting framework (such as IFRS or a local framework) to be used in preparing the financial statements acceptable? Factors to consider include: t 5IF OBUVSF PG UIF FOUJUZ CVTJOFTT QVCMJD t 5IF QVSQPTF PG UIF öOBODJBM TUBUFNFOUT D t 5IF OBUVSF PG UIF öOBODJBM TUBUFNFOUT DP TJOHMF öOBODJBM TUBUFNFOU BOE t 8IFUIFS MBX PS SFHVMBUJPO QSFTDSJCFT UIF BQ Does management agree to and acknowledge/understand its responsibility for: t 1SFQBSJOH UIF öOBODJBM TUBUFNFOUT JO BDD SFQPSUJOH GSBNFXPSL JODMVEJOH XIFSF SFM t 4VDI JOUFSOBM DPOUSPM BT NBOBHFNFOU EFUR preparation of financial statements that are free from material misstatement, XIFUIFS EVF UP GSBVE PS FSSPS BOE t 1SPWJEJOH UIF BVEJUPS XJUI – Access to all relevant information such as records, documentation, and other matters, – Additional information requested from management for the purpose of the audit (such as written representations), and – Unrestricted access to persons within the entity to obtain the necessary audit evidence?
* TIFSF B 4DPQF Limitation?	Has management or those charged with governance imposed any type of limitation on the scope of the audit? This could include unrealistic deadlines, not accepting certain firm's staff to perform the work, and denial of access to a facility, key personnel, or relevant documents. If such a limitation would result in a disclaimer of opinion, the firm would decline the engagement, unless the firm is required by law or regulation to proceed with the engagement.

Where management does not agree to and acknowledge its responsibilities as set out in ISA 210.6(b) above, or the financial reporting framework is not acceptable, the auditor is required by ISA 210.8 to decline the engagement unless required by law or regulation.

4.4 Agreeing the Terms of Engagement

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
210.7	If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.
210.9	The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: Para. A21)

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
210.10	Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include: (Ref: Para. A22-A25) B 5IF PCKFDUJWF BOE TDPQF PG UIF BVEJU PG UIF öOBOD C 5IF SFTQPOTJCJMJUJFT PG UIF BVEJUPS D 5IF SFTQPOTJCJMJUJFT PG NBOBHFNFOU (d) Identification of the applicable financial reporting framework for the preparation of the öOBODJBM TUBUFNFOUT BOE (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.
210.11	If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (Ref: Para. A22, A26-A27)
210.12	If law or regulation prescribes responsibilities of management similar to those described in paragraph 6(b), the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in that paragraph. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the written agreement. For those responsibilities that are not prescribed by law or regulation such that their effect is equivalent, the written agreement shall use the description in paragraph 6(b). (Ref: Para. A26)
210.13	On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (Ref: Para. A28)
210.14	The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. (Ref: Para. A29-A31)
210.15	If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so. (Ref: Para. A32-A33)
210.16	If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.
210.17	If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall: (a) Withdraw from the audit engagement where withdrawal is possible under applicable law PS SFHVMBUJPO BOE (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators

Note: Paragraphs 18-22 of ISA 210 contain some additional considerations in engagement acceptance, such as where financial reporting standards are supplemented by law or regulation and where the financial reporting framework is prescribed by law or regulation.

To ensure a clear understanding between management and the auditor on the terms of engagement, an engagement letter (or other suitable form of written agreement) is prepared and agreed upon with the appropriate

representative of senior management. To avoid any potential for misunderstanding, the engagement letter would be finalized and signed before the engagement work commences.

Even in countries where the audit objective, scope, and obligations are established by law, an engagement letter may still be useful to inform clients about their specific roles and responsibilities.

A sample of an engagement letter based on the example contained in ISA 210 is provided in the case study materials that follow.

The engagement letter would address the matters set out below.

Exhibit 4.4-1

5F S N T	Description
5 I F 0 C K F D U J W F Accounting ' S B N F X P S L 4 D P Q F B O E ' P S N P G "V E J U P S Report Resulting from the Audit P G U I F ' J O B O D J B M Statements	t W F 5 I F B D D P V O U J O H G S B N F X P S L U P C F V T F E t 0 C K F D U J W F P G U I F B V E J U P G öO B O D J B M T U B U F auditor's report or other communication. Also, the circumstances in which a report may differ from its expected form and content. t T 5 I F T D P Q F P G U I F B V E J U J O D M V E J O H S F G F S F O D ISAs, and ethical and other pronouncements of professional bodies to which the auditor adheres. t 0 U I F S Q B S U J F T U P X I P N B S F Q P S U J S F R V J S F E
5 I F Responsibilities of the Auditor	t 5P D O E V D U U I F B V E J U J O B D D P S E B O D F X J U I * C (ISAs). t 3 F D P H O J U J P O U I B U E V F U P U I F J O I F S F O U M J N J limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.
5 I F Responsibilities P G .B O B H F N F O U	t 'P S U I F Q S F Q B S B U J O P G U I F öO B O D J B M T U B U F applicable financial framework, and for designing and implementing such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. t "D D F Q U U I F U F S N T P G U I F F O H B H F N F O U B S P V U t 1 S P W J E F V O S F T U S J D U E E B D D F T T U P B O Z S E D P S information requested in connection with the audit. t 1 S P W J E F V O S F T U S J D U E E B D D F T T U P Q F S T P O T X t $P O öS N B V E J U P S T F Y Q F D U B U J O P G S E C F J W J O management concerning representations made in connection with the audit. t "H S E F F N F O U P G N B O B H F N F O U U P J O G P S N U I F B V I financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.

Other matters that could be included in the engagement letter are outlined below.

Exhibit 4.4-2

5F S N T	Description
) P X U I F "8 V J E M I Ne # F $ P O E V D U F E Any Dispute 3 F T P M V U J P O 0 C M J H B U J P O T U F ' F F "S S B O H F M E O U T	Address arrangements regarding: t 5 I F Q M B O O J O H B O E Q F S G P S N B O D F P G U I F B V E J U the audit team and details of what (if any) draft financial statements or other working papers are to be prepared by the client, along with the dates on which B O E B V E J U P S S F R V J S F T U I F T F t N F O U T t * O W P M W F N F O U P G P U I F S B V E J U P S T B O E F Y Q F S U t * O W P M W F N F O U P G U I F Q S F E F D F T T P S B V E J U P S C B M B N C E T t 0 U I F S N B U U F S T – Any restrictions of the auditor's liability where such possibility exists, – The basis on which fees are computed and any billing arrangements, – Any obligations by the firm to provide audit working papers to other parties, and – Reference to any further agreements between the auditor and the client, or other letters or reports the auditor expects to issue to the client. Client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.

Updating the Engagement Letter

When no changes have occurred, the auditor is required to assess whether there is a need to remind the entity of the existing terms of the audit engagement. The terms of engagement may be reconfirmed at the time of the auditor's reappointment without the need to obtain a new letter each year.

The engagement letter is required to be revised when the circumstances change. Matters that may constitute a change in circumstance include:

t "O Z S F W J T F E P S T P F D J B M U F S N T P G U I F F O H B H F N F O U
t " S F D F O U D I B O H F J O T F O J P S N B O B H F N F O U
t " T J H O J ö D B O U D I B O H F J O P X O F S T I J Q
t " T J H O J ö D B O U D I B O H F J O U I F O B U V S F P S T J [F P G U I F F O U J U
t " D I B O H F J O M F H B M P S S F H V M B U P S Z S F R V J S F N F O U S
t " D I B O H F J O U I F ö O B O D J B M S F Q P S U J O H G S B N F X P S L B E P Q U F
t " D I B O H F J O P U I F S S F Q P S U J O H S F R V J S F N F O U S B O E
t 4 P N F J O E J D B U J P O U I B U N B O B H F N F O U N J T V O E F S T U B O E T U I F

A Change in the Terms of the Audit Engagement

If management requests changes to the terms of the audit engagement, the auditor would consider whether there is reasonable justification for the request, and the implications for the scope of the audit engagement. A reasonable justification could include a change in the client's circumstances or a misunderstanding of the nature of the original service requested.

A change would not be reasonable if it is motivated by issues raised during the audit. This could include audit information that does not support management representations, an inability to obtain certain audit information (which would effectively limit the scope of the audit), or evidence that is otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding inventory balances, and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

If the change in terms is reasonable, a revised engagement letter or other suitable form of written agreement would be obtained. If, however, the auditor is unable to agree to the proposed change in terms and is not permitted by management to continue the original audit engagement, the auditor is required to:

- 8JUIESBX GSPN UIF BVEJU FOHBHFNFOU XIFSF QPTTJCMF VO
- %FUFSNJOF XIFUIFS UIFSF JT BOZ PCMJHBUJPO FJUIFS DPO
  to other parties, such as those charged with governance, owners, or regulators.

4.5 Case Studies—Client Acceptance and Continuance

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Note: In general, a more structured approach (such as checklists etc) has been used for documenting the audit evidence for Dephta Furniture and a less structured approach (use of memoranda etc) for Kumar. This is simply to illustrate alternative means of documentation. It would not preclude memoranda from being used in the audit of Dephta or checklists being used in the audit of Kumar. The choice of how to document compliance with the ISAs is a matter of professional judgment that should ideally be discussed during audit planning.

Assuming that this is an ongoing audit engagement, the partner or senior manager in the audit firm would make some inquiries to identify and assess any new or revised risk factors relevant to deciding to continue with the audit engagement. Include inquiries such as the following:

$BTF 4UVEZ "‰%FQIUB 'VSOJUVSF *OD

Client Acceptance and Continuance

A questionnaire such as the following could be used.

t) B W F U I F B V E J U Q S F D P O E J U I P O T m a n c i a l S t a t e m e n t s will be prepared by management using IFRS. The engagement letter has been signed, and management have acknowledged their responsibility to: t . B L F B W B J M B C M F B M M J O G P S M A T I O N t 1 S P W J E F V O M J N J U F E B D D F T S t % F T J H O B O E J N Q M F N F O U T V D I J C management determines is necessary to enable the preparation of nancial statements that are free from material misstatement, whether due to fraud or error.
t) B W F U I F B D D F Q U B O D F D P O T J E F S F E Y e s . R e f e r t o p o l i c i e s F X a n d S F in our QC manual. in the firm's quality control manual been followed?
t "O Z D I B O H F J O U I F U F S M T P G S F G F S E N O requirements for the audit engagement?
t "O Z J O E F Q F O E F O D F J T T V F T O P I y matter noted was that one of our staff bought a lot Consider: family/personal relationships with key client people, non-audit services such as accounting, financial interests, and other business relationships. of bedroom furniture from Dephta; he paid the catalog price. This incident is not considered a threat to our independence.
t "O Z D J S D V M S T U B O D F T U I B U X P V M E D B U U F S E B V H I T E a d v i s o r) received some negative publicity in July. She was the integrity of the client's owners? Consider convictions, regulatory proceedings/sanctions, suspicion or confirmation of illegal acts or fraud, police investigations, and any negative publicity. an advisor in a land deal where government o cials were accused of receiving bribes from developers. This matter has also been noted on our listing of risk factors for the audit.
t "S F U I F S F B S F B T X I F S F T Q F D J B M I S review controls over the Internet sales. necessary?
t % P F T U I F ö S N I B W F U I F D B Q B C I M competencies, and resources to complete the engagement in accordance with professional and firm standards?
t "S F U I F S F B O Z J T T V F S J E E N T I S and other engagements for this entity that need to be addressed? decision to accept sales over the Internet.
t "S F U I F S F B O Z O F X D J S D V M S T U B O D F T U I B U X P V M E I N C R E A S E our engagement risk? control.
t $B O U I F D M J F O U D P O U J O V F Y E S P Q B Z P V S G F F T

Conclusion

Overall assessment of engagement risk = Low

We should continue with this client.

Sang Jun Lee

The terms of engagement would be included in a letter such as outlined below.

Jamel, Woodwind & Wing LLP
55 Kingston St., Cabetown, United Territories 123-53004

October 15, 20X2

Mr. Suraj Dephta, Managing Director
Dephta Furniture, Inc.
2255 West Street
North Cabetown
United Territories
123-50214

Dear Mr. Dephta:

You have requested that we audit the financial statements of Dephta Furniture, which comprise the balance sheet as at December 31, 20X2, and the income statement, statement of changes in equity and cash-flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

0 V S 3 F T Q P O T J C J M J U J F T

We will conduct our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

Unless unanticipated difficulties are encountered, our report will be substantially in the following form:

[Form and content of the auditor's report not has not been reproduced.]

The form and content of our report may need to be amended in the light of our audit findings.

. B O B H F N F O U T 3 F T Q P O T J C J M J U Z

Our audit will be conducted on the basis that management and those charged with governance acknowledge and understand that they have responsibility:

(a) For the preparation and fair presentation of the financial statements in accordance with International ' J O B O 3D F JQBMS4UJBOEE B S E T

(b) For such internal control as management determines is necessary to enable the preparation of ö O B O D J B M T U B U F N F O U T U I B U B S F G S F F G S P N N B U F S J B M N J T

(c) To provide us with:

(i) Access to all information of which you are aware that is relevant to the preparation of the ö O B O D J B M T U B U F N F O U T T V D I B T S F D P S E T E P D V N F O U B U J J J " E E J U J P O B M J O G P S N B U J P O U I B U X F N B Z S F R V F T U G S P

(iii) Unrestricted access to persons within the company from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from management and, where appropriate, those charged with governance written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation from your staff during our audit.

' F F T

Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

This letter will be effective for future periods unless it is terminated, amended, or superseded.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements.

Yours truly,

_____

Sang Jun Lee
Jamel, Woodwind & Wing, LLP

Acknowledged on behalf of Dephta Furniture, Inc. by

_____

Suraj Dephta
Managing Director
November 1, 20X2

Client Acceptance and Continuance

Assuming that this is an ongoing audit engagement, the inquiries to identify and assess any new or revised risk factors could be documented in a memo as follows.

$MJFOU $PONJOVBODF .FNP ‰ ,VNBS $P

October 15, 20X2

We spoke to the client, Raj Kumar, on September 15, 20X2 to determine whether we should accept this engagement.

Matters arising:

- Raj requires an audit opinion on the financial statements of Kumar & Co. using IFRS.
- We considered all possible threats to our independence (as contained in section 290 of the IESBA Code) and did not identify any.
- Nothing new happened that might raise concerns over the integrity of the owner.
- Operations are similar to the previous period, although Raj's absence from day-to-day operations does create more opportunity for fraud to be committed. We should consider expanding our substantive procedures this year to address the potential fraud risks.
- No additional specialists are necessary, and the same people as last period can perform the audit.

Two possible concerns this period:

- The company has experienced a drop in demand for products from its major customer, Dephta.
- Raj has diverted much of his focus to personal family matters. During our audit, we should ensure that books and records have been kept up to date and that no undetected errors occurred. This could also create a fraud risk.

Overall assessment of engagement risk = Moderate

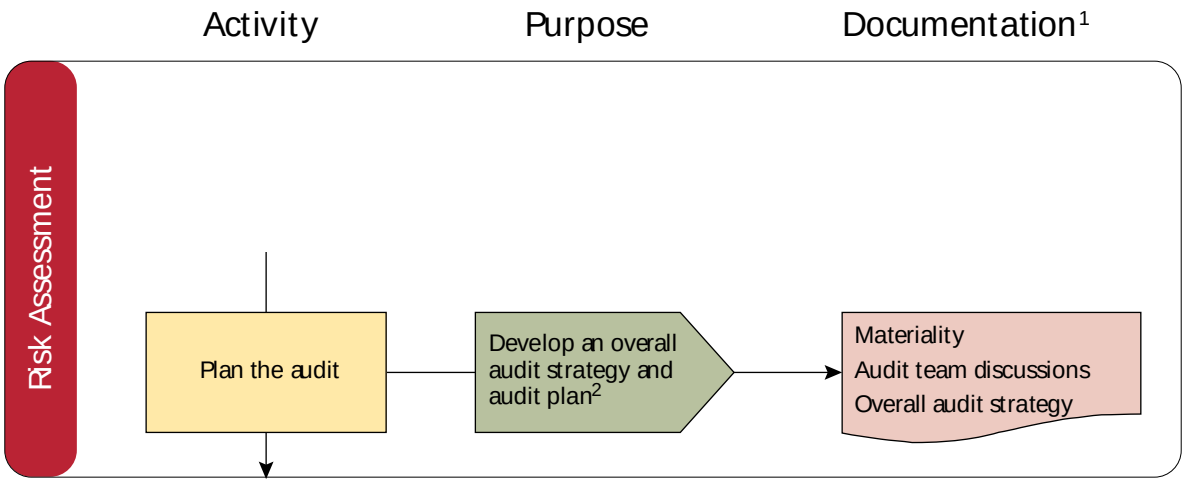
We will accept this engagement for the current period.

Sang Jun Lee

The terms of engagement would be included in a letter that would be very similar to the example previously provided in Case Study A: Dephta Furniture, Inc.

Chapter Content	Relevant ISA
Outline of steps involved in developing an overall plan and strategy for the audit.	300

Exhibit 5.0-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.

Paragraph #	* 4 " 0 C K F D U J W F T
300.4	The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
200.15	The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.
300.5	The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (Ref: Para. A4)
300.7	The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
300.8	In establishing the overall audit strategy, the auditor shall: B *EFOUJGZ UIF DIBSBDUFSJTUJDT PG UIF FOHBHFNFOU U (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and UIF OBUVSF PG UIF DPNNVOJDBUJPOT SFRVJSFE (c) Consider the factors that, in the auditor's professional judgment, are significant in EJSFDUJOH UIF FOHBHFNFOU UFBN T FòPSUT (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the FOUJUZ JT SFMFWBOU BOE (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement. (Ref: Para. A8-A11)
300.9	The auditor shall develop an audit plan that shall include a description of: (a) The nature, timing and extent of planned risk assessment procedures, as determined under ISA 315. (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA 330. (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs. (Ref: Para. A12)
300.10	The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A13)
300.11	The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A14-A15)

5.1 Overview

Planning is important to ensure that the engagement is performed in an efficient and effective manner and that audit risk has been reduced to an acceptably low level.

Audit planning is not a discrete phase of the audit. It is a continual and iterative process that starts shortly after completion of the previous audit, and continues until the completion of the current audit.

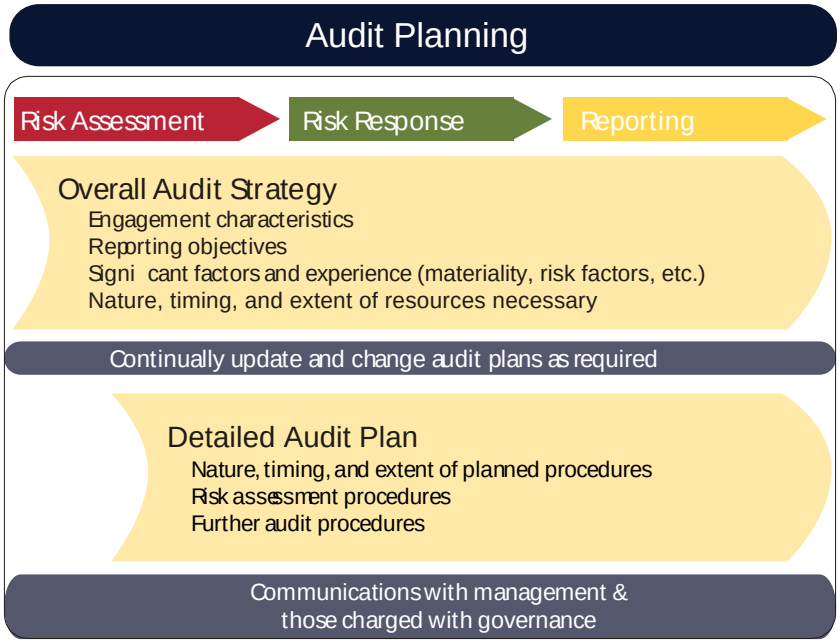
The benefits of audit planning are outlined in the exhibit below.

Exhibit 5.1-1

#FOFöUT PG Audit Planning	t 5FBN NFNCFST MFBSO GSPN UIF FYQFSJFODF JC personnel.
	t 5IF FOHBHFNFOU JT QSPQFSMZ PSHBOJ[FE TUB
	t &YQFSJFODF HBJOFE GSPN QSFWJPVT QFSJPET is properly utilized.
	t *NQSPUBOU BSFBT PG UIF BVEJU SFDFJWF UIF E
	t 1PUFOUJBM QSPCMFNT BSF JEFOUJöFE BOE SFT
	t "VEJU öMF EPDVNFOUBUJPO JT SFWJFXFE PO B
	t 8PSL QFSGPSNFE CZ PUIFST JT DPPSEJOBUFE F

There are two levels of planning for the audit as illustrated in the exhibit below.

Exhibit 5.1-2



$0 / 4 * % &03* /15

It is often said that an hour spent planning can save five hours in execution. A well-planned audit ensures that the audit effort is directed to addressing the high-risk areas, that unnecessary audit procedures are scoped out, and that audit staff knows what is expected of them.

Development of the overall audit strategy begins at the commencement of the engagement, and is completed and then updated based on the information obtained from:

- 1SFWJPVT FYQFSJFODF XJUI UIF FOUJUZ
- 1SFMJNJOBSZ DMJFOU BDDFQUBODF BOE DPOUJOVBUJPO BD
- %JTDVTTJPOT XJUI UIF DMJFOU PO DIBOHFT TJODF MBTU QF
- 0UIFS FOHBHFNFOUT QFSGPSNFE GPS UIF DMJFOU EVSJOH U
- "VEJU UFBN EJTDVTTJPOT BOE NFFUJOHT
- 0UIFS FYUFSOBM TPVSDFT TVDI BT OFXTQBQFS BOE *OUFSO
- /FX JOGPSNBUJPO PCUBJOFE GBJMFE BVEJU QSPDFEVSFT F
  that will change previously planned strategies.

The detailed audit plan will begin a little later when the specific risk assessment procedures are planned and when there is sufficient information about assessed risks to develop an appropriate audit response. The requirements for developing the detailed audit plan are addressed in Volume 2, Chapter 16.

The time required to prepare an overall audit strategy will vary based on:

- 5IF TJ[F BOE DPNQMFYJUZ PG UIF FOUJUZ
- 5IF DPNQPTJUJPO BOE TJ[F PG UIF BVEJU UFBN 4NBMMFS BV
  QMBOD PPSE EJCBEFPN VOJFBUJPS
- 1SFWJPVT FYQFSJFODF XJUI UIF FOUJUZ BOE
- $JSDVNTUBODFT FODPVOUFSFE JO QFSGPSNJOH UIF BVEJU

$0 / 4 * % &03* /15

Small entity audits are often conducted by very small audit teams. This makes coordination and communication among the team members easier, and development of the overall audit strategy can be straightforward. Documentation for small entities may be in the form of a brief memorandum that includes:

- /BUVSF PG FOHBHFNFOU BOE UJNJOH
- *TTVFT JEFOUJöFE JO UIF BVEJU KVTU DPNQMFUFE
- 8IBU IBT DIBOHFE JO UIF DVSSFOU QFSJPE
- "OZ SFWJTJPOT SFRVJSFE JO UIF PWFSBMM BVEJU TUSBUF
- 4QFDJöD SFTQPOTJCJMJUJFT PG FBDI NFNCFS PG UIF BVEJ

Planning for the current period can start with a brief memo prepared at the end of the previous audit. However, the memo needs to be updated for the current period, based on discussions with the owner-manager and the results of audit team meetings.

5.2 Developing the Overall Audit Strategy

The overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. The strategy will document the decisions arising from conducting the planning steps outlined in the exhibit below. Note that specific details of risk assessment and further audit procedures to be performed would be documented in the detailed audit plan.

Exhibit 5.2-1

# B T4JDF Q T	Description
Getting Started	t 1FSGPSN QSFMJNJOBSZ BDUJWJUJFT DMJFOU B terms of engagement). t (BUIFS SFMFWBOU JOGPSNBUJPO BCPVU UIF FOU results from previous engagements, and significant changes in the current period. t "TTJHO TUBò UP UIF FOHBHFNFOU JODMVEJOH quality control reviewer and any experts required. t 4DIFEVMF UIF BVEJU UFBN NFFUJOH JODMVEJO discuss the susceptibility of material misstatements (including fraud) in the financial statements. t %FUFSNJOF UIF BQQSPQSJBUF UJNFGSBNFT EB will be undertaken (inventory counts, risk assessment procedures, external confirmations, the period-end visit, and meetings to discuss audit results).
Assessing Risks and Responses	t %FUFSNJOF NBUFSJBMJUZ GPS UIF öOBODJBM T materiality. t %FUFSNJOF UIF OBUVSF BOE FYUFOU PG UIF SF and who will perform them. t 8IFO SJTL IBT CFFO BTTFTTFE BU UIF öOBODJBM appropriate overall response (refer to Volume 1, Chapter 9). Also include the impact on the further audit procedures to be performed. t $PNNVOJDBUF BO PWFSWJFX PG UIF QMBOOFE T those charged with governance. t 6QEBUF BOE DIBOHF UIF TUSBUFHZ BOE BVEJU circumstances.

When the risks of material misstatement have been identified and assessed, the overall strategy (including timing, staffing, and supervision) can be finalized, and the detailed audit plan developed. The detailed plan will set out the further audit procedures required at the assertion level that respond to the identified and assessed risks.

As work commences, changes may be required to the overall strategy and detailed plans to respond to new circumstances, audit findings, and other information obtained. Any such changes are to be documented along with the reasons in the audit documentation, such as the overall audit strategy or audit plan.

The overall strategy documents relevant matters such as those listed below.

Exhibit 5.2-2

Document	Description
Engagement Characteristics	t 5IF öOBODJBM SFQPSUJOH GSBNFXPSL UP CF VT t "EEJUJPOBM SFQPSUT SFRVJSFE TVDI BT TUBO requirements (by regulators, etc.). t "OZ OFFE GPS TQFDJBMJ[FE LOPXMFEHF PS FYQ and high-risk audit areas. t &WJEFODF SFRVJSFE GSPN TFSWJDF PSHBOJ[BU t 6TF PG FWJEFODF PCUBJOFE JO QSFWJPVT BVE and tests of controls). t &òFDU PG JOGPSNBUJPO UFDIOPMPHZ PO BVEJU use of computer-assisted audit techniques). t /FFE UP JOUSPEVDF TPNF VOQSFEJDUBCJMJUZ J t "WBJMBCJMJUZ PG FOUJUZ QFSTPOOFM BOE EBU
Reporting 0CKFDUJWFT	t &OUJUZ T UJNFUBCMF GPS SFQPSUJOH t 5JNJOH PG NFFUJOHT XJUI NBOBHFNFOU BOE UI discuss: – The nature, timing, and extent of the audit work. This could include dates for inventory counts, external confirmations, and interim and other required procedures, – Status of audit work throughout the engagement, and – The auditor's report and other communications such as management letters. t 5JNJOH PG NFFUJOHT DPNNVOJDBUJPOT BNPOH discuss: – Entity risk factors (business and fraud), – Nature, timing, and extent of work to be performed, – Review of work performed, and – Other communications with third parties.

Document	Description
4JHOJöDBOUt	'BDUPST JOGMVFODJOH TJHOJöDBOU QWFSBMM JOEJWJEVBM öOBODJB materiality). t 1SFMJNJOBSZ BTTFTTNFOU PG SJTL BU UIF PWF impact on the audit. t 1SFMJNJOBSZ JEFOUJöDBUJPO PG – Significant and material classes of transactions, account balances, and disclosures and – Areas where there may be a higher risk of material misstatement. t)PX FOHBHFNFOU UFBN NFNCFST XJMM CF SFNJOE and to exercise professional skepticism in gathering and evaluating audit evidence. t 3FMFWBOU SFTVMUT PG QSFWJPVT BVEJUT JOD action taken by management to address them. t %JTDVTTJPOT XJUI öSN T QFSTPOOFM XIP QSPW t &WJEFODF PG NBOBHFNFOU T BUUJUVEF UPXBSI attached to internal control generally throughout the entity. t 7PMVNF PG USBOTBDUJPOT XIJDI NBZ EFUFSNJ the auditor to rely on internal control.
4JHOJöDBOU Changes and Developments	t 4JHOJöDBOU CVTJOFTT EFWFMPQNFOUT BòFDUJ information technology and business processes, changes in key management and acquisitions, mergers, and divestitures. t 4JHOJöDBOU JOEVTUSZ EFWFMPQNFOUT TVDI B new reporting requirements. t 4JHOJöDBOU DIBOHFT JO UIF öOBODJBM SFQPSU accounting standards. t 0UIFS TJHOJöDBOU SFMFWBOU EFWFMPQNFOUT environment affecting the entity.
/BUVSF BOE &YUFOU of Resources Required	t 5IF FOHBHFNFOU UFBN JODMVEJOH XIFSF OFD control reviewer). t "TTJHONFOU PG BVEJU XPSL UP UIF UFBN NFNC appropriately experienced team members to areas where there may be higher risks of material misstatement. t &OHBHFNFOU CVEHFUJOH JODMVEJOH DPOTJEF to set aside for areas where there may be higher risks of material misstatement.

If the entity has components (such as subsidiaries or operating divisions), reference should be made to the additional planning considerations outlined in the Appendix to ISA 300 and to the requirements of ISA 600.

For smaller entities, a brief memorandum may serve as the documented overall strategy. For the audit plan, standard audit programs or checklists may be used, assuming there are few relevant control activities and provided the programs are tailored to the circumstances of the engagement, including the auditor's risk assessments.

5.3 Communicating the Audit Plan With Management and Those Charged With Governance

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
260.15	The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: Para. A11-A15)

An ongoing, two-way dialogue with management and those charged with governance can play an important role in the audit planning process. Good communication regarding the planned scope and timing of the audit may assist management and those charged with governance to:

- 6OEFSTUBOE UIF DPOTFRVFODFT PG UIF BVEJUPS T XPSL
- %JTDVTT JTTVFT PG SJTL BOE UIF DPODFQU PG NBUFSJBMJU
- *EFOUJGZ BOZ BSFBT JO XIJDI UIFZ NBZ SFRVFTU UIF BVEJU dialogue may also assist the auditor in developing a better understanding of the entity and its environment.

Take care, though, not to compromise the effectiveness of the audit. For example, communicating the exact nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

Matters that the auditor may consider for communication include:

-)PX UIF BVEJUPS QSPQPTFT UP BEESFTT UIF TJHOJöDBOU SJ GSBVE PS FSSPS
- 5IF BVEJUPS T BQQSPBDI UP JOUFSOBM DPOUSPM SFMFWBOU
- 5IF BQQMJDBUJPO PG NBUFSJBMJUZ JO UIF DPOUFYU PG BO

Other planning matters that may be appropriate to discuss include:

- 5IF WJFXT PG UIPTF DIBSHFE XJUI HPWFSOBODF PG
  - The allocation of responsibilities between those charged with governance and management,
  - The entity's objectives and strategies, and the related business risks that may result in material misstatements,
  - Matters that those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken,
  - Significant communications with regulators, and
  - Other matters that those charged with governance consider may influence the audit of the öOBODJBM TUBUFNFOUT
- 5IF BUUJUVEFT BXBSFOFTT BOE BDUJPOT PG UIPTF DIBSHF processes for identifying and responding to the risks of error and fraud in the entity and the internal control that management has established to mitigate such risks. This would also include how those DIBSHFE XJUI HPWFSOBODF PWFSTFF UIF FòFDUJWFOFTT PG
- 5IF BDUJPOT PG UIPTF DIBSHFE XJUI HPWFSOBODF JO SFTQP DPSQPSBUF HPWFSOBODF QSBDUJDFT BOE PUIFS SFMBUFE N
- 5IF SFTQPOTFT PG UIPTF DIBSHFE XJUI HPWFSOBODF UP QSP

Note: This two-way communication does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing, and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Further matters may be required to be communicated by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement. Also note that ISA 265 sets out the requirements to communicate significant deficiencies identified in internal control.

5.4 Documentation

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
300.12	The auditor shall include in the audit documentation: B 5IF PWFSBMM BVEJU TUSBUFHZ C 5IF BVEJU QMBO BOE (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A16-A19)

The overall audit strategy and detailed audit plan, including details of any significant changes made during the audit engagement, would be documented. The auditor may use a memorandum, standard audit programs, or audit planning and completion checklists, tailored as needed to reflect the particular engagement circumstances.

5.5 Case Studies—The Overall Audit Strategy

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Once the decision has been made to continue with the audit, and materiality has been determined, the next step is to develop or update the overall audit strategy for conducting the engagement. This can be documented by some form of planning checklist or a brief but structured memorandum (see the consider point in 5.1 above) such as the examples that follow.

%FQIUB 'VSOJUVSF *OD

Overall strategy memo

Period end December 31, 20X2

Scope

The scope of the audit has not changed this period. Audit to comply with ISAs and the IFRS accounting framework. There have been no changes in IFRS that affect Dephta this year.

Entity Changes

Dephta is planning to make sales in foreign currencies.

Internet sales are also increasing and Dephta's IT capabilities will be stretched.

Dephta is now selling to Franjawa Merchandising. This company is renowned for squeezing profit margins of suppliers in exchange for giving large orders. It also requires suppliers to maintain additional inventories of some products for instant delivery as required.

Risk

Our assessment of risk at the financial statements level is low (refer to WP ref. #). Management is not QBSUJDVMBSMZ TPQIJTUJDBUFE CVU UIFSF JT B TUSPOH DPNN ethics and, in general, has a good attitude toward internal control.

0WFSBMM 4USBUFHZ

- t .BUFSJBMJUZ GPS UIF öOBODJBM TUBUFNFOUT JT 10,000 This is higher than last period to reflect the growth in sales and profitability during the last period. Management bonuses of approximately 70,000 were added back to income for calculating materiality for the financial statements as a whole [refer to working paper on determining materiality Volume 2, Chapter 6]. Performance materiality (based on our assessment of audit risk) has been set at 7,000 , except for certain account balances as described on WP ref. #.
- t 6TF UIF TBNF TFOJPS TUBò BT MBTU QFSJPE BOE QFSGPSN
- t 1FSGPSN PVS SJTL BTTFTTNFOU QSPDFEVSFT UP UIF FOE PG UIF QFSJPE BU UIF FOE PG UIF QFSJPE BOE UP UIF FOE PG UIF QFSJPE BU UIF FOE PG UIF QFSJPE BU UIF FOE PG UIF QFSJPE BU

$BTF 4UVEZ #‰ ,VNBS $P

,VNBS $P

Overall strategy memo

Period end December 31, 20X2

Scope

t 1FSGPSN UIF TUBUVUPSZ BVEJU

t .BOBHFNFOU XBOUT UP VTF *'34 for SMEs

Risk

t Risk at the financial statement level has been assessed as moderate (refer to WP ref. #).

Entity Changes

t -PXFS TBMFT EVF UP GFXFS PSEFST GSPN %FQIUB

t $PVME MFBE UP VOTBMFBCMF öOJTIFE HPPET JOWFOUPSZ E

t 3BK OPU BT BDUJWF JO UIF CVTJOFTT BT JO QSJPS QFSJPE

t /FX öOBODJOH SFTVMUJOH JO OFX CBOL DPWFOBOUT UP N

0WFSBMM 4USBUFHZ

t .BUFSJBMJUZ GPS UIF öOBODJBM TUBUFNFOUT BT B XIPMF 3,250 due to decline in sales and profitability. Performance materiality (based on our assessment of audit risk) has been set at 1,800 , except for certain account balances as described on WP ref. #.

t 6TF UIF TBNF TUBò BT MBTU QFSJPE GPS DPOUJOVJUZ BOE

t 1FSGPSN SJTL BTTFTTNFOU QSPDFEVSFT BU FOE PG %FDFN

t "U PVS UFBN QMBOOJOH NFFUJOH UP CF IFME PO /PWFNCFS

- Consider the susceptibility of the financial statements to fraud,
- Discuss the potential for employee fraud and management override. The bookkeeper seems disgruntled and may have motivation and opportunity. Raj has not been as involved in reviewing the financial statements as he did in the past, and
- Focus on the growing related party transactions to Dephta.

t "UUFOE UIF QFSJPE FOE JOWFOUPSZ DPVOU

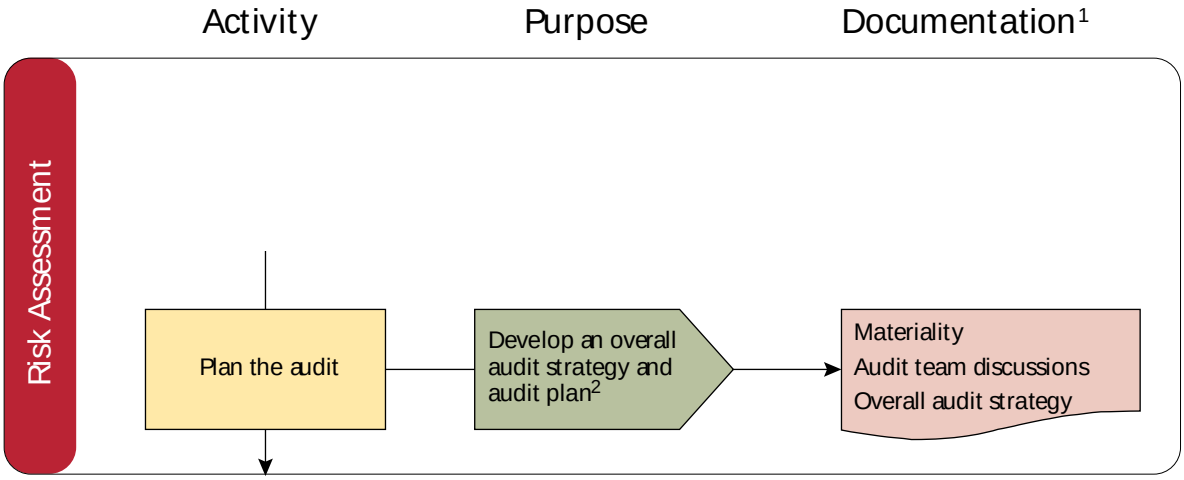
t &YQBOE PVS UFTUJOH XJUI SFHBSE UP SFMBUFE QBSUZ US

Audit partner (signed): Sang Jun Lee

Date: October 20, 20X2

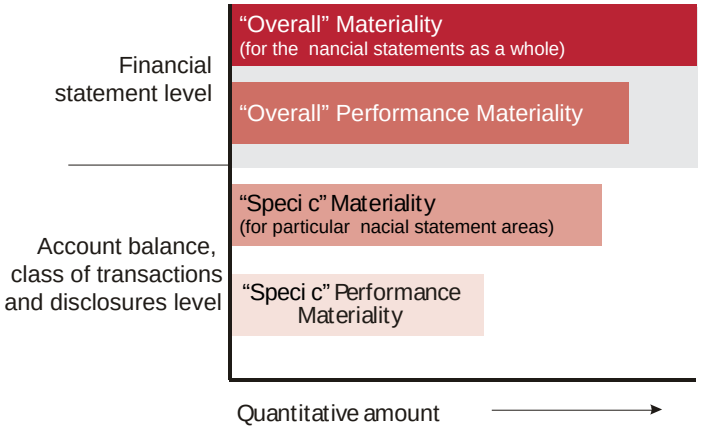
Chapter Content	Relevant ISAs
Determination and use of materiality in an audit engagement.	320, 450

Exhibit 6.0-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.

Exhibit 6.0-2



Note: The terms "overall" materiality and "specific" materiality used in the exhibit above and in the text below are used solely for the purposes of this Guide and are terms that are not used in the ISAs. Overall materiality refers to the financial statements as a whole, and specific materiality relates to materiality of particular classes of transactions, account balances, or disclosures.

Paragraph #	*4" 0CKFDUJWF T
320.8	The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.
450.3	The objective of the auditor is to evaluate: B 5IF FòFDU PG JEFOUJöFE NJTTUBUFNFOUT PO UIF BVEJU (b) The effect of uncorrected misstatements, if any, on the financial statements.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
320.9	For purposes of the ISAs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.
320.10	When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A11)
320.11	The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)
320.12	The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)
320.13	If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.
320.14	The auditor shall include in the audit documentation the following amounts and the factors considered in their determination: B .BUFSJBMJUZ GPS UIF öOBODJBM TUBUFNFOUT BT B XIP (b) If applicable, the materiality level or levels for particular classes of transactions, account CBMBODFT PS EJTDMPTVSFT TFF QBSBHSBQI D 1FSGPSNBODF NBUFSJBMJUZ TFF QBSBHSBQI BOE (d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
450.6	The auditor shall determine whether the overall audit strategy and audit plan need to be revised if: (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements BDDVNVMBUFE EVSJOH UIF BVEJU DPVME CF NBUFSJBM (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with ISA 320. (Ref: Para. A5)

6.1 Overview

Decisions made by the auditor on materiality will form the basis for risk assessments and for determining the extent of auditing procedures required.

Determining materiality is a matter of professional judgment. It is based on the auditor's perception of the common financial information needs of users of the financial statements as a group. Overall materiality (which is a term used in this Guide to summarize materiality for the financial statements as a whole) is the total amount of misstatements in a financial statement, including omissions, which, if exceeded, could reasonably be expected to influence the economic decisions of users. This differs from audit risk, which relates to an inappropriate audit opinion being issued on financial statements that are materially misstated.

This chapter addresses the determination of overall and specific materiality, and the auditor's use of performance materiality to obtain sufficient and appropriate audit evidence. Materiality is used throughout the audit for audit planning, risk assessment, risk response, and reporting. Additional information on materiality and audit risk is contained Volume 1, Chapter 7 of this Guide.

There are two levels of materiality to consider—overall materiality, and specific materiality—as described below.

Exhibit 6.1-1

	Description
0WFSBMM .BUFSJBMJUZ (For the Financial Statements as a Whole	Materiality for the financial statements as a whole (overall materiality) is based on the auditor's professional judgment as to the highest amount of misstatement(s) that could be included in the financial statements without affecting the economic decisions taken by a financial statement user. If the amount of uncorrected misstatements, either individually or in the aggregate, is higher than the overall materiality established for the engagement, it would mean that the financial statements are materially misstated. Overall materiality is based on the common financial information needs of the various users as a group. Consequently, the possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

	Description
4 Q F D J ö D . B U F S J B M J U Z (Materiality Level or Levels for Particular Classes of Transactions, Account Balances, or Disclosures	In some cases, there may be a need to identify misstatements of lesser amounts than overall materiality that would affect the economic decisions of financial statement users. This could relate to sensitive areas such as particular note disclosures (i.e., management remuneration or industry-specific data), compliance with legislation or certain terms in a contract, or transactions upon which bonuses are based. It could also relate to the nature of a potential misstatement.

Nature of Misstatements

In addition to the size of a misstatement, the auditor would consider the nature of potential misstatements and the particular circumstances of their occurrence when evaluating their effect on the financial statements. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Examples could include illegal acts, non-compliance with loan covenants, and non-compliance with statutory/regulatory reporting requirements. However, it is not considered practicable to design audit procedures to detect misstatements that could be material solely because of their nature.

Performance Materiality

Performance materiality is used by the auditor to reduce the risk to an appropriately low level that the accumulation of uncorrected and unidentified misstatements exceeds materiality for the financial statements as a whole (overall materiality), or materiality levels established for particular classes of transactions, account balances, or disclosures (specific materiality).

Performance materiality is set at a lower amount (or amounts) than overall or specific materiality. The objective is to perform more audit work than would be required by the overall or a specific materiality to:

- & O T V S F U I B U N J T T U B U F N F O U T M F T T U I B O , P W F S B M M P S T Q F D reduce the probability that the aggregate of uncorrected errors and undetected misstatements exceeds materiality for the financial statements as a whole B O E thus
- 1 S P W J E F B N B S H J O P S C V ò F S G P S Q P T T J C M F V O E F U F D U F E N uncorrected misstatements in the aggregate and the overall or specific materiality.

This margin provides some assurance for the auditor that undetected misstatements, along with all uncorrected misstatements, will not likely accumulate to reach an amount that would cause the financial statements to be materially misstated.

The determination of performance materiality is not a simple mechanical calculation. It involves the exercise of professional judgment based on the specific risk factors identified, the auditor's understanding of the entity, and any matters the auditor has identified in previous audit engagements.

Performance materiality is set in relation to overall materiality or specific materiality. For example, a specific performance materiality can be set at a lower amount than overall performance materiality for testing repairs and maintenance expenses if there is a higher risk of assets not being capitalized. Specific performance materiality may also be used to perform additional work in areas that may be sensitive due to the nature of potential misstatements and their occurrence, rather than their monetary size.

6.2 How to Determine Materiality

The following paragraphs address the determination and use of overall and specific materiality.

Overall Materiality

Overall materiality is based on the auditor's perceptions of the needs of financial statement users. Auditors can assume the following about financial statement users.

Exhibit 6.2-1

	Assumptions
'JOBODJBM 4UBUFNFOU 6TFST	t)BWF B SFBTPOBCMF LOPXMFEHF PG CVTJOFTT BOE t)BWF B XJMMJOHOFTT UP TUVEZ UIF JOGPSNBUJ SFBTPOBCMF EFHSFF PG EFUBJM t 6OEFSTUBOE UIBU öOBODJBM TUBUFNFOUT BSF MFWFMT PG NBUFSJBMJUZ t 3FDPHOJ[F UIF VODFSUBJOUJFT JOIFSFOU JO UIF UIF VTF PG FTUJNBUFT KVEHNFOU BOE UIF DPOT t .BLF SFBTPOBCMF FDPOPNJD EFDJTJPOT PO UIF financial statements.

A percentage numerical threshold (or benchmark) is often used as a starting point in the determination. The nature of the benchmark and the percentage to be applied are based on professional judgment. For example, in an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

$0 / 4 * % &03* /15

To provide some consistency, accounting firms may want to establish some firm-wide guidelines on how materiality will be initially be determined, including the use of appropriate benchmarks. However, the actual benchmark to be used would be based on professional judgment in light of the particular circumstances of the entity. This also applies to the use of performance materiality, which is essentially a tool used by the auditor to address the risk of material misstatement by "catching" misstatements that fall below a certain threshold.

When identifying an appropriate benchmark to use, the auditor would consider the matters outlined in the exhibit below, and obtain an understanding of the views and expectations of management and those charged with governance.

Exhibit 6.2-2

	Consider
Choosing the 3JHIU #FOD IBSL UP 6TF	6TFST Determine who are the likely users of the financial statements. This would include the entity's owners (and other shareholders) and those charged with governance, financial institutions, franchisors, major funders, employees, customers, creditors, and government agencies and departments.

	Consider
Choosing the 3JHIU #FOD IdentifyU6TF (continued)	4QFDJöD VTFS FYQFDUBUJPOT Identify any specific user expectations such as the following: t .FBTVSFNFOU PS EJTDMPTVSF PG JUFNT TVDI BT SF SFNVOFSBUJPO BOE DPNQMJBODF XJUI TFOTJUJWF t *OEVTUSZ TQFDJöD EJTDMPTVSFT TVDI BT FYQMPS SFTFBSDI DPTUT JO B IJHI UFDIOPMPHZ PS QIBSNB t .BKPS FWFOUT PS DPOUJOHFODJFT 5IJT DPVME J acquisition, divestiture, restructuring, or significant legal proceedings against the FOUBUOE t &YJTUFODF PG DPWFOBOUT JO MPBO BHSFFNFOUT is close to breaching a covenant. If a small uncorrected error would mean that a covenant had been violated, this could have a significant effect on the financial statements and could, at worst, affect the appropriateness of using the going concern assumption in preparing the financial statements.
	3FMFWBOU öOBODJBM TUBUFNFOU FMFNFOUT What are the major elements of the financial statements that will be of interest to users (e.g., assets, liabilities, equity, income, and expenses)?
	Nature of the entity Consider the nature of the entity, where the entity fits in the life cycle (growing, mature, declining, etc.), and the industry and economic environment in which the entity operates.
	"EKVTUNFOUT SFRVJSFE Are adjustments required to “normalize” the benchmark base? For example, income from continuing operations could be adjusted for: t 6OVTVBM PS OPO SFDVSSJOH SFWFOVF FYQFOTF J t *UFNT TVDI BT B NBOBHFNFOU CPOVT XIJDI NBZ C bonus or simply paid out to reduce income left in the company.
	5IF QSJNBSZ GPDVT PG VTFST What information in financial statement items will attract the most attention by users? For example, users interested in: t &WBMVBUJOH öOBODJBM QFSGPSNBODF XJMM GPDV t 5IF SFTPVSDFT VUJMJ[FE UP BDIJFWF DFSUBJO HP extent of revenues and expenditures.
	'JOBODJOH How is the entity financed? If financed solely by debt (rather than equity capital), users may put more emphasis on the pledged assets and any claims than on the entity’s earnings.
	Volatility How volatile is the proposed benchmark? For example, a benchmark based on earnings might normally be appropriate, but if the entity is operating close to break-even each period (such as small profits or losses) or their results fluctuate widely, it may not be the appropriate base for determining materiality.
	Alternatives Is an alternative benchmark necessary to address special circumstances? Alternative benchmarks could include current assets, net working capital, total assets, total revenues, gross profit, total equity, and cash flow from operations.

Performance Materiality

Whereas overall and specific materiality is set in relation to the needs of financial statement users, performance materiality is set at a lower amount. This will result in more audit work being performed (smaller misstatements may be identified) and audit risk being reduced to an appropriately low level.

If the audit was planned solely to detect individually material misstatements, there would be no margin of error to identify and account for immaterial misstatements that might exist. As a result, it could be possible for the aggregate of individually immaterial misstatements to cause the financial statements to be materially misstated.

Performance materiality is designed to:

- &OTVSF UIBU JNNBUFSJBM NJTTUBUFNFOUT MFTT UIBO PWFS
- 1SPWJEF B NBSHJO PS CVòFS GPS QPTTJCMF VOEFUFDUFE N uncorrected misstatements in the aggregate and the overall or specific materiality.

The determination of performance materiality would not be a simple mechanical calculation such as 80% of overall materiality. This simplification would ignore specific risk factors that may be relevant to the entity. For example, if there was a high risk of errors in inventory pricing, performance materiality could be lowered so that additional work is performed to identify the extent of misstatements. Conversely, if the risk of misstatement in the receivables balance is assessed as low, the performance materiality could be raised, resulting in less substantive audit work on the balance.

Performance materiality requires the auditor to exercise professional judgment and is affected by:

- 5IF BVEJUPS T VOEFSTUBOEJOH PG UIF FOUJUZ XIJDI JT VQ QSPDFEVSFT BOE
- 5IF OBUVSF BOE FYUFOU PG NJTTUBUFNFOUT JEFOUJöFE JO

$0 / 4 * % &03* /15

Do not reduce the overall materiality level based on high audit risks

Avoid the mistake of reducing the overall (financial statement) materiality level because of an audit risk assessed as high. Overall materiality is based on users' information needs, not on how risky a particular balance might be to audit. Lowering the overall materiality threshold implies that:

- 5IF EFDJTJPO PG B öOBODJBM TUBUFNFOU VTFS JT BòFDUF DPOUBJOFE JO UIF öOBODJBM TUBUFNFOUT BOE
- "EEJUJPOBM XPSL XJMM CF QFSGPSNFE CZ UIF BVEJUPS UP F statements that, individually or accumulated together, exceed the overall materiality threshold.

A better approach is to address audit risk by setting the performance materiality at the class of transaction or account balance level at a lower level. This will ensure that sufficient work is performed to detect any misstatements, without having to reduce the overall materiality level. It also creates a safety buffer to cover unidentified misstatements in the work performed.

Establish the overall materiality level by reference to financial statement users, and then establish performance materiality for the purpose of designing further audit procedures.

4FOTJUJWF öOBODJBM TUBUFNFOU EJTDMPTVSFT CBMBODFT

Use a specific performance materiality for designing further audit procedures that address specific risks and balances in sensitive audit areas.

Summary

The materiality levels and use of performance materiality are summarized in the exhibit below.

Exhibit 6.2-3

	0 W F S B M M	4 Q F D J ö D	Performance
Purpose	To establish the threshold for determining whether the financial statements are free from material misstatement, whether due to error or fraud.	To establish a threshold(s) (lower than overall materiality) to be applied to particular classes of transactions, account balances, or disclosures where misstatements of lesser amounts than overall materiality for the financial statements could reasonably be expected to influence the economic decisions of users.	To establish the threshold(s) (lower than overall or specific materiality) that ensures immaterial misstatements (less than overall or specific materiality) are identified, and provide the auditor with a safety margin.
# B T J T P W Calculation	What level of misstatement in the financial statements would be tolerable to users (i.e., would not affect the economic decisions made by a financial statement user)?	What level of misstatement relating to special circumstances in a particular class of transactions, account balances, or disclosures could reasonably be expected to influence the economic decisions of users?	What amount of audit work will be required to: t Identify misstatements below overall or specific N B U F S J B L E J U Z t - F B W F B sufficient buffer for undetected misstatements?
Rules of 5 I V N C (For Use as a Starting Point)	Materiality is a matter of professional judgment rather than a mechanical exercise. As a result, no specific guidance is provided in the ISA. However, profit from continuing operations (3 to 7%) is often used in practice as having the greatest significance to financial statement users. If this is not a useful measure (such as for a not-for-profit entity or where profit is not a stable base), then consider other bases such as: t Revenues or F Y Q F O E J U V S F T U P t " T T F U T U P P S t & R V J U Z U P	Establish a lower, specific materiality amount (based on professional judgment) for the audit of specific or sensitive financial statement areas.	No specific guidance is provided in the ISAs. Percentages range from 60% (of overall or specific materiality), where there is a higher risk of material misstatement, up to 85%, where the assessed risk of material misstatement is less.

	0WFSBMM	4QFDJöD	Performance
6TF JO Audit	UIF Determining whether uncorrected misstatements, individually or in aggregate, exceed overall materiality.	Determining whether uncorrected misstatements, individually or in aggregate, exceed the specific materiality.	t "TTFTTJOH UIF SJ NBUFSJBM NJTTUB and t %FTJHOJOH GVSU procedures to respond to assessed risks.
Revision as Audit Progresses	t " DIBOHF JO circumstances that occurred during the audit such as the sale of QBSU PG UIF CVTJOFTT t /FX JOGPSNBUJPO PS t " DIBOHF JO UIF BVEJUPShT understanding of the entity and its operations, as a result of performing further audit procedures (e.g., actual operating results being very different from expected).	A change in the special circumstances.	t $IBOHFT JO BTTFT SJTLT t /BUVSF BOE FYUF misstatements found when performing further audit QSPDFEVSFT t $IBOHF JO understanding of the entity.

6.3 Materiality in Planning and Risk Assessment

Determining the various materiality levels is a key component of the planning process. This is not a discrete phase of an audit, but rather a continual and iterative process. The following exhibit summarizes the use of materiality in planning and risk assessment.

Exhibit 6.3-1

	.BUFSJBMJUZ
Planning (Overall Strategy and Audit Plans)	Use materiality to: t %FUFSNJOF XIBU öOBODJBM TUBUFNFOU BSFBT SF t 4FU UIF DPOUFYU GPS UIF PWFSBMM BVEJU TUSBU t 1MBO UIF OBUVSF UJNJOH BOE FYUFOU PG TQFD t %FUFSNJOF TQFDJöD NBUFSJBMJUZ GPS QBSUJDV balances, or disclosures where misstatements at lesser amounts than overall or performance materiality could reasonably be expected to influence the economic decisions of users. t %FUFSNJOF QFSGPSNBODF NBUFSJBMJUZ GPS FBD be necessary for the auditor to work using a performance materiality level for a particular class of transactions, account balance, or disclosure, depending on the level of risk associated with that item. t &WBMVBUF MBUFS FWJEFODF UP EFUFSNJOF UIF C materiality levels. If so, the auditor would revise the nature, timing, and extent of procedures accordingly.

	.BUFSJBMJUZ
Risk Assessment Procedures	t *EFOUJGZ XIBU SJTL BTTFTTNFOU QSPDFEVSFT BS t 1SPWJEF B DPOUFYU XIFO FWBMVBUJOH UIF JOGP t "TTFTT UIF NBHOJUVEF JNQBDU PG UIF SJTLT JE t "TTFTT SFTVMUT PG SJTL BTTFTTNFOU QSPDFEVSI
5FBN .FFUJOHT	&OTVSF UIBU UFBN NFNCFST VOEFSTUBOE UIF JEP reasonably be expected to change their economic decisions. This may help in the event that a team member becomes aware of information during the audit that would have caused a different amount of materiality to be determined initially. Examples of such matters include: – A decision to dispose of a major part of the entity's business, – New information or risk factors that would have affected the initial determination of materiality, and – A change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures, such as when actual financial results are substantially different from anticipated results. t &TUBCMJTI PWFSBMM BVEJU TUSBUFHZ t %FUFSNJOF UIF FYUFOU PG UFTUJOH JO SFMBUJP – Performance materiality, and – Specific performance materiality. t *EFOUJGZ DSJUJDBM BVEJU JTTVFT BOE BSFBT GP

$0 / 4 * % &03* /15

The determination of overall performance and specific performance materiality levels requires the use of professional judgment. It is suggested (but not required) that teams discuss the judgments applied in determining materiality levels with the engagement partner and obtain his/her approval. Finally, record the judgments used in determining materiality in sufficient detail in the audit working papers.

6.4 Materiality in Performing Audit Procedures

Auditors should consider materiality when determining the nature, timing, and extent of audit procedures, as illustrated in the following exhibit.

Exhibit 6.4-1

	.BUFSJBMJUZ
Performing Audit Procedures	Use materiality to: t *EFOUJGZ XIBU GVSUIFS BVEJU QSPDFEVSFT BS t %FUFSNJOF XIJDI JUFNT UP TFMFDU GPS UFTUJ techniques. t "TTJTU XJUI EFUFSNJOJOH TBNQMF TJ[FT F H (materiality) ÷ confidence factor). t &WBMVBUF SFQSFTFOUBUJWF TBNQMJOH FSSPS "likely" misstatements. t &WBMVBUF UIF BHHSFHBUF PG UPUBM FSSPST B statement level. t &WBMVBUF UIF BHHSFHBUF PG UPUBM FSSPST misstatements in opening retained earnings. t "TTFTT SFTVMUT PG QSPDFEVSFT

Note: The overall audit strategy and audit plan will need to be revised where:

- t 5IF OBUVSF PG JEFOUJöFE NJTTUBUFNFOUT BOE UIF DJS other misstatements may exist that, when aggregated with misstatements accumulated during UIF BVEJU DPVME CF NBUFSJBM PS
- t 5IF BHHSFHBUF PG NJTTUBUFNFOUT BDDVNVMBUFE EVSJ

$0 / 4 * % &03* /15

Overall materiality is unlikely to change very often. However, it may need to be revised as the auditor becomes aware of new information or if there is a change in the auditor's understanding of the entity and its operations. If a change is required, ensure that the audit team is informed and assesses the impact on the audit plan.

Performance materiality may change based on new risk factors or new audit findings that may not impact overall materiality. Changes in performance materiality will result in the modification of the nature, timing, and extent of audit procedures. Of course, if overall materiality changes, a corresponding change will likely be required in performance materiality.

6.5 Materiality in Reporting

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
450.11	The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider: (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and UIF QBSUJDVMBS DJSDVNTUBODFT PG UIFJS PDDVSSFODF (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A18)
450.12	The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)

Refer to Volume 2, Chapter 21 for more information on evaluating misstatements.

Prior to issuing an opinion, the auditor would:

- $PO öSN UIF NBUFSJBMJUZ FTUBCMJTIFE GPS UIF öOBODJBM
- &WBMVBUF UIF OBUVSF BOE UIF BHHSFHBUF PG VODPSSFDUF
- .BLF BO PWFSBMM BTTFTTNFOU BT UP XIFUIFS UIF öOBODJBM

Exhibit 6.5-1

	.BUFSJBMJUZ
Reporting	The auditor would use materiality to: t &WBMVBUF UIF BHHSFHBUF PG UPUBM FSSPST B statement level. t &WBMVBUF UIF BHHSFHBUF PG UPUBM FSSPST J misstatements in opening retained earnings. t %FUFSNJOF XIFUIFS BEEJUJPOBM BVEJU QSPDF aggregate misstatements are approaching overall or specific materiality. t 3FRVFTU UIBU NBOBHFNFOU DPSSFDU BMM JEFO t $POTJEFS SFDIFDLJOH BSFBT PG IJHIFTU NJTTU t .BLF KVEHNFOUT BCPVU UIF OBUVSF BOE TFOTJ identified, as well as their size. t %FUFSNJOF XIFUIFS UIF BVEJUPS T SFQPSU OFF uncorrected material misstatements.

The aggregate of misstatements is made up of:

- 4QFDJöD NJTTUBUFNFOUT JEFOUJöFE CZ UIF BVEJUPS BT B S
- "O FTUJNBUF PG PUIFS NJTTUBUFNFOUT JEFOUJöFE UIBU DB

The auditor would then request management to record all the identified misstatements. Refer to Volume 2, Chapter 21 for additional information on evaluating audit evidence obtained.

6.6 Other Considerations

Other considerations include:

- $PNNVOJDBUJOH UP NBOBHFNFOU BOE UIPTF DIBSHFE XJUI H
- 6QEBUJOH NBUFSJBMJUZ BOE
- 3FEVDJOH NBUFSJBMJUZ MFWFM GSPN QSFWJPVT QFSJPE

Communicating with Management and Those Charged With Governance

Management and those charged with governance need to understand the limitations concerning the degree of precision that can be expected from an audit. They also need to be aware that it is not economically feasible to design audit procedures that will provide absolute assurance that the financial statements are not materially misstated. An audit can provide only reasonable assurance in this regard.

When misstatements are identified by the auditor during the course of the audit, the first step is to request from management that all the uncorrected misstatements be corrected. If management decides not to correct certain misstatements, the auditor is then required to communicate with those charged with governance the following:

- %FUBJMT PG VODPSSFDUFE NJTTUBUFNFOUT BOE UIF FòFDU UIF PQJOJPO JO UIF BVEJUPS T SFQPSU VOMFTT QSPIJCJUFE
- .BUFSJBM VODPSSFDUFE NJTTUBUFNFOUT JOEJWJEVBMMZ B
- 5IF FòFDU PG VODPSSFDUFE NJTTUBUFNFOUT SFMBUFE UP Q account balances, or disclosures, and the financial statements as a whole.

Updating Materiality

The preliminary assessment of overall and performance materiality may change from the initial audit planning to the time of evaluating the results of the audit procedures. This could result from a change in circumstances or from a change in the auditor's knowledge as a result of performing audit procedures. For example, if audit procedures are performed prior to the period end, the auditor will anticipate the results of operations and the financial position. If the actual results of operations and financial position are substantially different, the assessments of materiality and audit risk may also change.

Reducing Materiality Level from Previous Period

When circumstances change from one period to the next, the auditor should consider the effect of any misstatement on the opening equity. For example, where sales and income are substantially less than the previous period's, a lower materiality is required. Errors could exist in opening figures, as the audit was previously conducted using a higher materiality level. To reduce the risk of a material error occurring in the opening equity, the auditor may perform further audit procedures on the opening asset and liability balances.

$0 / 4 * % &03* /15

/ F X F O H B H F N F O U T

When accepting a new audit engagement, inquire about the overall materiality used by the previous auditor. If available, this would help in determining whether further audit procedures may be required on the opening asset and liability balances.

6 T F P G N B O B H F N F O U F Y Q F S U T

Ensure that any experts employed by the entity (to assist the entity in preparing the financial statements) or used by the audit team are instructed to use an appropriate materiality level in relation to the work they perform.

6.7 Documentation

Document the determination of the following and the factors considered in their determination:

- 0 W F S B M M J U Z J B M J U Z
- 8 I F S F B Q Q M J D B C M F U I F T Q F D J ö D N B U F S J B M J U Z M F W F M T G P S E J T D M P T V S F T
- 1 F S G P S N B O D F N B U F S J B M J U Z B O E
- " O Z S F W J T J P O P G U I F B C P W F G B D U P S T B T U I F B V E J U Q S P H S

6.8 Case Studies—Determining and Using Materiality

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Materiality is often documented on a worksheet that includes a summary of operating results and provides space for other materiality considerations such as qualitative factors.

%FQIUB 'VSOJUVSF *OD

(Excerpt)

.BUFSJBMJUZ BTTFTTNFOU

The main users of the financial statements are the bank and the shareholders. The materiality number used in last period was 8,000 .

See WP ref. # for possible materiality amounts based on income from continuing operations, as well as revenue. Using our professional judgment, we decided to base our materiality on 5% of the profit before tax after adding back the management bonus of 70,000€. Other bases for materiality, such as revenues, were also considered but it was felt that profit before tax was the most meaningful amount in relation to the identified financial statement users.

For this period, the plan is to use 10,000€ as the overall materiality. The concept of materiality and its use in the audit has been discussed in general terms with the client.

Using professional judgment, and the types of misstatements identified in previous audits, overall performance materiality has been set at 7,500€.

A specific materiality for the local sales taxes paid has been set at 1,000€ as we are required to audit and report on this amount to the local government.

Also see WP 615 on quantitative analysis……..

Prepared by: JF Date: December 8, 20X2

3FWJFXFE CZ Date: January 5, 20X3

,VNBS $P

(Excerpt)

.BUFSJBMJUZ BTTFTTNFOU

The main users of the financial statements are the bank and the owners.

The materiality number used in the last period was 3,000 .

Based on consideration of user needs, we decided to base materiality at approximately 1% of sales. In our judgment, revenues provide a more stable base for materiality than profits before tax. For this period, we plan to use 2,500 as the overall materiality. The concept of materiality and its use in the audit has been discussed in general terms with the client.

Using professional judgment, which is largely based on the history of errors in previous periods, overall performance materiality has been set at 1,800 .

0UIFS NBUUFST

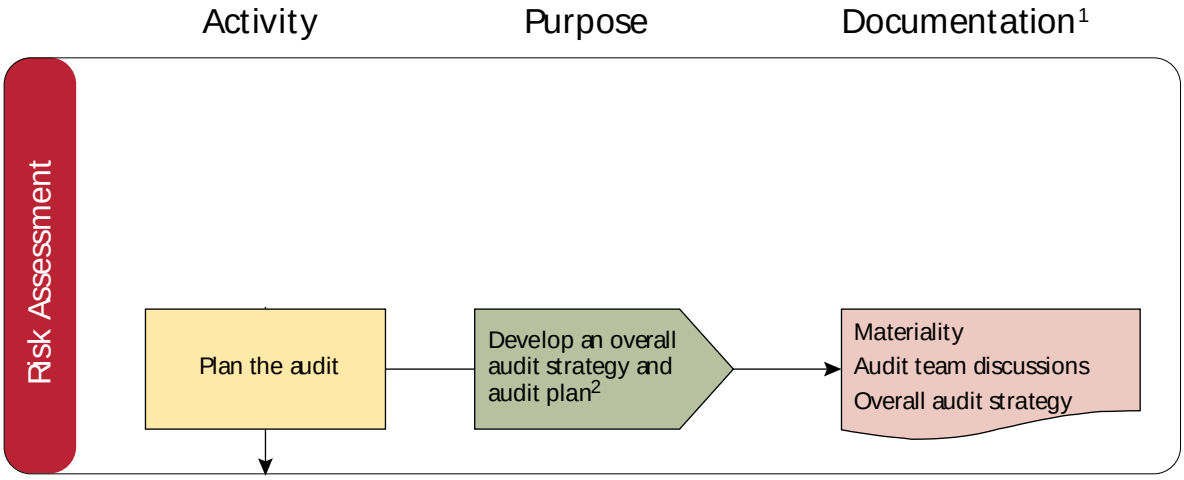
See WP 615 for…..

Prepared by: JF Date: December 8, 20X2

3FWJFXFE CZ: Date: January 5, 20X3

Chapter Content	Relevant ISAs
Purpose and nature of required discussions among the audit team about the susceptibility of the entity's financial statements to material misstatements.	240, 300, 315

Exhibit 7.0-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
240.15	ISA 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
240.44	The auditor shall include the following in the audit documentation of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by ISA 315: (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement EVF UP GSBVE BOE (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
315.10	The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A14-16)

7.1 Overview

A critical element in the success of any audit engagement is good communication among the audit team members. Communication starts with the assignment of team members, arranging the team meeting to plan the engagement, and then continues throughout the engagement. The benefits of good communication include those set out in the following exhibit.

Exhibit 7.1-1

	#FOFöUT
/FFE GPS 0OLRJQU Communication Among the Audit 5FBN .FNCFST	Audit productivity t &BDI QFSTPO PO UIF UFBN XJMM VOEFSTUBOE U reporting framework to be used, what his/her specific role will be in the audit, and the expectations about how and when work will be performed. t 1PUFOUJBM GPS PWFS BOE VOEFS BVEJUJOH XJ
	Audit e ectiveness t 4UBò JT QSPWJEFE JOTJHIUT JOUP UIF DMJFOU senior personnel such as the engagement partner. t 5FBN EJTDVTTJPOT PO UIF TVTDFQUJCJMJUZ PG misstatements will help determine the business and fraud risks that need to be addressed. t #FUUFS EFDJTJPOT XJMM CF NBEF BCPVU UIF O assessment and further audit procedures. t 0QFO MJOFT PG DPNNVOJDBUJPO FOBCMF RVJDL areas such as unusual transactions/events, related parties, and reporting issues.
	Sta development t #FTU QSBDUJDFT JO BVEJUJOH XJMM CF USBOT t 4UBò XJMM CF FODPVSBHFE UP BTL RVFTUJPOT the previous period's responses to assessed risks.

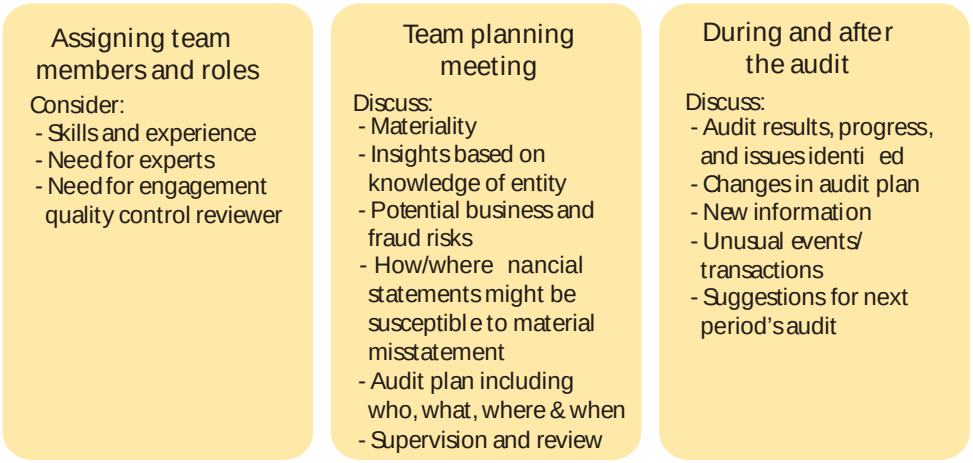
Effective ongoing communication requires:

- *OWPMWFNFOU CZ BOE VOEJWJEFE BUUFOUJPO PG UIF FOH
- 8JMMJOHOFTT PG TFOJPS QFSTPOOFM UP MJTUFO UP KVOJPS
  the perspective of junior staff, encouraging their questions and suggestions, and then providing feedback.

The following exhibit summarizes what to consider and discuss in audit team communications.

Exhibit 7.1-2

Audit Team Communications



$0 / 4 * % &03* /15

Audit team discussions are critical to an effective audit. Avoid the temptation to rush through the agenda due to other time pressures. These discussions enable audit risks to be discussed, fraud scenarios to be developed, and possible responses drafted. It also provides an opportunity for staff to learn about the entity's business and what is expected from them on the audit. Staff can also be encouraged to put forward their ideas on how the audit could be improved.

7.2 Audit Team Planning Meeting

On larger engagements, a planning meeting should be scheduled well in advance of the commencement of fieldwork. This will provide the time necessary to prepare or make changes in the detailed audit plan. On very small engagements, planning may best be achieved through brief discussions at the start of the engagement and as the audit progresses.

Team members should be encouraged to come to the meeting with a questioning mind, and be prepared to participate and share information with an attitude of professional skepticism. They should set aside any beliefs that management and those charged with governance are honest and have integrity. The extent of the discussion should be influenced by the roles, experience, and the information needs of the audit engagement team members.

The three key areas to address are outlined in the exhibit below.

Exhibit 7.2-1

,FZ "SFBT to Address	1VSQPTF 5P IBWF BO PQFO EJTDVTTJPO
Share Insights on UIF &OUJUZ "T UIF 1FPQMF 0QFSBUJPOT BOE 0CKFDUJWFT	5IF FOUJUZ t)JTUPSZ BOE CVTJOFTT PCKFDUJWFT t 5IF DPSQPSBUF DVMUVSF t $IBOHFT JO PQFSBUJPOT QFSTPOOFM PS TZTU t "QQMJDBUJPO PG UIF BQQMJDBCMF öOBODJBM S and circumstances. .BOBHFNFOU t 5IF OBUVSF TUSVDUVSF PG UIF FOUJUZ BOE NB t 5IF BUUJUVEF UPXBSE JOUFSOBM DPOUSPM t *ODFOUJWFT UP DPNNJU GSBVE t 6OFYQMBJOFE DIBOHFT JO UIF CFIBWJPS PS MJ t "OZ JOEJDBUJPOT PG NBOBHFNFOU CJBT ,OPXO SJTL GBDUPST t &YQFSJFODF GSPN QSFWJPVT BVEJU FOHBHFNF t 4JHOJöDBOU CVTJOFTT SJTL GBDUPST t 0QQPSUVOJUZ GPS GSBVE UP CF QFSQFUSBUFE

,FZ "SFBT to Address	1VSQPTF 5P CSBJOTUPSN JEFBT BOE QPTTJCMF
#SBJOTUPSN	Potential for errors and fraud t 8IJDI öOBODJBM TUBUFNFOU BSFBT NBZ CF TVT (fraud and error)? This step is a requirement on all audits. t)PX DPVME NBOBHFNFOU QFSQFUSBUF BOE DPO It may be helpful to develop various fraud scenarios or, where possible, use the services of a forensic accountant. Consider journal entries, management bias in estimates/provisions, changes in accounting policies, etc. t)PX DPVME BTTFUT CF NJTBQQSPQSJBUFE PS NJ t "SF UIFSF OPO TFMöTI JODFOUJWFT TVDI BT UP for-profit entity) to manipulate the financial statements? Response to risks t 8IBU QPTTJCMF BVEJU QSPDFEVSFT BQQSPBDIFT the risks identified above? t $POTJEFS XIFUIFS BO FMFNFOU PG VOQSFEJDU nature, timing, and extent of the audit procedures to be performed.

,FZ "SFBT to Address	1VSQPTF 5P QSPWJEF EJSFDUJPO
Audit Planning	4QFDJöD BSFBT UP BEESFTT Ensure that the specific requirements of all ISAs relevant to the audit are appropriately addressed in the audit plan. ISAs that include specific procedures to be performed include: ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements ISA 402 Audit Considerations Relating to an Entity Using a Service Organization ISA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures ISA 550 Related Parties ISA 600 Audits of Group Financial Statements (Including the Work of Component Auditors) Provide direction to the audit team: t %FUFSNJOF NBUFSJBMJUZ MFWFMT t "TTJHO SPMFT BOE SFTQPOTJCJMJUJFT t 1SPWJEF TUBöX JUI BO PWFSWJFX PG UIF BVEJU completing. Address the approach required, special considerations, timing, documentation required, the extent of supervision provided, file review, and any other expectations. t 4USFTT UIF JNQPSUBODF PG NBJOUBJOJOH QSPGF

Note: If non-key members of the audit team are not able (or are not invited) to attend the meeting, the engagement partner would determine which matters arising are to be communicated to them.

$0/4*%&03*/15

Emphasize the importance for staff to be alert for indications of dishonesty, but also to be careful not to jump to any conclusions, particularly when discussing findings with the entity's management or staff. Indicate possible circumstances (red flags) that, if encountered, might indicate the possibility of fraud.

Fraud is generally discovered by identifying patterns, exceptions, and oddities in transactions and events. For example, a false claim in an expense account would be immaterial to the financial statements by itself, but could be indicative of a much larger issue such as lack of management integrity.

7.3 Communication During and At Completion of the Audit

Each member of the audit team will have a slightly different perspective on the entity. Some of the information gathered by a particular team member may not even make sense unless it is combined with information obtained by other team members. This is particularly true in relation to fraud, where it is the identification of small patterns, oddities, and exceptions that may lead to its ultimate detection.

" TJNQMF BOBMPHZ JT UIF KJHTBX QV[[MF &BDI QBSU CZ JUTFMG E when all the pieces are put together that the big picture can be seen. The same is true in auditing. It is only when the individual knowledge/findings of each auditor are shared with the team that the bigger picture emerges. This is illustrated in the following exhibit.

Exhibit 7.3-1
4 I B S J ƛ DHE J O H T

Team discussions need not be confined to just the planning meeting. Audit team members should be encouraged to communicate and share the information that they obtain throughout the audit on any matters of relevance, particularly when it affects the assessment of risk and planned audit procedures.

$0 / 4 * % &03* /15

) P M E T I P S U E F C S J F öO H N F F U J O H T B U T U S B U F H J D U J N F T E V S J C
In addition to the audit planning discussions at the start of the engagement, it may be beneficial (but not required) for the audit team, however small, to meet (or arrange a conference call) and discuss audit findings after the following audit phases.

Performing risk assessment procedures and further audit procedures
These debriefing sessions do not need to be formal or long, but they enable audit team members to report verbally on their findings, exceptions found, and concerns noted. They can also report on any matters (however small) that seemed odd or did not make sense. It is often the small matters that, when combined with information obtained by other team members, point to a possible risk factor (such as fraud) that may require further work to be performed. Even when the audit team comprises only two people, these meetings can yield significant results.

$0 / 4 * % &03* /15continued

Completing the audit

Once the previous audit is complete, the temptation is always to move on and start the next engagement. As a result, a lot of knowledge that could be helpful for performing the next period's audit can get lost. A short meeting or conference call after each audit could be used to obtain feedback from the audit team and determine what can be improved. This would include identifying:

- "VEJU BSFBT UIBU NJHIU SFRVJSF BEEJUJPOBM PS MFTT
- "OZ PUIFS VOFYQFDUFE öOEJOHT VOVTVBM USBOTBDUJPO CF BO JOEJDBUPS PG GSBVE PS BO JODFOUJWF UP DPNNJU
- "OZ QMBOOFE DIBOHFT UIBU XJMM BòFDU GVUVSF FOHBHFN financing, an acquisition, new products or services, the installation of a new accounting system, or PUIFS JOUFSOBM DPOUSPM DIBOHFT
- "SFBT XIFSF BEEJUJPOBM BTTJTUBODF DPVME CF QSPWJEF öOBODJBM TUBUFNFOU BSFBT BOE
- 8IFSF TJHOJöDBOU SJTL GBDUPST FYJTU UIF EFCSJFöOH N wishes to continue with the client the following period. If the firm resigns right after the audit finishes, the reasons will be fresh in everyone's mind, and it would provide the entity with more time to find another auditor.

At the initial planning meeting, a time and date for these debriefing sessions can be scheduled.

7.4 Case Studies—Audit Team Discussions

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

The most recent financial statements, the listing of assessed risks from previous periods (or this period, if updated), and the audit response could usefully be circulated to engagement team members before the meeting. At the meeting, emphasize the need for professional skepticism, and the need to immediately report any suspicious situations or possible warning signals of fraud.

Documentation may be in the form of a standard agenda or a memo to file.

$BTF 4UVEZ " ‰ %FQIUB 'VSOJUVSF *OD

Date of meeting: December 8, 20X2

Agenda item	Minutes of meeting
1. Materiality and significant account balances.	Increase overall materiality to 10,000 based on growth in pro tability and sales, and performance materiality to 7,500.
2. Timing, key dates, and availability of client personnel.	Con rmed that last period's timing is appropriate BOE PVS SFRVFTUT GPS NBOBHFNF certain schedules are reasonable.
3. What can we learn from past experience such as issues/events that caused delays and areas of over-/under-auditing?	Inventory internal control was poor last year and resulted in additional work. Client has indicated that this will be addressed before this period end.
4. Any new concerns about management integrity, going concern, litigation, etc.?	See newspaper clipping re: Parvin. This may be isolated but we need to be cautious.
5. Changes this period in business operations and/or financial condition, industry regulations, accounting policies used, and people.	Internet sales now account for 12% of sales. There are also plans for signi cant growth. This will put a strain on cash resources, internal control, and the operating systems. The current economic downturn puts additional pressure on the organization to maintain sales levels despite the drop in demand and sales prices.
6. Susceptibility of the financial statements to fraud. In what possible ways could the entity be defrauded? Develop some possible scenarios, and then plan procedures that would confirm or dispel any suspicions.	Management bias and override to avoid tax liability are possible. Management's estimates, journal entries, and related party transactions are susceptible to manipulation. Also, Arjan (the senior salesperson) lives an expensive lifestyle. We should also look at the bonus calculations and the sales revenue.
7. Significant risks that require special attention.	Defaulting on bank covenants. Suraj says he is going to renegotiate the bank terms this period to provide some exibility.
8. Appropriate audit responses to the risks identified.	The detailed audit plan was reviewed in some detail with the sta member responsible and a number of e ciencies were identi ed.
9. Consider the need for specialized skills or consultants, testing internal controls vs. substantive procedures, the need to introduce unpredictability in some audit tests, and work that could be completed by the client.	IT specialist to look at Internet sales and IT controls in general. Scheduled visit for December this period.
10. Audit team roles, scheduling, and file reviews	Overall and detailed audit plans have been updated.
Prepared by: FJ Date: December 8, 20X2 Reviewed by: LF Date: January 5, 20X3	

.FNP UP öMF Kumar & Co.

On December 8, 20X2, the audit team (partner and senior) met to plan the Kumar & Co. audit engagement.

We discussed the following:

- 0WFSBMM NBUFSJBMJUZ IBT CFFO EFDSFBTFE UP k CBT Performance materiality has been set at 1,800€.
- 3BK T GPDVT IBT CFFO EJWFSUFE SFDFOUMZ UP QFSTPOBM not be adequately reviewed. That leaves Ruby with a lot of control over the reported numbers. Any unintentional or intentional errors of Ruby's could go undetected. This should be treated as a significant fraud risk in the audit.
- .BOBHFNFOU CJBT BOE PWFSSJEF DPVME PDDVS UP BWPJE Management's estimates have traditionally been conservative. The audit team was reminded to be alert for anything that appears unusual.
- 8F XJMM QBZ DBSFGVM BUUFOUJPO UP USBOTBDUJPOT BOE Dephta.

Audit Plan:

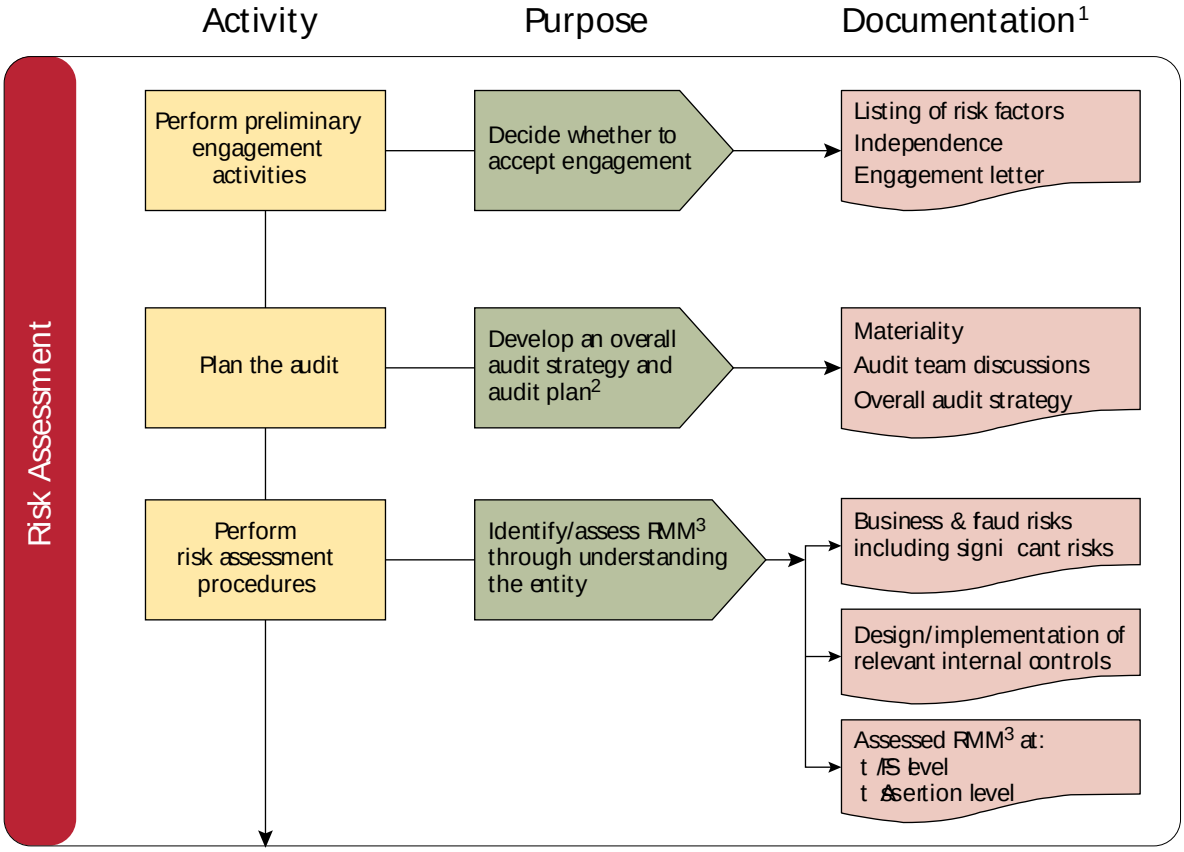
- $PO öSNFE UIBU MBTU QFSJPE T UJNJOH JT BQQSPQSJBUF E preparing certain schedules. However, since Kumar & Co. had a difficult time getting the requested schedules for us on time last period, we will spend time this period with Ruby in advance, and provide her with example schedules to ensure that she understands what is needed and the required due dates.
- 5IF EFUBJMFE BVEJU QMBO XBT SFWJFXFE JO TPNF EFUBJM based on the assessed risk, and a number of other procedures were eliminated where the assessed risk was low.
- 8F EFDJEFE UIBU JU XJMM CF NPSF FóDJFOU UP QFSGPSN of controls, as there are no assertions where substantive procedures alone would not provide sufficient appropriate audit evidence.

Prepared by: FJ Date: December 8, 20X2

3FWJFXFE Date: January 5, 20X3

Chapter Content	Relevant ISAs
How to identify risks of material misstatement in the financial statements.	240, 315

Exhibit 8.0-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	*4" 0CKFDUJWF T
240.10	The objectives of the auditor are: B 5P JEFOUJGZ BOE BTTFTT UIF SJTLT PG NBUFSJBM NJTTUBU (b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material NJTTUBUFNFOU EVF UP GSBVE UISPVHI EFTJHOJOH BOE JNC (c) To respond appropriately to fraud or suspected fraud identified during the audit.
315.3	The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
200.13	For purposes of the ISAs, the following terms have the meanings attributed below: (n) Risk of material misstatement ‰The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level: (i) Inherent risk—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. (ii) Control risk—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
240.11	For purposes of the ISAs, the following terms have the meanings attributed below: (a) Fraud—An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. (b) Fraud risk factors ‰Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.
240.12	In accordance with ISA 200, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7- A8)
240.13	Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)
240.15	ISA 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
240.17	The auditor shall make inquiries of management regarding: (a) Management's assessment of the risk that the financial statements may be materially NJTTUBUFE EVF UP GSBVE JODMVEJOH UIF OBUVSF FYU (Ref: Para. A12-A13) (b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for XIJDI B SJTL PG GSBVE JT MJLFMZ UP FYJTU 3FG 1BSB (c) Management's communication, if any, to those charged with governance regarding its QSPDFTTFT GPS JEFOUJGZJOH BOE SFTQPOEJOH UP UIF S (d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.
240.18	The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15-A17)
240.22	The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.
240.23	The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)
240.24	The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)
240.44	The auditor shall include the following in the audit documentation of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by ISA 315: (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement EVF UP GSBVE BOE (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
315.11	The auditor shall obtain an understanding of the following: (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A17-A22) (b) The nature of the entity, including: J JUT PQFSBUJPOT JJ JUT PXOFSTIJQ BOE HPWFSOBODF TUSVDUVSFT (iii) the types of investments that the entity is making and plans to make, including JOWFTUNFOUT JO TQFDJBM QVSQPTF FOUJUJFT BOE (iv) the way that the entity is structured and how it is financed to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A23-A27) (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A28) (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A29-A35) (e) The measurement and review of the entity's financial performance. (Ref: Para. A36-A41)

8.1 Overview

Identification of risk is the foundation of the audit. It is based upon, and forms an integral part of, the auditor's procedures to understand the entity and its environment. Without a solid understanding of the entity, the auditor may miss certain risk factors. For example, if a client's sales were increasing, it would be important for the auditor to know that the industry sales as a whole were actually in sharp decline.

The objective of the risk assessment phase of the audit is to identify sources of risk, and then to assess whether they could possibly result in a material misstatement in the financial statements. This provides the auditor with the information needed to direct audit effort to areas where the risk of material misstatement is the highest, and away from less risky areas.

Risk assessment has two distinct parts:

- 3JTL JEFOUJöDBUJPO BTLJOH iXIBU DBO HP XSPOHw BOE
- 3JTL BTTFTTNFOU EFUFSNJOJOH UIF TJHOJöDBODF PG FBDI

Risk assessment is addressed in Volume 2, Chapter 9.

Risk identification is illustrated below.

Exhibit 8.1-1

$0 / 4 * % &03* /15

'JSTU JEFOUJGZ UIF SJTLT

You cannot assess a risk that has not first been identified. Avoid the temptation to assume that because the entity is small, there are no relevant risks or that the risks of material misstatement will be the same as the previous period. New risks may now exist, and the nature/significance of some previously identified risks may have changed.

"GUFS UIF öSTU FOHBHFNFOU GPDVT PO XIBU IBT DIBOHFE GS

After the first engagement, focus on what has changed within each of the six risk sources (see Exhibit 8.4-1) as opposed to starting all over again. This will save time, and focuses attention on the nature and effect of new risks that may now exist and revisions to risks previously identified.

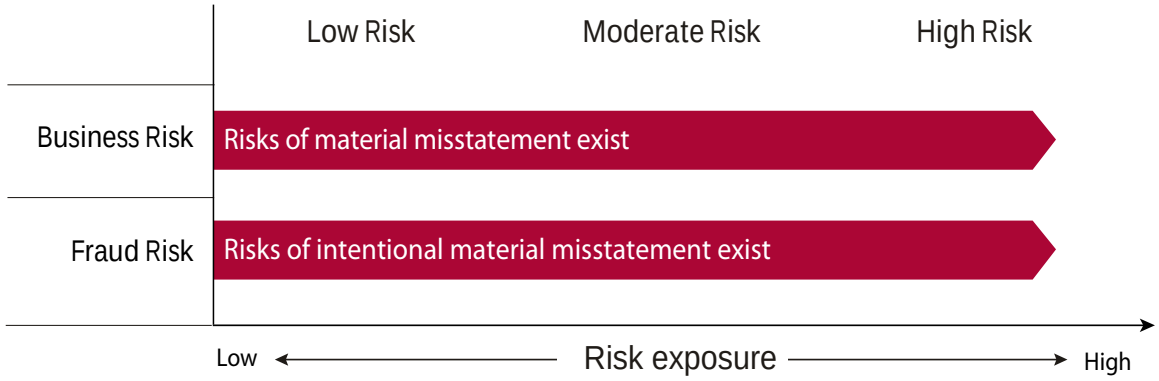
8.2 Types of Risk

There are two major classifications of risk:

- #VTJOFTT SJTL BOE
- 'SBVE SJTL

The difference between business risk and fraud risk is that fraud risk results from a person's deliberate actions. This is illustrated in the following exhibit.

Exhibit 8.2-1



Note: In many instances, a risk can be both a business and a fraud risk. For example, the introduction of a new accounting system creates uncertainty (errors could be made as personnel learn the new system) and would be classified as a business risk. However, it could also be classified as a fraud risk, because someone could take advantage of the uncertainty to misappropriate assets or manipulate the financial statements.

Business Risk

The term "business risk" encompasses more than just the risks of material misstatement in the financial statements. 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. This could also include the setting of inappropriate objectives and strategies.

Business risk also includes events that arise from change, complexity, or the failure to recognize the need for change. Change may arise, for example, from:

- 5IF EFWFMPQNFOU PG OFX QSPEVDUT UIBU NBZ GBJM
- "O JOBEFRVBUF NBSLFU FWFO JG OFX QSPEVDUT BSF TVDDF
- 'MBXT JO UIF QSPEVDUT UIBU NBZ SFTVMU JO MJBCJMJUJFT

Fraud Risk

Fraud risk relates to events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

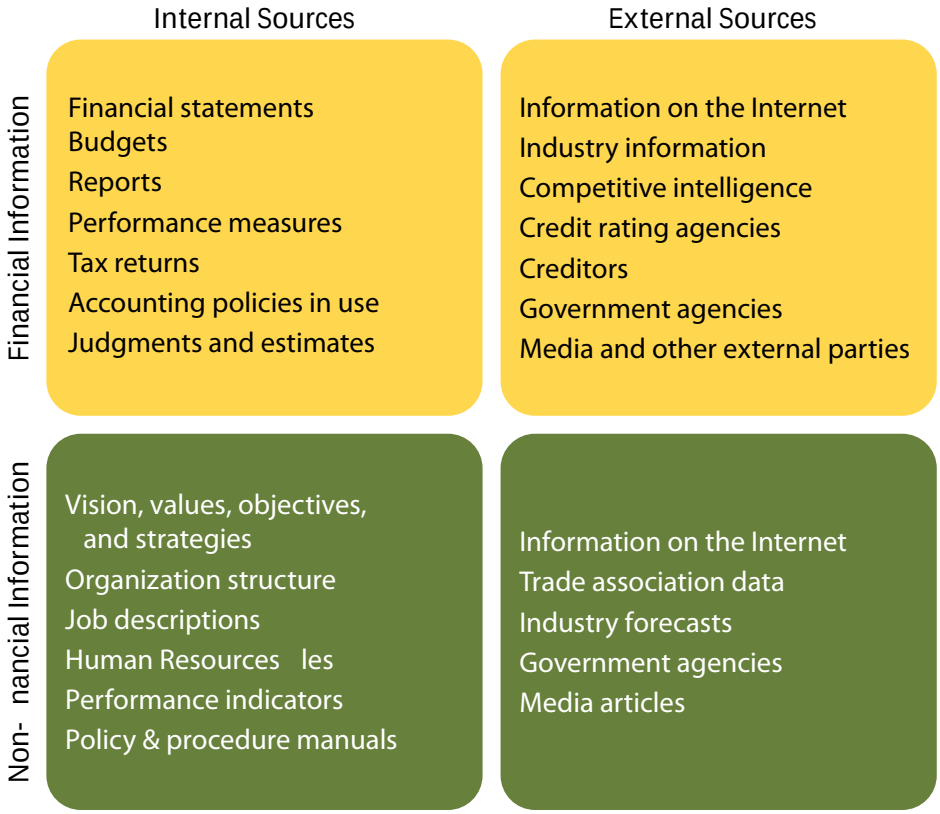
The auditor's understanding of business and fraud risk factors increases the likelihood of identifying the risks of material misstatement. However, there is no responsibility for the auditor to identify or assess all of the possible business risks.

8.3 Sources of Information about the Entity

The first step in the risk assessment process is to gather (or update) as much relevant information about the entity as possible. This information provides an important frame of reference for identifying and assessing possible risk factors.

Information about the entity and its environment can be obtained from both internal and external sources. In many cases, the auditor will start with internal sources of information. This information can then be checked for consistency with information obtained from external sources such as trade association data and data about general economic conditions, which can often be obtained from the Internet. The following exhibit shows some of the potential sources of information available.

Exhibit 8.3-1



$0 / 4 * % &03* /15

A major source of information that is often overlooked is the auditor's working paper files from previous periods' engagements. They often contain valuable information on matters such as:

- $POTJEFSBUJPOT PS JTTVFT UP BEESFTT JO QMBOOJOH UI
- &WBMVBUJPO BOE TPVSDF PG QPTTJCMF BEKVTUNFOUT BO
- "SFBT XIFSF UIFSF BSF SFDVSSJOH EJTBHSFFNFOUT TVDI BT
- "SFBT XIJDI BQQFBS UP CF TVTDFQUJCMF UP FSSPS BOE
- .BUUFST SBJTFE JO UIF BVEJUPS T DPNNVOJDBUJPO XJUI NBO

The information gained from risk assessment procedures conducted before engagement acceptance or continuance can be used as part of the audit team's understanding of the entity.

8.4 Risk Assessment Procedures

Based on the information obtained about the entity, the auditor is now in a position to design the risk assessment procedures discussed in Volume 1, Chapter 8. These risk assessment procedures will be designed to obtain and document an understanding of the entity and its environment, including internal control.

The scope of the understanding required by the auditor for identifying risks is contained in six key areas, as follows.

Exhibit 8.4-1

A. External Factors	Nature of industry Regulatory environment Financial reporting framework
B. Nature of Entity	Operations and key personnel Ownership and governance Investment, structure and financing
C. Accounting Policies	Selection and application Reasons for changes Appropriateness to entity
D. Entity Objectives & Strategies	Business plans and strategies Financial implications and risks undertaken
E. Measurement/ Review of Financial Performance	What is measured Who reviews financial results
F. Internal Control Relevant to the Audit	Processes and relevant controls to mitigate risks at the entity level and at the transactional level

The sufficiency of information (depth of understanding) required by the auditor is a matter of professional judgment. It is less than that possessed by management in managing the entity. The last section ("F" in the exhibit above), which relates to internal controls relevant to the audit, is discussed in Volume 1, Chapter 5, and Volume 2, Chapters 4, 11, and 12.

Obtaining an understanding of the nature of the entity and its environment, including internal control, has a number of benefits, as outlined below.

Exhibit 8.4-2

1SPWJEFT B 'SBNF PG 3FGFSFODF	
#FOFöUT 0CUBJOFE GSPN.BLJOH KVEHNFOUT BCPVU UIF SJTL BTTFTTNFO 6OEFSTUBOEJOH%FWFMPQJOH BQQSPQSJBUF SFTQPOTFT UP JEF the Entity	Identifying risks and developing responses in the financial statements. t &TUBCMJTIJOH NBUFSJBMJUZ SFGFS UP 7PMVN t %FWFMPQJOH FYQFDUBUJPOT OFFEFE GPS QFS t %FTJHOJOH QFSGPSNJOH GVSUIFS BVEJU QSPD acceptably low level. t &WBMVBUJOH TVóDJFODZ BQQSPQSJBUFOFTT PG appropriateness of assumptions used and management's oral and written representations). 'JOBODJBM TUBUFNFOU SFWJFX t "TTFTTJOH NBOBHFNFOU T TFMFDUJPO BOE BQQ t $PNQMFUJOH UIF BEFRVBDZ PG öOBODJBM TUB t *EFOUJGZJOH BVEJU BSFBT GPS TQFDJBM DPOT unusual or complex contractual arrangements, going concern or unusual transactions).

$0 / 4 * % &03* /15

Obtaining an understanding of the entity is not a discrete task that can be completed early in the audit and then put to one side. It is important to keep learning about the entity throughout the audit, and to remain alert to risk factors not previously identified or where the original assessment of risk needs updating.

8.5 Sources of Risk

Errors and fraud in financial statements arise from risk factors that have their origin in one or more of the six required areas of understanding the entity (see Exhibit 8.4-1).

An example would be a new and complex tax being imposed on the entity. This would be an external risk factor. A risk of misstatement in the financial statements could be a misinterpretation of the new law, resulting in an incorrect calculation of tax payable and the amount owed. Note that the source (or cause) of the risk is the new tax that affects the entity, and not the error in calculation, which is the effect of the risk factor. As a consequence of the new tax, the risk of a calculation error increases.

The following exhibit shows the six required areas of understanding as being potential sources of risk. Note that the that sources of risk do not usually relate to a specific financial statement area. For example, a downturn in the economy could result in misstatements in many financial statement areas such as inventory,

receivables, sales etc. So first identify the source of the risk and then identify where the misstatements could consequently occur in the financial statements.

Exhibit 8.5-1

Examples of sources of risk (but not the effect on specific financial statement areas) are outlined below.

Exhibit 8.5-2

4PVSDFT PG #VTJOFTT BOE 'SBVE 3JTL	
Entity 0CKFDUJWFT and Strategies	t *OBQQSPQSJBUF VOSFBMJTUJD PS PWFSMZ BH t /FX QSPEVDUT PS TFSWJDFT PS NPWJOH JOUP t &OUFSJOH JOUP CVTJOFTT BSFBT USBOTBDUJPC experience. t *ODPOTJTUFODJFT CFUXFFO *5 BOE CVTJOFTT T t 3FTQPOTF UP SBQJE HSPXUI PS EFDMJOF JO TB systems and people's skills. t 6TF PG DPNQMFY öOBODJOH BSSBOHFNFOUT t $PSQPSBUF TUSVDUVSJOHT t 4JHOJöDBOU USBOTBDUJPOT XJUI SFMBUFE QBS

4PVSDFT PG #VTJOFTT BOE 'SBVE 3JTL	
&YUFSOBM 'BDUPST	t 4UBUF PG UIF FDPOPNZ BOE DIBOHFT JO HPWFS t %FDMJOJOH EFNBOE GPS UIF FOUJUZ T QSPEVD t)JHI EFHSFF PG DPNQMFY SFHVMBUJPO t $IBOHFT JO UIF JOEVTUSZ t *OBCJMJUZ UP PCUBJO SFRVJSFE SFTPVSDFT N t %FMJCFSBUF TBCPUBHF PG BO FOUJUZ T QSPEV t $POTUSBJOUT PO UIF BWBJMBCJMJUZ PG DBQJU
Nature of Entity	t 1PPS DPSQPSBUF DVMUVSF BOE HPWFSOBODF t *ODPNQFUFOU QFSTPOOFM JO LFZ QPTJUJPOT t $IBOHFT JO LFZ QFSTPOOFM JODMVEJOH EFQBS t $PNQMFYJUZ JO PQFSBUJPOT PSHBOJ[BUJPOBM t 1SPEVDU PS TFSWJDF øBXT UIBU NBZ SFTVMU J t 'BJMVSF UP SFDPHOJ[F UIF OFFE GPS DIBOHF T t 8FBLOFTTFT JO JOUFSOBM DPOUSPM FTQFDJBM t 1PPS SFMBUJPOTIJQT XJUI FYUFSOBM GVOEFST t (P JcOHern and liquidity issues, including loss of significant customers. t *OTUBMMBUJPO PG OFX TZTUFNT SFMBUFE UP ö
Performance Indicators	t 1FSGPSNBODF NFBTVSFT OPU VTFE CZ NBOBHFN performance and achievement of objectives. t .FBTVSFT OPU VTFE UP JNQSPWF PQFSBUJPOT P
Accounting Policies	t *ODPOTJTUFOU BQQMJDBUJPO PG BDDPVOUJOH t *OBQQSPQSJBUF VTF PG BDDPVOUJOH QPMJDJF
Internal Control	t *OBEFRVBUF NBOBHFNFOU PWFSTJHIU PG EBZ U t 1PPS PS OPOFYJTUFOU DPOUSPMT PWFS FOUJU resources, fraud, and preparation of accounting information such as estimates and financial reports. t 1PPS PS OPOFYJTUFOU DPOUSPMT PWFS USBOT expenses, and payroll. t 1PPS TBGFHVBSEJOH PG BTTFUT

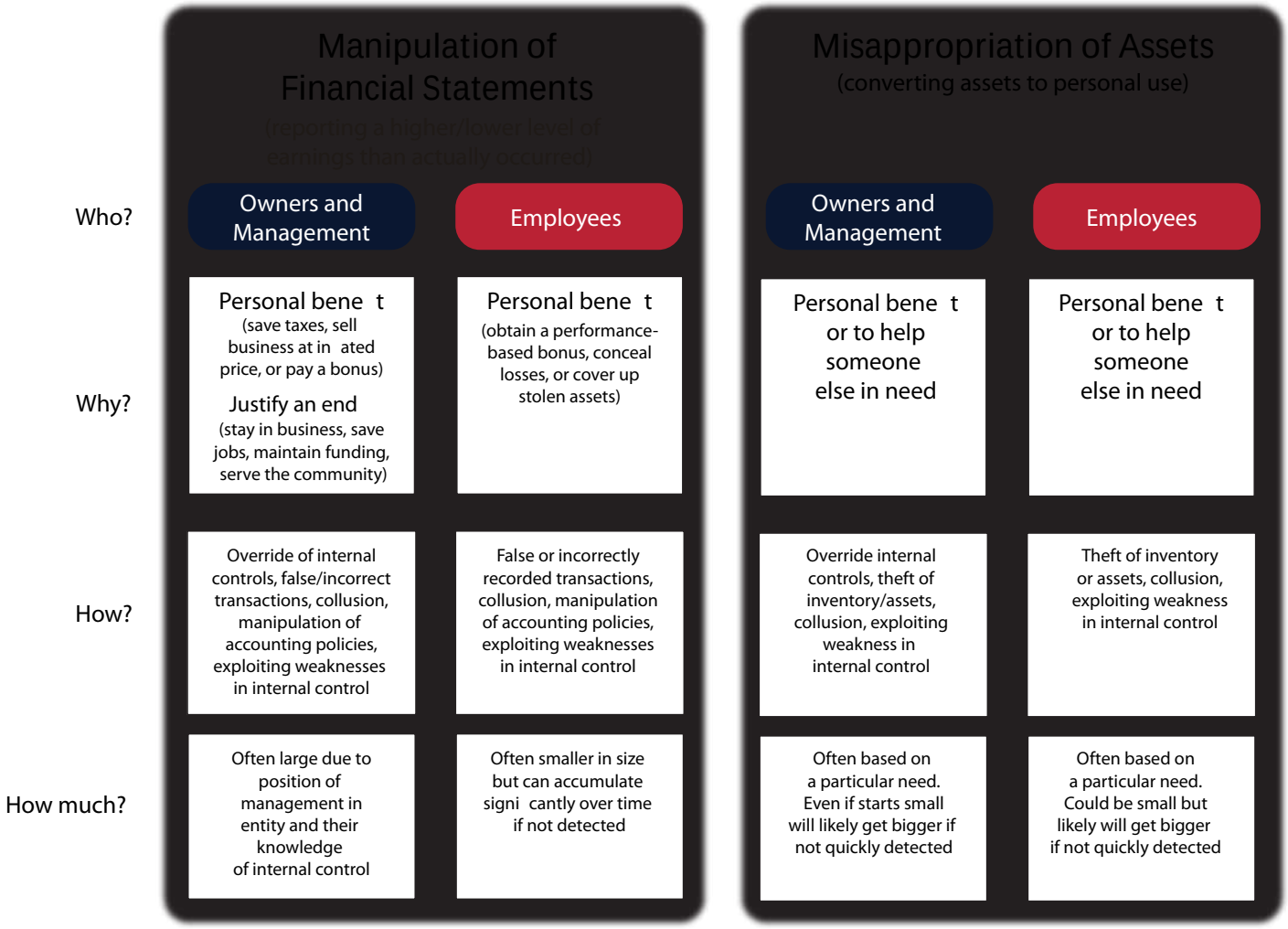
8.6 Fraud Risk

The term “fraud” refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties involving the use of deception to obtain an unjust or illegal advantage.

Fraud involving one or more members of management or those charged with governance is referred to as “management fraud.” Fraud involving only employees of the entity is referred to as “employee fraud.” In either case, there may be collusion within the entity or with third parties outside of the entity.

The following exhibit outlines the types and characteristics of fraud.

Exhibit 8.6-1



$0 / 4 * % &03* /15

For each risk factor identified, consider whether it is a business risk, a fraud risk, or both. Many sources of risk can result in both business and fraud risks. For example, a change in accounting personnel can result in errors being made (business risk), but may also provide an opportunity for someone to commit a fraud.

8.7 Types and Characteristics of Fraud

Although fraud can occur at any level in the organization, it tends to be more serious (and involve higher monetary amounts) when senior management is involved.

Some of the major conditions that create an environment for fraud include:

t * O F ò FDDPUSJQWHRSPBWUFS O B O D F

t - B D L P G M F B E F S T I J Q C Z N B O B H F N F O U B O E Q P P S iU P O F B U U

t) J H I J O D F O U J W F T Q S P W J E F E G P S öO B O D J B M Q F S G P S N B O D F

- 5BYFT PS PUIFS FYQFOTFT UIBU BSF DPOTJEFSFE WFSZ IJHI
- $PNQMFYJUZ JO UIF FOUJUZ T SVMFT SFHVMBUJPOT BOE Q
- 6OSFBMJTUJD FYQFDUBUJPOT GSPN CBOLFST JOWFTUPST F
- %PXOXBSE BOE VOFYQFDUFE TIJGUT JO QSPöUBCJMJUZ
- 6OSFBMJTUJD CVEHFU UBSHFUT GPS TUBò UP BUUBJO BOE
- *OBEFRVBUF JOUFSOBM DPOUSPM FTQFDJBMMZ JO UIF QSFT

As can be determined from the above, the most effective anti-fraud internal control would be a strong commitment by those in governance and senior management positions to doing the right thing. This is evidenced through articulated entity values and a commitment to ethics that are modeled on a day-to-day basis. This is true for any size of organization.

8.8 The Fraud Triangle

In conducting risk assessment procedures, audit team members need to consider the existence of the three conditions that often provide clues to the existence of fraud. Forensic accountants often refer to this as the "fraud triangle" (see exhibit below) because when all three conditions are present, it is highly likely that fraud may be occurring.

The conditions are:

- 1SFTTVSF
  This is often generated by immediate needs (such as having significant personal debts or meeting an analyst's or bank's expectations for profit) that are difficult to share with others.
- 0QQPSUVOJUZ
  A poor corporate culture and a lack of adequate internal control procedures can often create confidence that a fraud could go undetected.
- 3BUJPOBMJ[BUJPO
  Rationalization is the belief that a fraud has not really been committed. For example, the perpetrator rationalizes that "this is not a big deal" or "I am only taking what I deserve."

Exhibit 8.8-1

For example, an owner-manager in the construction business might be offered a job to build a significant addition to a friend's house, as long as it is a cash-only transaction with no paperwork involved. Consider

the three conditions.

- The "pressure" on the owner-manager might be to reduce taxes that would otherwise be payable.
- The "opportunity" is for the owner-manager to override the internal controls over revenue recognition and not record the revenue from the sale.
- The "rationalization" would be that the owner-manager is already paying far too much in taxes.

Note: If any one of the three conditions is not present, the cash sale is unlikely to take place.

Consider the three sources of fraud risk set out below.

Exhibit 8.8-2

Sources of Fraud Risk	
Incentives and Pressures	• Financial stability or profitability of the entity's operating conditions. • Excessive pressure on management or operating personnel to meet expectations of third parties or those charged with governance (such as earnings targets or compliance with onerous environmental regulations, etc.). • Personal financial obligations of employees with access to cash or other assets susceptible to theft to misappropriate those assets. • Adverse relationships between the entity and employees with access to cash or other assets. For example: – Known or anticipated future employee layoffs, – Recent or anticipated changes to employee compensation or benefit plans, and – Promotions, compensation, or other rewards inconsistent with expectations. • The personal financial situation of management or governance may be threatened by the entity's financial performance (such as financial interests, compensation, guarantees, etc.).
Attitudes and Rationalizations	Attitudes and Rationalizations • Management is intentionally misrepresenting earnings in order to: – Minimize reported earnings for tax-motivated reasons, and – Increase reported earnings to avoid violating bank covenants, increase the sale price of the entity, or meet targets set by a third party. • Employees with access to assets susceptible to theft • Known history of violations of securities laws • Management is unresponsive to communications from employees, ineffective in communicating, implementing, supporting or enforcing the entity's values or ethical standards • Management fails to correct known reportable conditions on a timely basis. For example, action is taken when an employee is caught stealing. • Management does not communicate adequately the entity's • Management gives inappropriate significance to the misappropriations of assets.

4PVSDFT PG 'SBVE 3JTL	
Attitudes and 3BUJPOBMJ[BUJPOT (continued	Attitudes t .BOBHFNFOU IBT B LOPXO IJTUPSZ PG WJPMBUJ allegations of fraud. t .BOBHFNFOU FYIJCJUT DIBOHFT JO CFIBWJPS PS have been misappropriated. t 4FOJPS NBOBHFST EFNPOTUSBUF B QPPS FUIJD accounts and committing petty thefts, etc.). t .BOBHFNFOU IBT PWFSSJEEFO FYJTUJOH DPOUS t .BOBHFNFOU IBT GBJMFE UP UBLF BQQSPQSJBU deficiencies in internal control. t 5IF PXOFS NBOBHFS NBLFT OP EJTUJODUJPO CFUXFF t %JTQVUFT FYJTU CFUXFFO TIBSFIPMEFST JO B t .BOBHFNFOU NBLFT SFDVSSJOH BUUFNQUT UP K accounting on the basis of materiality. t 5IF SFMBUJPOTIJQ CFUXFFO NBOBHFNFOU BOE UIF DV
0QQPSUVOJUJFT	Assets susceptible to misappropriation t -BSHF BNPVOUT PG DBTI PO IBOE PS QSPDFTTF t *OWFOUPSZ JUFNT UIBU BSF TNBMM JO TJ[F PG t &BTJMZ DPOWFSUJCMF BTTFUT TVDI BT CFBSFS t 1SPQFSUZ QMBOU BOE FRVJQNFOU BSF TNBMM identification of ownership.
	Inadequate internal controls t *OBEFRVBUF PWFSTJHIU CZ UIPTF DIBSHFE XJU processes for identifying and responding to the risks of fraud. t *OBEFRVBUF TFHSFHBUJPO PG EVUJFT PS DIFDL t *OBEFRVBUF PWFSTJHIU PG TFOJPS NBOBHFNFC t *OBEFRVBUF NBOBHFNFOU PWFSTJHIU PG FNQM t *OBEFRVBUF KPC BQQMJDBOU TDSFFOJOH GPS t *OBEFRVBUF SFDPSE LFFQJOH XJUI SFTQFDU UP t *OBEFRVBUF BVUIPSJ[BUJPO BOE BQQSPWBM PG t *OBEFRVBUF QIZTJDBM TBGFHVBSET PWFS DBTI plant, and equipment. t -BDL PG DPNQMFUF BOE UJNFMZ SFDPODJMJBUJ t -BDL PG UJNFMZ BOE BQQSPQSJBUF EPDVNFOUE merchandise returns). t -BDL PG NBOEBUPSZ WBDBUJPOT GPS FNQMPZFI t *OBEFRVBUF NBOBHFNFOU VOEFSTUBOEJOH PG enables information-technology employees to perpetrate a misappropriation. t *OBEFRVBUF BDDFTT DPOUSPMT PWFS BVUPNBU review of computer systems event logs.

4PVSDFT PG 'SBVE 3JTL	
0QQPSUVOJUJFT (continued	4QFDJöD BSFBT PG WVMOFSBCJMJUZ t .BOBHFNFOU FTUJNBUFT SFWFOVF SFDPHOJUJP with related parties, etc.

$0 / 4 * % &03* /15

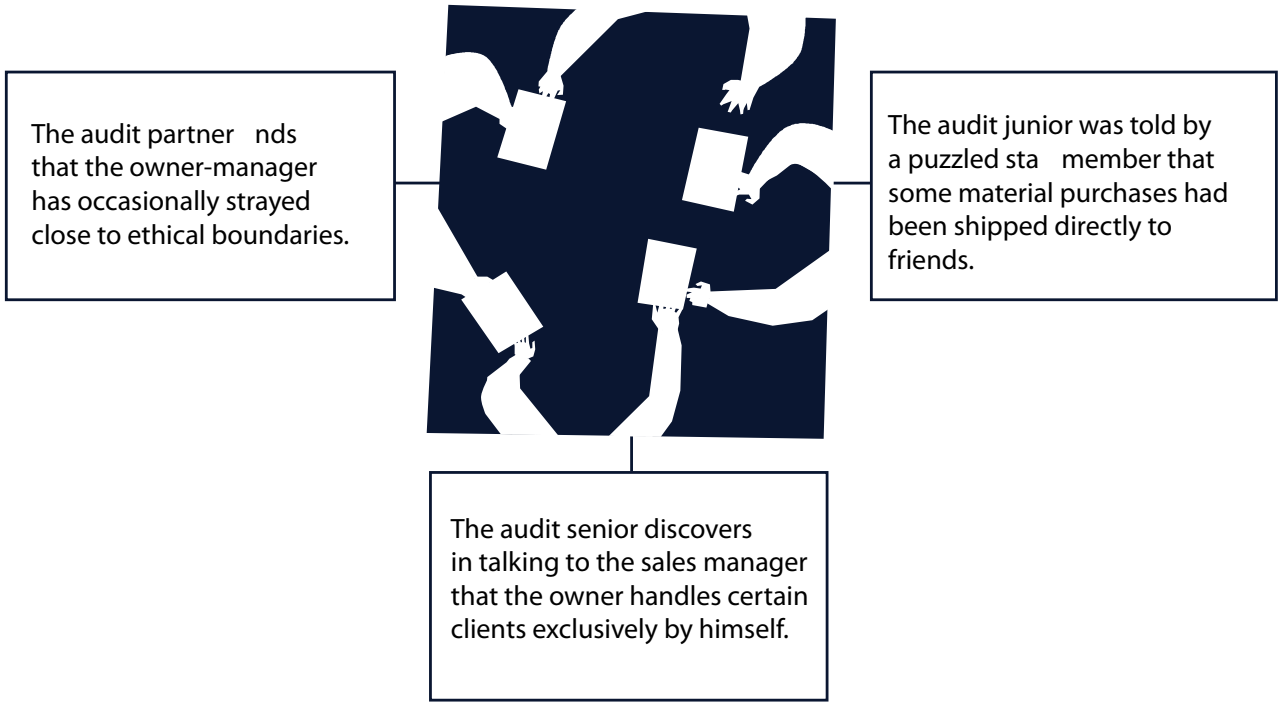
Fraud is always intentional. It involves concealment of information from the auditor and deliberate misrepresentations. Consequently, fraud is discovered by looking for patterns, oddities, and exceptions, often in what might be considered very small monetary amounts.

Fraud is unlikely to be detected through substantive procedures alone. For example, an auditor is unlikely to identify a missing transaction or determine that a transaction is invalid unless there is some additional "understanding of the entity" that can be used as a frame of reference.

Auditors, depending on their role and position on the audit team, may identify a fraud risk factor that relates to one or more of the triangle elements. However, it is less likely that any one auditor will identify all three conditions (opportunity, pressure, and rationalization) together. For this reason, it is important for the audit team to continually discuss their findings throughout the engagement.

The benefits of audit team discussions are outlined in the exhibit below.

Exhibit 8.8-3



In the absence of communication, it would be difficult for any single member of the above audit team to see the big picture. Ongoing audit team discussion enables the team to pull together small pieces of information so that the bigger picture can be seen.

8.9 Professional Skepticism

It is the responsibility of the auditor to maintain an attitude of professional skepticism at all times during the engagement. An attitude of professional skepticism involves matters outlined in the following exhibit.

Exhibit 8.9-1

Skepticism Involves:	
3 F D P H O S J [B O M . B O B H F N F O U $ B O " M X B Z T $ P N N J U ' S B V E	Management is always in a position to override otherwise good internal control. Engagement team members are to set aside any beliefs that management and those charged with governance are honest and have integrity, notwithstanding the auditor's past experience of their honesty and integrity.
A Questioning . J O E	Make critical assessments about the validity of audit evidence obtained.
# F J O H " M F S J	Does audit evidence contradict or bring into question the reliability of: t % P D V N F O U T B O E S F T Q P O T F T U P J O R V J S J F T t 0 U I F S J O G P S N B U J P O P C U B J O F E G S P N N B O B H F N F governance?
# F J O H $ B S F G V M	Avoid: t 0 W F S M P P L J O H V O V T V B M D J S D V N T U B O D F T t 0 W F S H F O F S B M J [J O H X I F O E S B X J O H D P O D M V T J P t 6 T J O H G B V M U Z B T T V N Q U J P O T J O E F U F S N J O J O H audit procedures and evaluating the results thereof. t " D D F Q U J O H M F T T U I B O Q F S T V B T J W F B V E J U F W J those charged with governance are honest and have integrity. t " D D F Q U J O H S F Q S F T F O U B U J P O T G S P N N B O B H F N F sufficient appropriate audit evidence.

$0 / 4 * % &03* /15

Applying professional skepticism to an audit of a client you know and trust can be difficult. There is a natural human tendency to place trust in people, assuming there is no information to the contrary. Consequently, partners and staff need to be reminded on a regular basis to apply professional skepticism. Some practical suggestions for applying this concept include:

- $SFBUF B öDUJPOBM DIBSBDUFS BOE OBNF PG TPNFPOF X and poor ethics. When the discussion around possible fraud scenarios and financial statement susceptibilities takes place, imagine this person (not your client) as being the client or the senior manager in charge.
- *OWJUJOH TPNFPOF JEFBMMZ XJUI TPNF GPSFOTJD FYQFS participate in the planning discussions about fraud.

8.10 How to Identify Inherent Risk Factors

The most effective way to avoid missing a relevant risk factor is to make risk identification an integral part of understanding the entity. The more that the auditor knows about the six areas of understanding, the more likely the auditor will be able to identify risk factors. Understanding the entity is also helpful when identifying and later responding to possible fraud scenarios. Remember that management override is always a possibility and fraud is thereby concealed (especially from the auditor).

As information is gathered (or updated) about each of the required areas of understanding the entity, the existence of relevant business and fraud risk factors will be considered. For many of the business risks identified, there may also be a fraud risk to consider. For this reason, it is suggested that, where possible, fraud risks be listed separately from business risks and assessed separately. For example, if the sales outlook for an entity's products was poor (an external source of risk), consider what could go wrong (implications for) in the financial statements. Poor sales could result in excess inventory that may need to be written down, but it could also trigger a fraud risk if it provided an incentive for a salesperson to inflate his/her sales to meet a bonus threshold.

$0 / 4 * % &03* /15

The business and fraud risks (inherent risks) are identified before any consideration of any internal controls that might mitigate such risks. Internal control to mitigate risks is addressed in Volume 2, Chapters 11 and 12. This is also important for identifying any significant risks that might exist (refer to Volume 2, Chapter 10).

The effect of some of the risk factors identified will relate to a specific financial statement area, but other risk factors will be pervasive and relate to many financial statement areas. For example, if the senior accountant is incompetent, errors will not likely be limited to one financial statement area. In addition, if someone took advantage of the situation to commit fraud, misstatements could occur in any number of asset or liability balances, and could be covered up with additional misstatements in revenue and expense transactions.

Pervasive risks often derive from a weak control environment and potentially affect many financial statement areas, disclosures, and assertions. Pervasive risks will likely affect the assessment of risk at the financial statement level. Risks at the financial statement level will be addressed through an overall response by the auditor (such as more audit work performed, assigning more experienced staff members, etc.).

As the audit progresses, additional risk factors may be identified. These should be added to the list of identified risks and appropriately assessed before making any decisions as to the impact on audit strategy and the audit plan, such as the nature and extent of further audit procedures required. This will ensure that, when planning takes place for the next period, the risk identification and assessment will be complete.

A suggested three-step risk identification process is outlined below.

Exhibit 8.10-1

3JTL *EFOUJöDBUJPO	
Step 1 (BUIFS #BTJD Information about the Entity	The starting point is to obtain a basic understanding or frame of reference for designing the risk assessment procedures to be performed. Without this understanding, it would be difficult, if not impossible, to identify what errors and fraud could occur in the financial statements. t 0CUBJO PS VQEBUF SFMFWBOU CBTJD JOGPSN culture, operations, key personnel, and the internal organization and control.
Step 2 %FTJHO 1FSGPSN and Document Risk Assessment Procedures	t 3JTL BTTFTTNFOU QSPDFEVSFT BDUJWJUJFT TF be performed so that: – The sources of risks of material misstatement are identified, – An appropriate understanding of the entity is obtained, and – The necessary supporting audit evidence is obtained. t 6TJOH UIF CBTJD VOEFSTUBOEJOH PG UIF FOUJ and perform risk assessment procedures and related activities. t)PME EJTDVTTJPOT BNPOH UIF BVEJU UFBN SFH entity's financial statements to material misstatement, caused by error or fraud (see Volume 2, Chapter 7). t .BLF JORVJSJFT PG NBOBHFNFOU BT UP IPX UIF (particularly fraud), and what risk factors have in fact been identified and managed. Also ask management if errors or fraud have actually occurred. t %PDVNFOU BMM SJTL GBDUPST JEFOUJöFE

3JTL *EFOUJöDBUJPO	
4UFQ 3FMBUF PS NBQ UIF SJTLT JEFOUJöFE UP .BUFSJBM 'JOBODJBM Statement Areas	For each risk factor (risk cause) identified, identify the effect (specific misstatements such as fraud and error) that could occur in the financial statements as a result. Note that a single risk factor can result in a number of differing types of misstatements that may affect more than just one financial statement area. (See the Consider Point below for some examples.) t *EFOUJGZ UIF NBUFSJBM BDDPVOU CBMBODFT D the financial statements. t 3FMBUF PS NBQ UIF SJTLT JEFOUJöFE UP UIF TC disclosures, and assertions affected. If the risk identified is pervasive, then relate it to the financial statements as a whole. Identifying the effect of risks by financial statement area helps in assessing risks at the assertion level. Identifying the effect of pervasive risks helps in assessing risks at the financial statement level.

$0 / 4 * % &03* /15

A natural tendency for auditors is to use the financial statements as the starting point for identifying risks. For example, inventory may be considered high risk because of the errors found in previous periods. However, this is equivalent to identifying the effect of a risk but not the underlying cause.

,OPXJOH JOWFOUPSZ JT IJHI SJTL JT JNQPSUBOU IPXFWFS JU

If the cause of a risk is not identified, it is possible that some risk factors will be missed altogether. Consider the following:

.JTTJOH CBMBODFT PS USBOTBDUJPOT

Financial statements only summarize the results of business decisions and transactions that have been recorded. If transactions have not been recorded, or if assets have been misappropriated or contingencies are not disclosed, it is quite possible that the risk factors associated with such missing amounts or disclosures will not be identified or assessed.

'BDU HBUIFSJOH WFSTVT SJTL JEFOUJöDBUJPO

The process of understanding the entity can easily become focused on collecting facts about the entity rather than identifying sources of risk. When this occurs, new risk factors, events, transactions, and fraud risks may be missed altogether.

Cause and e ect of misstatements

The significance of certain risk sources may be missed if attention is paid primarily to the effect or consequence of the risk factor (such as focusing on the errors in the inventory balance, rather than the reasons for their occurrence in the first place). The source of the risk is the event(s) that would cause errors to occur in the first place. The source of errors in the inventory balance could be inadequate or poorly trained staff, an outdated system of internal control, misapplication of accounting policies such as revenue recognition, lack of security over inventory or outright fraud by employees, etc.

$0/4*%&3 10*/5 continued

" DBVTF XJUI NVMUJQMF NJTTUBUFNFOU FòFDUT

An individual risk source may often affect many financial statement balances. For example, a downturn in the economy may affect the valuation of inventory, the collectability of receivables, compliance with banking agreements, manipulation of sales transactions to achieve bonus thresholds, and possibly even going concern issues.

Pervasive risks

By focusing on one financial statement area at a time, certain pervasive risks and fraud risks may not be identified. For example, the introduction of a new accounting system could result in errors being made in many financial statement balances. In addition, someone could take advantage of the uncertainty created by the new system to commit a fraud.

8.11 Documenting the Risk Identi cation Process

The auditor should use professional judgment regarding the manner in which these matters are documented. For example, the documentation of the risk identification process following the three steps outlined above would consist of:

- *OGPSNBUJPO BCPVU UIF FOUJUZ
- 3JTL BTTFTTNFOU QSPDFEVSFT BOE
- 3FMBUJOH JEFOUJöFE SJTLT UP QPTTJCMF FSSPST BOE GSBV

Exhibit 8.11-1

Document	Description
Information about the Entity	Document information obtained under the appropriate area of understanding, such as the entity's objectives, external factors, nature of the entity, etc. Documentation may vary from very simple to complex, depending on the size of the entity, and could include: t $MJFOU QSFQBSFE JOGPSNBUJPO TVDI BT CVTJ t &YUFSOBM EBUB JOEVTUSZ SFQPSUT JOUFSOB QPMJDJFT BOE QSPDFEVSFT t 3FMFWBOU DPSSFTQPOEFODF MFHBM HPWFSON SFQPSUT NFNPSBOEB BOE t 'JSN T DIFDLMJTUT

Document	Description
Risk Assessment Procedures	Document details of the risk assessment procedures performed. This would include: t %JTDVTTJPOT BNPOH UIF BVEJU UFBN SFHBSEJOH U TUBUFNFOUT UP NBUFSJBM NJTTUBUFNFOU DBVTFE t ,FZ FMFNFOUT PG UIF VOEFSTUBOEJOH PG UIF F – Each of the aspects of the entity and its environment outlined above, – Each of the five internal control components, as outlined in Volume 1, Chapter 5, and o 4PVSDFT PG JOGPSNBUJPO GSPN XIJDI UIF V t 5IF JEFOUJöFE BOE BTTFTTFE SJTLT PG NBUFSJ statement level and assertion level.
3FMBUF *EFOUJöFE Risks to Possible &SSPST BOE 'SBVE JO UIF 'JOBODJBM Statements	Document the material account balances, class of transactions, and disclosures in the öOBODJBM TUBUFNFOUT BOE UIFO GPS FBDI TPVSD t 1FSWBTJWF UP UIF öOBODJBM TUBUFNFOUT BT t $POöOFE UP TQFDJöD öOBODJBM TUBUFNFOU BS

There are a number of ways that identified risks can be documented. One way of documenting the risks identified is outlined in the following exhibit. The exhibit shows the risk source by area of understanding (external factors, nature of entity, etc.), the impact or possible consequence of the risk, and the financial statement areas affected.

Exhibit 8.11-2

Risk Source	*NQBDU PG 3JTL PO 'JOBODJBM 4UBUFNFOU &SSPST PS 'SBVE	'JOBODJBM Statement Area Affected or Pervasive Risk
&OUJUZ T 0CKFDUJWFT		
Introduction of B OFX QSPEVDU during the year	Errors in cost allocation and inventory valuation.	Inventory valuation
	New product costing and pricing methodologies/systems could create opportunities for fraud to occur.	Inventory accuracy
	The new financing required will make it difficult to comply with existing bank covenants. If the entity is in breach of covenants, the loan may actually be payable on demand.	Note disclosures on financing, debt covenants, and loan classification
	Management may be tempted to manipulate financial statements to ensure compliance with the bank covenants.	Pervasive risk

Risk Source	*NQBDU PG 3JTL PO 'JOBODJBM 4UBUFNFOUT &SSPST PS 'SBVE	'JOBODJBM Statement Area Affected or Pervasive Risk
Nature of the Entity		
Senior accountant not trained properly	Errors in the financial statements.	Pervasive risk
	Opportunity for fraud.	Pervasive risk

$0 / 4 * % &03* /15

0OF MPDBUJPO GPS SJTLT

Consider recording all the risk factors identified in a single document, single place, or with a common file reference number in the working paper file. This has a number of advantages:

- &BTF PG öMF SFWJFX "MM SJTL GBDUPST JEFOUJöFE DBO
- $POTJTUFOU BTTFTTNFOU 8IFO SJTLT BSF SFWJFXFE UPHF differently from others will be more evident.
- 3JTLT DBO CF TPSUFE VTJOH BO FMFDUSPOJD TQSFBETIFF at the top of the page. In this way, a file reviewer can check to ensure that all the major risks identified have been addressed with an appropriate audit response.

Separate lists of fraud and business risk factors

List and assess fraud risks separately from business risk factors. Many business risks also create an opportunity or incentive for fraud to occur. If fraud is not separately considered, some fraud risk factors may be missed. For example, a new accounting system may create potential for errors (business risk), but may also provide an opportunity for someone to manipulate the financial results or misappropriate assets (fraud risk). Another reason for keeping them separate is that the audit response to a fraud risk (identification of any patterns, exceptions, or oddities that might exist) might be quite different from the response to a related business risk.

Leave the assessment of risk until later

Avoid the temptation to only list risk factors that are likely to be significant or important. A key part of risk or event identification is to develop as complete a listing of risk factors as possible. Inconsequential risk factors can always be removed later after each risk is appropriately assessed. This will help to ensure that all material risks are indeed identified.

3F VTF EPDVNFOUBUJPO UP FYUFOU QPTTJCMF

Avoid having to re-document the risk factors identified and the understanding of the entity obtained each period. If information about risk assessment procedures performed and the risks identified is captured in a structured way (see “one location for risks above”), it can simply be updated each period. This may require more time initially (in the first period) to prepare, but will save time in subsequent periods. However, be sure that appropriate risk assessment procedures are carried out and documented each period, and that any changes made can be identified. Also ensure that each document records the fact that the information was updated.

$0 / 4 * % &03* /15 Continued

Impact of risks

The most important, but also the most difficult, column to complete is “impact of risk on financial statements” (see above exhibit). It is in this column that the auditor sets out the implication of the identified risk. Declining sales is a risk factor but, if recorded accurately by the entity, this would not result in risks of material misstatement. However, declining sales could result in inventories being obsolete or overvalued, and receivables may become difficult to collect. It is the implication of each risk factor that the auditor needs to identify so that an appropriate audit response can be developed.

Note: The risk sources identified in this example have multiple impacts, each of which has been considered separately. If the various impacts of risk sources are not broken out into discrete components, not only will the risk assessment process be more difficult, but the auditor could easily miss some risk implications (such as fraud) altogether.

8.12 Case Studies — Inherent Risks — Identi cation

For details of the case studies, refer to Volume 2, Chapter 2 — Introduction to the Case Studies.

Risk identification involves:

- Performing risk assessment procedures to understand the entity and identify possible sources (causes) of business risk and fraud risk. This includes performing the specific risk assessment procedures outlined in ISAs such as ISA 240 on fraud, ISA 540 on estimates, ISA 550 on related parties, and ISA 570 on going D P O D F S O
- % P D V N F O U J O H U I F S J T L T J E F O U J öF E " D P N N P O G P S N P G E P S J T L T B S F M J T U F E B O E B T T F T T F E J O P O F Q M B D F B O E
- 'P S F B D I S J T L T P V S D F U I B U J T J E F O U J öF E D P O T J E F S X I B U T (the ‘effect’ of each risk) in the financial statements as a result.

Documentation required:

- 6 O E F S S T U a n d i n g o f t h e E n t i t y H
  This can be documented in a memo that is similar to the one in Volume 2, Chapter 2 that outlines the details of these two case studies.
- 5 I F i s k f a c t o r s i n v o l v e d
  One way of documenting the cause and effect of identified risks (both business and fraud) is to list them in a structured format such as the risk register outlined below. This will ensure that all risks are recorded in one place and that the assessment of risks will be consistent. The alternative approach is to list the risks identified in a memo format. Avoid the temptation to combine business and fraud risk on one form. The assessment of and response to a business risk versus a fraud risk may be quite different.

$BTF 4UVEZ " ‰ %FQIUB 'VSOJUVSF *OD

Planned Risk Assessment Procedures:

1. Document potential risk factors identified from:

B $MJFOU BDDFQUBODF DPOUJOVBODF QSPDFEVSFT

C 0UIFS UZQFT PG FOHBHFNFOUT QFSGPSNFE GPS UIF FOUJU

c) Previous audit engagements.

2. Review the most recent trial balance for:

B 3FWFOVF BOE FYQFOTF USFOET BOE

b) Changes in assets and liabilities.

Inquire about the reasons for significant changes or trends identified.

3. Identify potential risk factors from reading key entity documents such as business plans, budgets, minutes, and most recent financial results.

4. Make inquiries of management and key financial personnel about:

a) Business objectives, industry trends, management's assessment of current and potential risk factors and their planned responses.

b) Major events or changes that took place during the period.

c) Any instances of alleged, suspected or actual fraud.

d) Any performance bonuses or incentive plans.

e) The identity of and nature/amount of related party transactions during the period.

f) Any going concern events or conditions.

g) Transactions, events and conditions that give rise to accounting estimates.

h) Nature, extent and status of litigation/claims against the entity or key personnel.

5. Make inquiries of members of the governance board about:

a) The composition, mandate and meetings of the governance board.

b) Any knowledge of management override, fraud or suspected fraud.

c) Their opinion on:

o 5IF FòFDUJWFOFTT PG NBOBHFNFOU PWFSTJHIU BOE

– The control environment (culture, competence, attitudes, etc.).

d) What financial statement areas are susceptible to fraud.

6. Identify others (if any) in the entity who could provide information about potential risk factors and changes occurring since the previous period.

Outlined below is a structured format for documenting the results of performing risk assessment procedures for Dephta Furniture, Inc.

# V T J O F T T 3 J T L T		
Risk Event/Source	* N Q M J D B U J P O P G 3 J T L ' B D U P S	Assertions
	What financial statement areas could be misstated and in what way?	P CAEV
Downturn in economy	Receivables may be di cult to collect	V
Downturn in economy	* O W F O U P S Z X S J U F E P X O T N B Z	C F S FVR V J S F E
Inventory clerk known to make errors	Inventory balances may be overstated/understated and possibly impact valuation	CAEV
Continued growth (despite downturn) and poor inventory control	Breach of debt covenants	P
General IT controls are weak in a number of areas	Data integrity may be compromised or data may even be lost	P
New sales being sought in other countries	Foreign exchange risks in receivables	A

Key:

P = Pervasive (all assertions)

C = Completeness

A = Accuracy

E = Existence

V = Valuation

' S B V E 3 J T L T		
Risk Event/Source	* N Q M J D B U J P O P G 3 J T L ' B D U P S	Assertions
	What financial statement areas could be misstated and in what way?	P CAEV
Pressures		
Minimize tax burden	Management bias in estimates (such as valuation of inventory) to reduce income.	CAV
Minimize tax burden	Unauthorized journal entries or manipulation of nancial statements.	P
Rapid growth putting pressure on nancing	Financial statement manipulation to avoid bank covenant being violated.	P
Salesman's bonus based on sales above certain thresholds	In ated sales to meet thresholds.	E
Paying bribes to obtain contracts	Damage to reputation, overstatement of expenses, unaccrued nes.	CAE
0 Q Q P S U V O J U J F T		
High value, easily transportable items of inventory	Goods stolen from inventory.	E
High incidence of cash sales	Goods stolen/cash stolen.	E
Transactions with related parties	Sales/purchases may not be complete, properly valued or disclosed in the nancial statements.	P
Signi cant expansion in the use of related party transactions	Sales/purchases could be undervalued/overvalued. Balances with related parties may not be collectable. Manipulation of nancial statements could be achieved by transferring "risky" balances to a related party. This would replace a risky balance with a related party balance.	V
3 B U J P O B M J [B U J P O		
Low morale among temporary workers	Goods or cash stolen	E

Key:

P = Pervasive (all assertions)

C = Completeness

A = Accuracy

E = Existence

V = Valuation

Planned Risk Assessment Procedures:

1. Inquire about the state of the industry and update our understanding of the entity W/P x.x and the risk assessment memos). This will involve:

a) Discussions with Raj and Ruby (the bookkeeper) about what has changed this year. Specifically address any personnel or organizational changes, related-party transactions, management estimates, going concern uncertainties and management's compliance with relevant laws and SFHVMBUJPOT

b) Inquiries of any changes in operations during the year, new laws and regulations and any DIBOHFT CFJOH QMBOOFE GPS UIF GVUVSF

c) Inquiries about the impact and risks involved with Raj not spending as much time on the business. Ask whether Raj will be resuming his regular duties next year or if the family situation XJMM DPOUJOVF UP DPOTVNF IJT UJNF

E 0VUDPNF PG MBTU ZFBS T NBOBHFNFOU FTUJNBUFT

F ,OPXMFEHF PG BOZ GSBVE UIBU IBT PDDVSSFE EVSJOH UI

G "OZ DIBOHF JO UIF UZQF BOE OBUVSF PG USBOTBDUJPOT

g) Documenting the source and effects of any new risks identified and indicating whether they have been mitigated through any new internal controls.

2. Review the most recent trial balance for:

B 3FWFOVF BOE FYQFOTF USFOET BOE

b) Changes in assets and liabilities.

Inquire about the reasons for significant changes or trends identified.

. FNP UP KJMF&‰o.

Inherent Risk Identification

As a result of performing the risk assessment procedures outlined on working paper X.X, which included potential sources of risk arising from the six areas of required understanding, we have identified the following risk factors:

#VTJOFTT 3JTLT

3BK T BCTFODF GSPN PQFSBUJPOT‰B QFSWBTJWF SJTL

t 5IF RVBMJUZ BOE BDDVSBDZ PG UIF BDDPVOUJOH SFDPSET personal family matters. The financial statements could be materially misstated.

Risk Assessment: (to be addressed in Volume 2, Chapter 9)

Risk Response: (to be addressed in Volume 2, Chapter 16)

t Raj used to inspect goods for quality before shipment. The quality of products sold could be compromised, leading to greater returns and/or unsaleable inventory. (Valuation)

Risk Assessment: (to be addressed in Volume 2, Chapter 9)

Risk Response: (to be addressed in Volume 2, Chapter 16)

%PXOUVSO JO FDPOPNZ BOE FDPOPNJD EFQFOEFODF

t ,VNBS $P JT EFQFOEFOU PO JUT QSJNBSZ DVTUPNFS %F
90% of its sales. In this economic downturn, Dephta could cancel orders. The impact could be bank covenant violations and overvalued assets.

t " EFDMJOF JO TBMFT BOE MJRVJEJUZ QSFTTVSFT NBZ MFBE
bank covenant violations.

t *G UIF CBOL DBMMFE UIFJS MPBO UIF DPNQBOZ NBZ OPU C
could result in a material uncertainty that should be disclosed in the financial statements, and an evaluation of the basis (i.e., the going concern assumption) on which the financial statements are prepared. This would affect all assertions.

Risk Assessment: (to be addressed in Volume 2, Chapter 9)

Risk Response: (to be addressed in Volume 2, Chapter 16)

'SBVE 3JTLT

5BY NJOJNJ[BUJPO

t 5IFSF has been management desire to minimize the tax burden. There may be a bias in management's estimates, or unauthorized journal entries could be used. (Completeness, Accuracy)

Risk Assessment: (to be addressed in Volume 2, Chapter 9)

Risk Response: (to be addressed in Volume 2, Chapter 16)

3BLT BSJTJOH GSPN PQFSBUJPOT‰B QFSWBTJWF SJTL

t 3BLT BSJTF SFTVMUT JO NJOJNBM PWFSTJHIU PG 3VCZ
morale (potential rationalization) and personal financial pressures (possible incentive). As a result, Ruby (who operates with minimal supervision) has the incentive, opportunity, and rationalization for misappropriating cash/goods. This should be treated as a fraud risk.

Risk Assessment: (to be addressed in Volume 2, Chapter 9)

Risk Response: (to be addressed in Volume 2, Chapter 16)

Related Parties

t 5SBOTBDUJPOT XJUI SFMBUFE QBSUJFT DPVME CF NBOJQVI
(Valuation) Attention should also be paid to the possible existence of other related parties and the valuation/accuracy of balances with related parties at period end.

Risk Assessment: (to be addressed in Volume 2, Chapter 9)

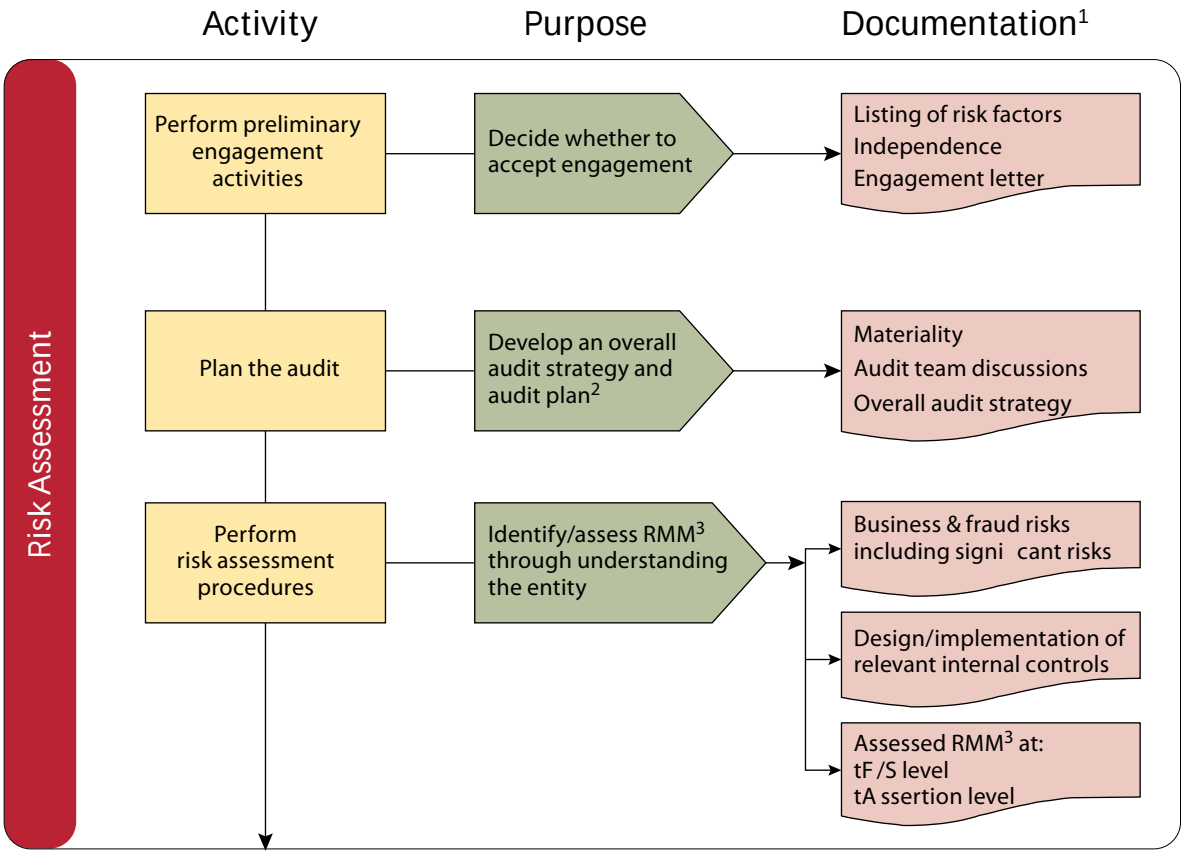
Risk Response: (to be addressed in Volume 2, Chapter 16)

Prepared by: FJ Date: December 8, 20X2

3FWJFXFE CZ ZZ Date: January 5, 20X3

Chapter Content	Relevant ISAs
How to assess the identified risks of material misstatement in the financial statements.	240, 315

Exhibit 9.0-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
240.25	In accordance with ISA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.
240.26	When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30)
240.27	The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. A31-A32)
315.25	The auditor shall identify and assess the risks of material misstatement at: B UIF öOBODJBM TUBUFNFOU MFWFM BOE 3FG 1BSB " (b) the assertion level for classes of transactions, account balances, and disclosures (Ref: Para. A109-A113) to provide a basis for designing and performing further audit procedures.
315.26	For this purpose, the auditor shall: (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the DMBTTFT PG USBOTBDUJPOT BDDPVOU CBMBODFT BOE E Para. A114-A115) (b) Assess the identified risks, and evaluate whether they relate more pervasively to the öOBODJBM TUBUFNFOUT BT B XIPMF BOE QPUFOUJBMMZ B (c) Relate the identified risks to what can go wrong at the assertion level, taking account of SFMFWBOU DPOUSPMT UIBU UIF BVEJUPS JOUFOET UP UF (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

9.1 Overview

Risk identification, which was addressed in the previous chapter, involves:

- 1FSGPSNJOH SJTL BTTFTTNFOU QSPDFEVSFT UP JEFOUJGZ T FOUJUZ
- %FUFSNJOJOH UIF QPTTJCMF FòFDUT PG UIF SJTL TPVSDFT TUBUFNFOUT JODMVEJOH UIF QPTTJCJMJUZ PG GSBVE BOE
- 3FMBUJOH UIF FòFDUT PG SJTLT UP UIF öOBODJBM TUBUFNF the risks are pervasive to the financial statements as a whole and potentially affect many assertions.

The next step is to assess the identified risks and determine their significance for the audit of the financial statements. Again, it is preferable to assess the inherent risks before considering any internal control that might mitigate such risks.

Risk assessment involves consideration of two attributes about the risk:

t 8IBU JT UIF MJLFMJIPPE PG B NJTTUBUFNFOU PDDVSSJOH BT

t 8IBU XPVME CF UIF NBHOJUVEF NPOFUBSZ JNQBDU JG UIF S

Likelihood of a Misstatement Occurring

What is the probability that the risk will occur? The auditor could evaluate this probability simply as high, medium, or low, or could assign a numerical score, such as 1 to 5. A numerical score provides a slightly more precise assessment. The higher the score, the more likely the risk would occur.

Magnitude (Monetary Impact) if the Risk Did Occur

If the risk occurred, what would be the monetary impact? This judgment needs to be assessed against a specified monetary amount, such as performance materiality. If not, different people (with different materiality amounts in mind) could come to entirely different conclusions. For audit purposes, the specified amount would relate to what constitutes a material misstatement for the financial statements as a whole. This assessment can also be evaluated simply as high, medium, or low, or by assigning a numerical score, such as 1 to 5. The higher the score is, the higher the magnitude of the risk.

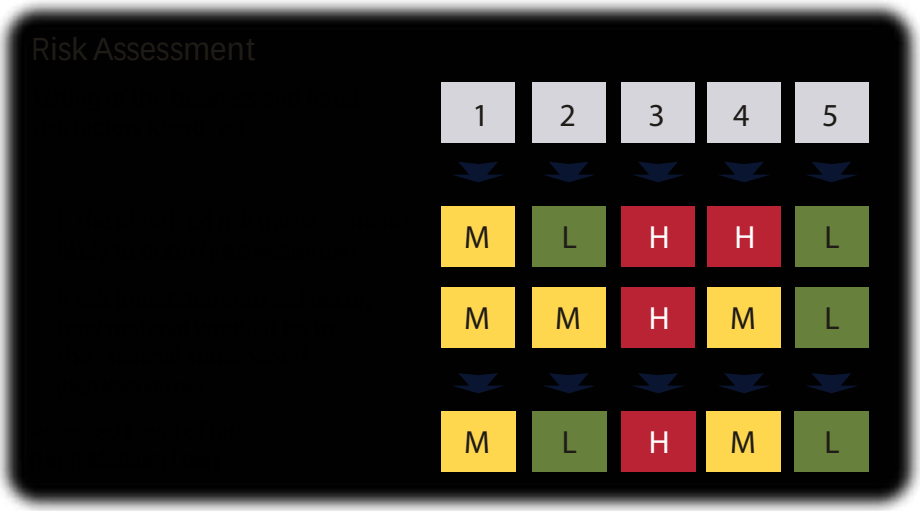
$0 / 4 * % &03* /15

If numeric scores are used to assess likelihood and magnitude, the numbers can be multiplied to provide a combined or overall risk assessment score. This calculation can be useful in considering whether significant risks exist. In addition, if an electronic worksheet is used, the listing of risks may be ranked and sorted so that the most significant identified risks are always at the top of the list. This can be useful information when reviewing the file and ensuring that an appropriate response has been developed for the assessed risks.

In smaller entities where the number of risk factors is small and the audit response has already been established, the two assessments (likelihood and magnitude) can still be considered separately but documented as one combined assessment.

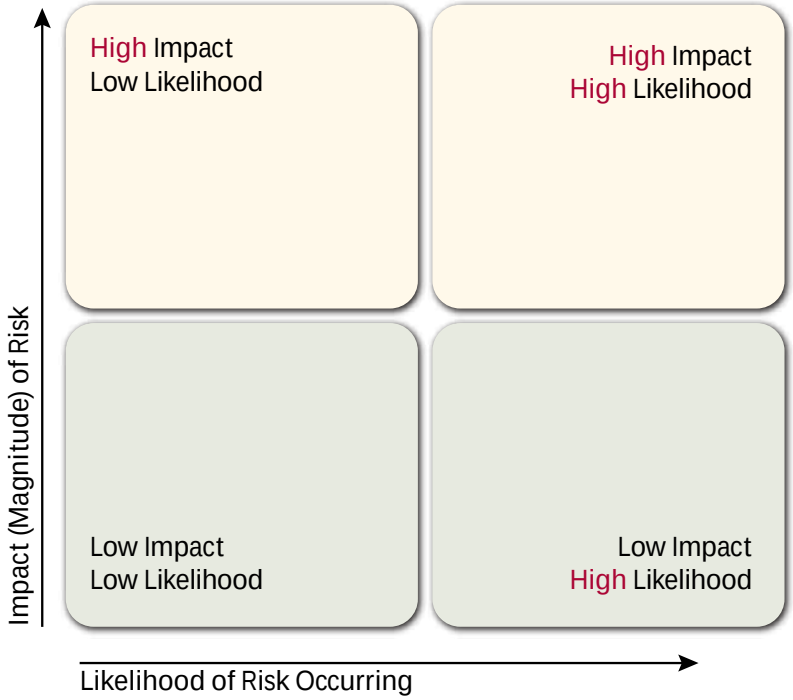
The steps involved in risk assessment (using assessment criteria of high, medium, or low) are illustrated below.

Exhibit 9.1-1



The results of the risk assessment process can also be set out in a chart, as illustrated below. Some commercial software packages provide charting capabilities.

Exhibit 9.1-2



Risks falling in the "high impact (magnitude), high likelihood" area of the chart clearly require management action to mitigate. In addition, these risks will likely be determined as being significant, which will require special audit consideration (refer to Volume 2, Chapter 10).

$0 / 4 * % &03* /15

% J T D V T T J P O T X J U I N B O B H F N F O U

When risk factors are documented and assessed by the auditor, it is important that the results be discussed with the entity's management. This discussion will help to ensure that a risk factor has not been overlooked and that the auditor's assessment of risks (likelihood and impact) is reasonable. However, it is always important to use professional skepticism when evaluating management's input and responses.

9.2 Risk Assessments Performed by the Entity

Risk assessment is one of the five components of internal control (see Volume 1, Chapter 5) that should be addressed by the entity's management.

In smaller entities, the risk assessment process is likely to be informal and unstructured. Risk in smaller entities is often recognized implicitly rather than explicitly. Management may be aware of risks related to financial reporting through direct personal involvement with employees and outside parties. As a result, the auditor would make inquiries of management as to how it identifies and manages risk, and then as to what risks have actually been identified and managed. The auditor would document the results.

As management understands the benefits of a more formalized risk assessment process, it may decide to develop, implement, and document its own processes. When this occurs, the auditor would evaluate:

- $P O U S P M T J O Q M B D F P W F S N B O B H F N F O U T Q S P D F T T F T
- 5 I F D P N Q M F U F O F T T P G U I F C V T J O F T T B O E G S B V E S J T L T J E F
  S F G F S S F E U P B T B iS J T L S F H J T U F S w
- . B O B H F N F O U T B T T F T T N F O U P G U I F N B H O J U V E F P G U I F S J T L
- . B O B H F N F O U T S F T Q P O T F T U P B E E S F T T U I F B T T F T T F E S J T L T

If management has failed to identify key risks, consideration should be given as to whether there is a significant deficiency in the entity's risk assessment process.

9.3 Documenting Assessed Risks

Professional judgment should be used regarding the manner in which risk factors are assessed.

The assessment of the risks of material misstatement is made at the:

- ' J O B O D J B M T U B U F N F O U M F W F M B O E
- " T T F S U J P O M F W F M G P S D M B T T F T P G U S B O T B D U J P O T B D D P V

Documentation may be in the form of memoranda or a risk listing (for fraud) such as that outlined in Exhibit 9.3-1. Note the following:

- 5 I F ö S T U U X P D P M V N O T J O U I F U B C M F C F M P X X P V M E C F D P N
  in Volume 2, Chapter 8.
- 5 I F B T T F S U J P O D P M V N O J T B O B T T F T T N F O U P G

- The specific assertions that relate to the financial statement area or disclosure impacted by the risk. This will help in the assessment of risks at the assertion level, and
- Pervasive risks that affect many assertions, and would impact the assessment of risk at the financial statement level.

t 5IF SJTLT CFJOH BTTFTTFE BSF JOIFSFOU SJTLT $POUSPM S

t 5IF BTTFTTNFOUT PG MJLFMJIPPE BOE NBHOJUVEF JNQBDU magnitude and 5 = high likelihood/magnitude. These scores may be multiplied to provide a combined overall score. However, these risks could just as easily have been assessed as high, medium or low.

Exhibit 9.3-1

Period ended: December 31, 20X2 Materiality 50,000					
			Inherent Risk Assessment		
Risk Event/Source	* N Q M J D B U J P O P G 3 J T L ' B D U P S	Assertions PCAEV	Likeli-hood to Occur	Impact	Com-bined Score
Salespersons' compensation based on sales commissions	Sales could be ctitious, recorded in the wrong period, overstated, or at terms di erent from the standard terms and conditions in order to achieve bonus targets	EA	4	4	16
Failure to comply with debt covenants is covered up to B W P C J E E J D R V J S J F T	Unauthorized journal entries to defer expense, bias in management estimates, etc.	P	2	5	10
Fictitious suppliers inserted by employees	Acme pays for expenses at in ated prices or for which no services/goods were rendered	EA	2	4	8
Related party transactions not identi ed. Shareholders not involved in business could be disadvantaged	Revenue and expenses not recorded at (Fair Market Value)	P	3	5	15
Cash sales for parts and service may go unrecorded and undeposited	Revenue and assets are understated	CAE	4	1	4

$0 / 4 * % &03* /15

When documenting risk factors, consider how they will be updated and used in subsequent periods. Recording information in one place and in a structured format (such as above) may take a little longer to prepare initially, but will be much easier to update in the future. A structured format also helps to ensure:

t 5IBU SJTLT BSF OPU BEESFTTFE NPSF UIBO PODF XIJDI DB

t " DPOTJTUFOU BTTFTTNFOU PG FBDI SJTL

t 5IBU TJHOJöDBOU SJTLT BSF JEFOUJöFE

t &BTF PG SFWJFX "O FMFDUSPOJD XPSLTIFFU FOBCMFT SJT DPNCJOFE TDPSF PS CZ MJLFMJIPPE PS JNQBDU BOE

t 5IF SJTL MJTUJOH DBO CF TIBSFE XJUI UIF DMJFOU UP PC prepare the listing of risk factors for the auditor's review.

9.4 Case Studies — Inherent Risks — Assessment

For details of the case studies, refer to Volume 2, Chapter 2 — Introduction to the Case Studies.

Where a structured format is used to document the assessment, it can be completed using the same form as the one started in Volume 2, Chapter 8. The audit response column can be used to cross-reference the risk factors to the specific audit procedures or audit programs that address the identified risks.

If a memo is to be used, the risk assessment and risk response could be added to the memo started in Volume 2, Chapter 8.

$BTF 4UVEZ "‰%FQIUB 'VSOJUVSF *OD

Business Risks						
Risk Event/Source	* N Q M J D B U J P O P G	A s s e r t i o n s	I n h e r e n t Risk Assessment			Signi- ö D B O U
	What financial statement areas could be misstated and in what way	PCAEV	Likelihood to Occur	€ Impact	Com- bined Score	Risk? Y/N
Continued growth (despite downturn) and poor inventory control	Breach of debt covenants	P	4	5	20	Y
Inventory clerk known to make errors	Inventory balances may be overstated/understated and possibly impact valuation	CAEV	5	3	15	N
General IT controls are weak in a number of areas	Data integrity may be compromised or data may even be lost	P	3	5	15	N
Downturn in economy	Inventory write-downs may C I S F R V J S F E	V	3	3	9	N
New sales being sought in other countries	Foreign exchange risks in receivables	A	2	2	4	N
Downturn in economy.	Receivables may be di cult to collect (i.e., overstated)	V	1	3	3	N

Key:	Assess likelihood (probability) to occur on a scale of 1-5	Assess the magnitude (monetary impact) in relation to materiality on a scale of 1–5
P = Pervasive (all assertions)	1 = Remote	1 = Immaterial
C = Completeness	2 = Unlikely	2 = Minor
A = Accuracy	3 = Likely	3 = Moderate
E = Existence	4 = Most likely	4 = Major
V = Valuation	5 = Almost certain	5 = Material

(As a guide, risk factors with a combined risk assessment (Likelihood x Impact) score of 20 or more should be considered as "significant" fraud risks.)

Note: The possible violation of the bank covenants has a combined risk score of 20, and is therefore considered to be a significant risk. Significant risks require special audit consideration by the auditor, including obtaining an understanding of the entity's related controls relevant to such risks.

Fraud Risks						
Risk Event/Source	* N Q M J D B U J P O P G 3 Assertions B D UI Inherent Risk Assessment					Signi- ö D B O U Risk? Y/N
	What financial statement areas could be misstated and in what way?	PCAEV	Likelihood to Occur	Є Impact	Com- bined Score	
Pressures						
Minimize tax burden	Unauthorized journal entries/ nancial statement manipulation	P	4	5	20	Y
Rapid growth putting pressure on nancing	Financial statement manipulation to avoid bank covenant being violated	P	4	5	20	Y
Minimize tax burden	Management bias in estimates to reduce income	CAV	4	4	16	Y
Salesman's bonus based on sales above certain thresholds	In ated sales to meet thresholds. However, the bonus amounts are small.	E	3	2	6	N
Paying bribes to obtain contracts	Damage to reputation, overstatement of expenses, unaccrued nes.	CAE	2	2	4	N
0 Q Q P S U V O J U J F T						
Revenue recognition	Inconsistent application of accounting policies	CAE	3	4	12	Y
Signi cant expansion in the use of related party transactions	Sales/purchases could be undervalued/overvalued	V	4	5	20	Y
High value, easily transportable items of inventory	Goods stolen from inventory	E	4	3	12	N
High incidence of cash sales	Goods stolen/cash stolen.	E	4	3	12	N
Transactions with related parties	Sales/purchases may not be complete, properly valued, or disclosed in the nancial statements	P	3	4	12	N
3 B U J P O B M J [B U J P O						
Low morale among temporary workers	Goods or cash stolen	E	3	2	6	N

Key:	Assess likelihood (probability) to occur on a scale of 1-5	Assess the magnitude (monetary impact) in relation to materiality on a scale of 1–5
P = Pervasive (all assertions)	1 = Remote	1 = Immaterial
C = Completeness	2 = Unlikely	2 = Minor
A = Accuracy	3 = Likely	3 = Moderate
E = Existence	4 = Most likely	4 = Major
V = Valuation	5 = Almost certain	5 = Material

(As a guide, risk factors with a combined risk assessment (Likelihood x Impact) score of 20 or more should be considered as "significant" fraud risks.)

Note: The possible management bias in estimates, unauthorized journal entries, the pressures to finance the rapid growth, and related party transactions have been assessed as significant risks (where the combined score exceeded 20). Significant risks require special audit consideration by the auditor, including obtaining an understanding of the entity's related controls relevant to such risks. If no controls exist, it is likely that a significant deficiency exists. Note that revenue recognition has a combined score of less than 16 but is presumed to be a significant risk. (Refer to ISA 240.26.)

.FNP UP 'JMF‰ ,VNBS $P

*OIFSFOU 3JTL *EFOUJöDBUJPO

Materiality = 3,000

As a result of performing the risk assessment procedures outlined on working paper X.X, which included potential sources of risk arising from the six areas of required understanding, we have identified the following risk factors:

#VTJOFTT 3JTLT

3BK T BCTFODF GSPN PQFSBUJPOT‰B QFSWBTJWF SJTL

t 5IF RVBMJUZ BOE BDDVSBDZ PG UIF BDDPVOUJOH SFDPSET personal family matters. The financial statements could be materially misstated.

Risk Assessment: High likelihood of occurrence/High magnitude (in relation to materiality) = High Risk, and also a significant risk. See WP # X.X.

Risk Response: (to be addressed in Volume 2, Chapter 16)

t 3BK VTFE UP JOTQFDU HPPET GPS RVBMJUZ CFGPSF TIJQN compromised, leading to greater returns and/or unsaleable inventory. (Valuation)

Risk Assessment: Low Likelihood/Low Magnitude = Low Risk

Risk Response: (to be addressed in Volume 2, Chaper 16)

%PXOUVSO JO FDPOPNZ BOE FDPOPNJD EFQFOEFODF - a pervasive ris

t ,VNBS $P JT EFQFOEFOU PO JUT QSJNBSZ DVTUPNFS %F 90% of its sales. In this economic downturn, Dephta could cancel orders. The impact could be bank covenant violations and overvalued assets. If the bank called its loan, the company would be unable to continue. (Valuation)

Risk Assessment: Moderate Likelihood/Moderate Magnitude = Moderate Risk

Risk Response: (to be addressed in Volume 2, Chapter 16)

'SBVE 3JTLT

Revenue Recognition

t 1PTTJCJMJUZ PG JODPOTJTUFOU BQQMJDBUJPO PG BDDPVC

Risk Assessment: Moderate Likelihood/Moderate Magnitude = Moderate Risk, but this is presumed by ISA 240.26 to be a significant risk, and will be treated as such.

Risk Response: (to be addressed in Volume 2, Chapter 16)

5 B Y N J O J N J [B U J P O - a pervasive risk

t 5 I F S F N B Z C F B N B O B H F N F O U C J B T U P N J O J N J [F U I F U B Y C
management's estimates, or unauthorized journal entries could be used. (Completeness, Accuracy)

Risk Assessment: High Likelihood/Moderate Magnitude = Moderate to High Risk, and should be considered a significant risk.

Risk Response: (to be addressed in Volume 2, Chapter 16)

% P X O U V S O J O F D P O P N Z B O E F D P O P N J D E F Q F O E F O D F - a pervasive ris

t " E F D M J O F J O T B M F T B O E M J R V J E J U Z Q S F T T V S F T N B Z M F B E
bank covenant violations. (All assertions)

Risk Assessment: Moderate Likelihood/High Magnitude = Moderate to High Risk, and should be considered a significant risk.

Risk Response: (to be addressed in Volume 2, Chapter 16)

3 B K T B C T F O D F G S P N P Q F S B U J P O T ‰ B Q F S W B T J W F S J T L

t 3 B K T B C T F O D F S F T V M U T J O N J O J N B M P W F S T J H I U P G 3 V C Z
morale and personal financial pressures. This creates incentive, opportunity, and rationalization for cash/goods being stolen (Existence) and/or financial statement manipulation.

Risk Assessment: Moderate Likelihood/Moderate Magnitude = Moderate Risk

Risk Response: (to be addressed in Volume 2, Chapter 16)

Related Parties

t 5 S B O T B D U J P O T X J U I S F M B U F E Q B S U J F T D P V M E C F N B O J Q V
(Valuation)

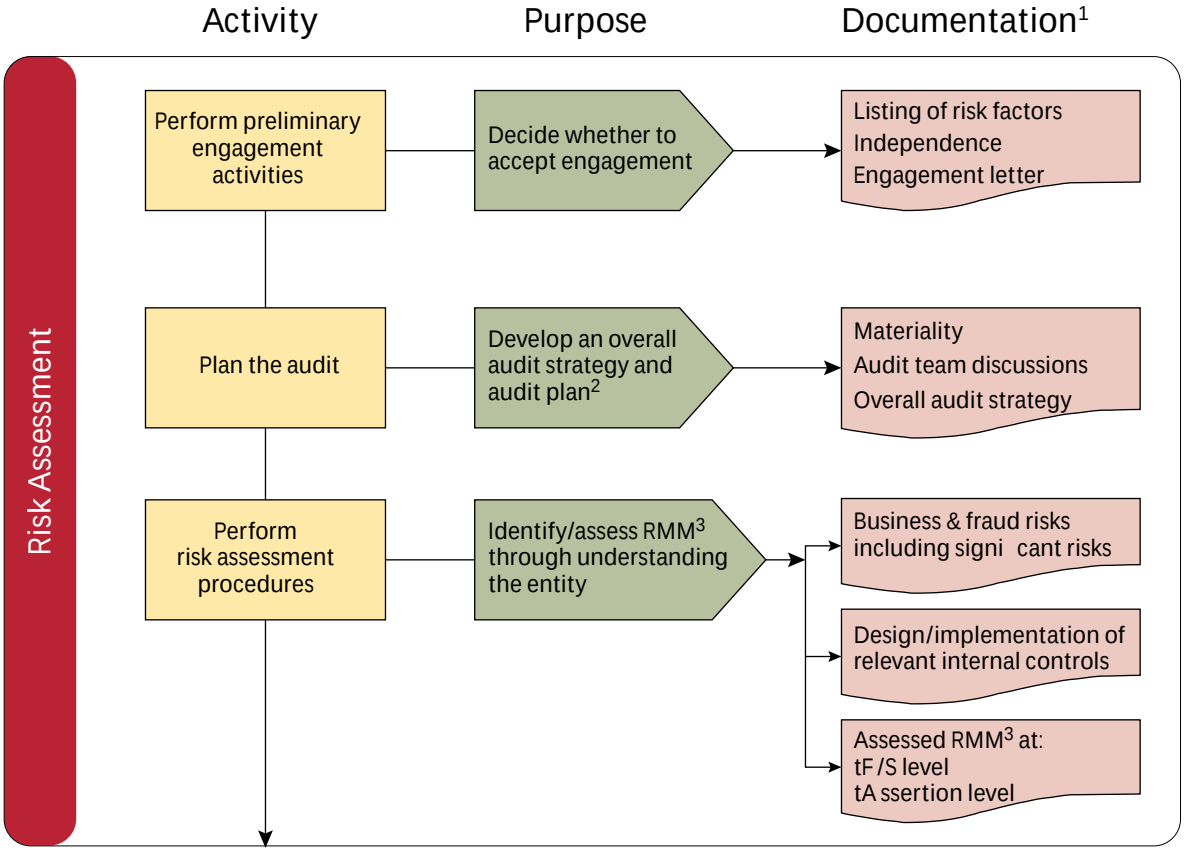
Risk Assessment: Moderate Likelihood/Moderate Magnitude = Moderate Risk and should be considered a significant risk

Risk Response: (to be addressed in Volume 2, Chapter 16)

Note: Significant risks require special audit consideration by the auditor, including obtaining an understanding of the entity's related controls relevant to such risks. If no controls exist, it is likely that a significant deficiency exists.

Chapter Content	Relevant ISAs
Guidance on the nature and determination of significant risks, and the consequences for the audit.	240, 315, 330

Exhibit 10.0-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
240.26	When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30)
315.4	For purposes of the ISAs, the following terms have the meanings attributed below: (e) Significant risk ‰An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.
315.25	The auditor shall identify and assess the risks of material misstatement at: B UIF öOBODJBM TUBUFNFOU MFWFM BOE 3FG 1BSB " (b) the assertion level for classes of transactions, account balances, and disclosures (Ref: Para. A109-A113) to provide a basis for designing and performing further audit procedures.
315.27	As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.
315.28	In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following: B 8IFUIFS UIF SJTL JT B SJTL PG GSBVE (b) Whether the risk is related to recent significant economic, accounting or other EFWFMPQNFOUT BOE UIFSFGPSF SFRVJSFT TQFDJöD BU D 5IF DPNQMFYJUZ PG USBOTBDUJPOT E 8IFUIFS UIF SJTL JOWPMWFT TJHOJöDBOU USBOTBDUJP (e) The degree of subjectivity in the measurement of financial information related to the risk, FTQFDJBMMZ UIPTF NFBTVSFNFOUT JOWPMWJOH B XJEF S (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A119-A123)
315.29	If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A124-A126)
330.21	If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)
550.18	In meeting the ISA 315 requirement to identify and assess the risks of material misstatement, the auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the auditor shall treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.
550.19	If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with ISA 240. (Ref: Para. A6, A29-A30)

10.1 Overview

After the business and fraud risks have been identified and assessed, consideration can be given to the existence of significant risks. A significant risk is where the assessed risk of material misstatement is so high that, in the auditor's judgment, it will require special audit consideration.

Significant risks are assessed before consideration of any mitigating controls. Significant risk is based on the inherent risk (before considering the related internal control) and not the combined risk (considering both inherent and internal control risks). For example, a company with a large inventory of diamonds would have a high inherent risk of theft. Management's response is to maintain secure facilities. The combined risks of material misstatement are therefore minimal. However, because the risk of loss (before considering internal control) is highly likely and its size would have a material impact on the financial statements, the risk would be determined as "significant."

$0 / 4 * % &03* /15

When considering the existence of significant risks, it can be difficult to ignore the mitigating effect of relevant internal control. This is particularly true when the people implementing the control are well known to the auditor and most likely are highly competent in what they do.

What is required is to separate the inherent risk from the controls in place. For example, an adult about to cross a busy street would not likely consider the activity to be very risky. This is because it is anticipated that adults use their eyes, ears, and previous experience (in crossing streets) to cross safely. But such a risk assessment combines the inherent risk involved in crossing the street with a number of control activities (the use of the eyes, ears, and previous experience). To assess whether crossing the street is a significant risk (i.e., before any controls), the person would have to be blindfolded, given earplugs, and then asked to walk across the street.

10.2 Examples

Examples of significant risks are set out in the exhibit below.

Exhibit 10.2-1

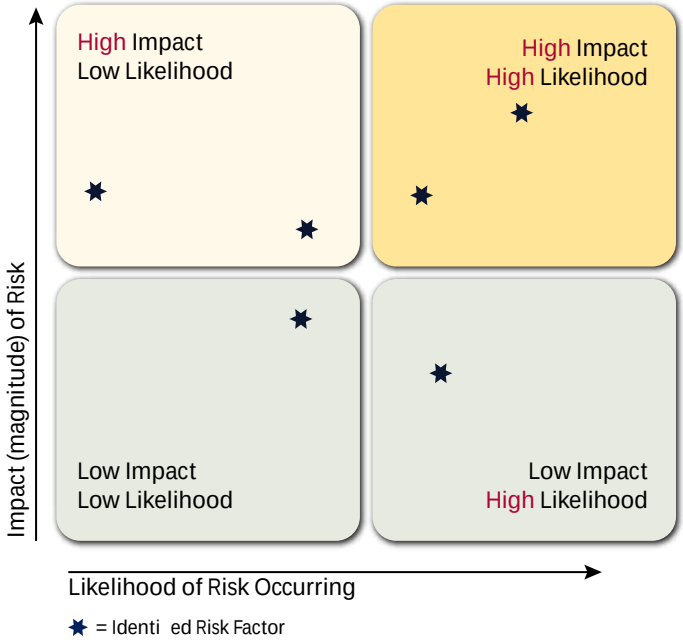
Sources	& Y B N Q M F T
High-Risk Activities	Includes operations or events where a material misstatement could easily occur. For example, an inventory of high-value diamonds or gold bars held by a jeweller, or a new/complex accounting system being introduced.

Sources	&YBNQMFT
Large Non-Routine 5SBOTBDUJPOT 4JJF PS /BUVSF	Identified significant related party transactions outside the entity's normal course of business are to be treated as giving rise to significant risks. Includes infrequent and large transactions. For example: t 6OVTVBM WPMVNF PG SPVUJOF USBOTBDUJPOT t " NBKPS TBMFT PS TVQQMZ DPOUSBDU t 5IF QVSDIBTF PS TBMF PG NBKPS CVTJOFTT BTT t 4BMF PG UIF CVTJOFTT UP B UIJSE QBSUZ Routine non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.
.BUUFST 3FRVJSJOH Judgment or .BOBHFNFOU Intervention	Examples would include: t 5IF BTTVNQUJPOT BOE DBMDVMBUJPOT VTFE CZ FTUJNBUFT t $PNQMFY DBMDVMBUJPOT PS BDDPVOUJOH QSJC t 3FWFOVF SFDPHOJUJPO QSFTVNFE UP CF B TJH EJòFSJOUHF SQSFUBUJPO t &YUFOTJWF NBOVBM EBUB DPMMFDUJPO BOE QS t 8IFSF NBOBHFNFOU JOUFSWFOUJPO JT SFRVJSF treatment to be used.
1PUFOUJBM GPS 'SBVE	The risk of not detecting a material misstatement resulting from fraud (which is intentional and deliberately concealed) is higher than the risk of not detecting one resulting from error. In evaluating whether significant risks could result from the identified fraud risk factors and the possible scenarios and schemes identified in team discussions (see Volume 2, Chapter 7), consider the following: t 4JHOJGJDBOU PG UIF QPUFOUJBM QFSQFUSBUPS t 3FMBUJWF TJ[F PG JOEJWJEVBM BNPVOUT NBOJ t -FWFM PG BVUIPSJUZ PG NBOBHFNFOU PS FNQM – Directly or indirectly manipulate accounting records, and ¦ 0WFSSJEF DPOUSPM QSPDFEVSFT t 'SFRVFODZ BOE FYUFOU PG NBOJQVMBUJPO JOV t 1PTTJCMF EFHSFF PG DPMMVTJPO t *OUFOUJPOBM NJTSFQSFTFOUBUJPOT CFJOH NB t 1SFWJPVT BVEJU FYQFSJFODF PS DPODFSOT FY Significant fraud risks may be identified at any stage in the audit as a result of new information being obtained.

10.3 Identifying Signi cant Risks

If the risks of material misstatement have already been identified and assessed, all that is required is to review the findings and then select (based on the use of professional judgment) those risks that are indeed significant. For example, if the assessment of risks was charted as illustrated below (the stars represent assessed risks), it would be the two risks falling within the shaded area (risks with high magnitude and high likelihood) that would first be considered as significant risks.

Exhibit 10.3-1



When considering whether significant risks exist, the auditor would consider the matters set out below.

	Considerations
' B D U 5 P I S B T U . B Z Indicate Possible i 4 J H O J ö D B O U 3 J T L T W	Risk of fraud.
	Risks related to recent significant economic, accounting, or other developments, and therefore require specific attention.
	Complexity of transactions.
	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.
	Significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

In smaller entities, significant risks can often relate to the matters outlined in the exhibit below.

Exhibit 10.3-2

4 V C K.FBDUUF S Information	Characteristics
4 J H O J ö D B O U Non-Routine 5 S B O T B D U J P O T	t)JHI JOIFSFOU SJTL MJLFMJIPPE BOE JNQBDU t 5SBOTBDUJPOT UIBU PDDVS JOGSFRVFOUMZ BOE I t 6OVTVBM EVF UP UIFJS TJ[F PS OBUVSF TVDI B t 3FRWXJSSFBHFNOUSWFOUJPO – To specify accounting treatment, and – For data collection and processing. t *OWPMWF DPNQMFY DBMDVMBUJPOT PS BDDPVO t /BUVSF PG USBOTBDUJPOT NBLFT JU EJóDVMU G internal control over the risks.
4 J H O J ö D B O U Judgmental .BUUFST	t)JHJDIFSSFJOTU t *OWPMWF TJHOJöDBOU NFBTVSFNFOU VODFSUBJ accounting estimates). t "DDPVOUJOH QSJODJQMFT JOWPMWFE NBZ CF T as preparation of accounting estimates or application of revenue recognition). t 5IF SFRVJSFE KVEHNFOU CZ NBOBHFNFOU NBZ C assumptions about the effects of future events (such as judgments about fair value, valuation of inventory subject to rapid obsolescence, etc.).
4 J H O J ö D B O U 5 S B O T B D U J P O B Risks	t 5IFSF NBZ CF B TNBMM OVNCFS PG USBOTBDUJP business processes (such as goods being shipped but not invoiced in a sales process) that would result in a material misstatement in the financial statements if not mitigated. Where these risks require special audit consideration, they would be regarded as significant risks. If there were no internal controls in place to mitigate such risks, they would also be reported to management as being a significant deficiency.
'SBVE	t 3FWFOVF SFDPHOJUJPO 5IJT JT B QSFTVNFE TJ t .BOBHFNFOU PWFSSJEF PS CJBT JO FTUJNBUFT t .BKPS SFMBUFE QBSUZ USBOTBDUJPOT VTFE UP t $PMMVTJPO XJUI TVQQMJFST PS DVTUPNFST TV t 6OSFDPSEFE PS öDUJUJPVT USBOTBDUJPOT

10.4 Responding to Signi cant Risks

When a risk is classified as being “significant,” the auditor should respond as outlined below.

Exhibit 10.4-1

Audit Steps	Description
Evaluate Internal $ P O U S P M % F T J H O Implementation 0 W F S & B D I 4 J H O J ö D B O U 3 J T L	Has management designed and implemented internal control that mitigates the significant risks? Consider the existence of direct controls such as control activities and indirect (pervasive) controls which may be included in the control environment, risk assessment, information systems, and monitoring elements. This information will be helpful in developing an effective audit response to the identified risks. Where significant non-routine or judgmental matters are not subject to routine internal control (such as a one-off or an annual event), the auditor would evaluate management’s awareness of the risks and the appropriateness of its response. For example, if the entity purchased the assets of another business, the entity’s response might include: t) J S J O H B O J O E F Q F O E F O U W B M V B U P S G P S U I F B t " Q Q M Z J O H B Q Q S P Q S J B U F B D D P V O U J O H Q S J O D J Q t 1 S P Q F S E J T D M P T V S F P G U I F U S B O T B D U J P O J O U Where the auditor determines that management has not appropriately responded (by implementing internal control over significant risks), a significant deficiency would exist in the entity’s internal control, which would be communicated (as soon as possible) to those charged with governance.
Design an Audit Response to U I F * E F O U J ö F E 4 J H O J ö D B O U 3 J T L T	Do the planned further audit procedures specifically address the significant risk? These procedures would be designed to obtain audit evidence with high reliability, and could include tests of controls and substantive procedures. In many cases, the audit procedures may simply be an extension of procedures that would be performed in any event. For example, if the significant risk related to potential management bias, such as in the preparation of an estimate, the extended substantive procedures would include: t " T T F T T J O H U I F W B M J E J U Z P G U I F B T T V N Q U J P O T t * E F O U J G Z J O H U I F T P V S D F T B O E S F M J B C J M J U Z P B O E O U F S O B M t $ P O T J E F S J O H U I F F Y J T U F O D F P G B O Z C J B T J O U D P N Q B S F E U P B D U V B M G B D T B O E t 3 F W J F X J O H U I F N F U I P E T V T F E J O D M V E J O H G P S the estimate calculation.
No Reliance $ B O # F 1 M B D F E O 4 W J E F O D F 0 G U B J O F E in Previous Periods	Where a test of operating effectiveness is planned for a control that mitigates a significant risk, the auditor may not rely on audit evidence about the operating effectiveness of internal control obtained in prior audits.

Audit Steps	Description
Substantive Analytical Procedures Alone are not Su cient	The use of substantive analytical procedures by themselves is not considered an appropriate response to address a significant risk. When the approach to significant risks consists only of substantive procedures, the audit procedures shall consist of either: t 5FTUT PG EFUBJMT BMPOF PS t " DPNCJOBUJPO PG UFTUT PG EFUBJMT BOE TV

10.5 Documenting Signi cant Risks

The identification of significant risks and the proposed audit response would be documented. If all risks are documented in a single location, the documentation of significant risks may simply be an extension of the information already documented.

Note: If the auditor concludes that revenue recognition is not a significant risk of material misstatement due to fraud, the reasons for that conclusion are to be included in the audit documentation.

10.6 Case Studies—Signi cant Risks

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Significant risks can be identified from the listing of risk factors and their assessment. See the forms contained in the case studies discussion in Volume 2, Chapters 8 and 9. Such a form can also be used to cross-reference each significant risk to the related detailed audit plan.

For each significant risk identified, management's response should be documented and appropriate audit procedures developed that respond to the specific risk.

$BTF 4UVEZ " ‰ %FQIUB 'VSOJUVSF *OD

(Excerpt)

4JHOJöDBOU Risk	. BOBHFNFOU T 3FTQPOTF	Audit Response	WP Reference
Possible violation of terms of their bank's nancing?	Preparation and monitoring of cash- ow forecasts. Renegotiate amount and terms of nancing.	Look at the company's growth plans and whether the forecasted cash ows are realistic. Review and compare actual results and cash ows. Ensure that the valuations of receivables and inventory (the security for the loans) are reasonable. Review the company's re nancing submission to the bank. Review any response/correspondence from the bank.	(Not included)
Financial statement manipulation could occur to avoid the bank covenants being violated.	None. Management does not see this as a risk at all.	Carefully review the assumptions used in the cash- ow forecasts and the basis on which actual cash- ow reports are prepared. Ensure that the basis for the valuations of receivables and inventory is valid and correct. Carefully test the existence and accuracy of sales, as there is pressure to maintain and grow sales levels despite the challenging economic environment.	
Inconsistent revenue recognition (a presumed fraud risk).	Sales contracts over 500 are reviewed by the sales manager	Review of major contracts (and a sample of smaller contracts) and discussion with sales manager to ensure that revenue was appropriately recognized in the period.	
Unauthorized journal entries.	Management has agreed to approval of all journal entries, but it has not yet been implemented.	Identify and review all journal entries over 1,500 and all entries in the month before and after the period end.	
Signi cant expansion in the use of related party transactions.	Policy is that all related party transactions are identi ed as such and conducted at the normal terms of sale. This includes any corporate assets or services provided for personal use by management or employees.	Review employees' understanding of the policy Seek to ensure that all related party transactions have been identi ed and that the transactions, terms of sale, nature of transaction, and the dates are indeed appropriate.	

Prepared by: FJ Date: December 9, 20X2

Reviewed by: LF Date: January 5, 20X3

.FNP UP 'JMF ,VNBS $P

*EFOUJöDBUJPO PG 4JHOJöDBOU 3JTLT

The following significant risk areas, including management's response and the audit response, are identified below.

%PXOUVSO JO FDPOPNZ

The company has not suffered too badly in the downturn. However, Raj should periodically review bank covenant calculations, but he has not been attentive to this in the current period under audit. We will recalculate all ratios to see status against covenants. We will also perform more audit procedures for audit areas that are input into the calculation. The risk is heightened the closer the company is to violation, due to possibility of financial statement manipulation.

5BY NJOJNJ[BUJPO

There are no management controls that specifically address this issue. The response to this risk will be to carefully review management's estimates and journal entries (see below).

6OBVUIPSJ[FE +PVSOBM &OUSJFT

Raj should authorize all journal entries, but this has not been happening consistently. We will identify and review all journal entries over 500€ and all entries in the month before and after period end.

3FMBUFE5SBOTBDUJPOT

Company policy is that all related party transactions are identified as such and conducted at the normal terms of sale. We will review Raj's and Ruby's understanding of the policy through inquiry and inspection. We will ensure that for all related party transactions, the terms of sale, nature of transactions, and the dates are indeed appropriate. We will also remain alert throughout the audit for transactions outside the normal course of business, and that all related party transactions have in fact been identified.

Revenue recognition

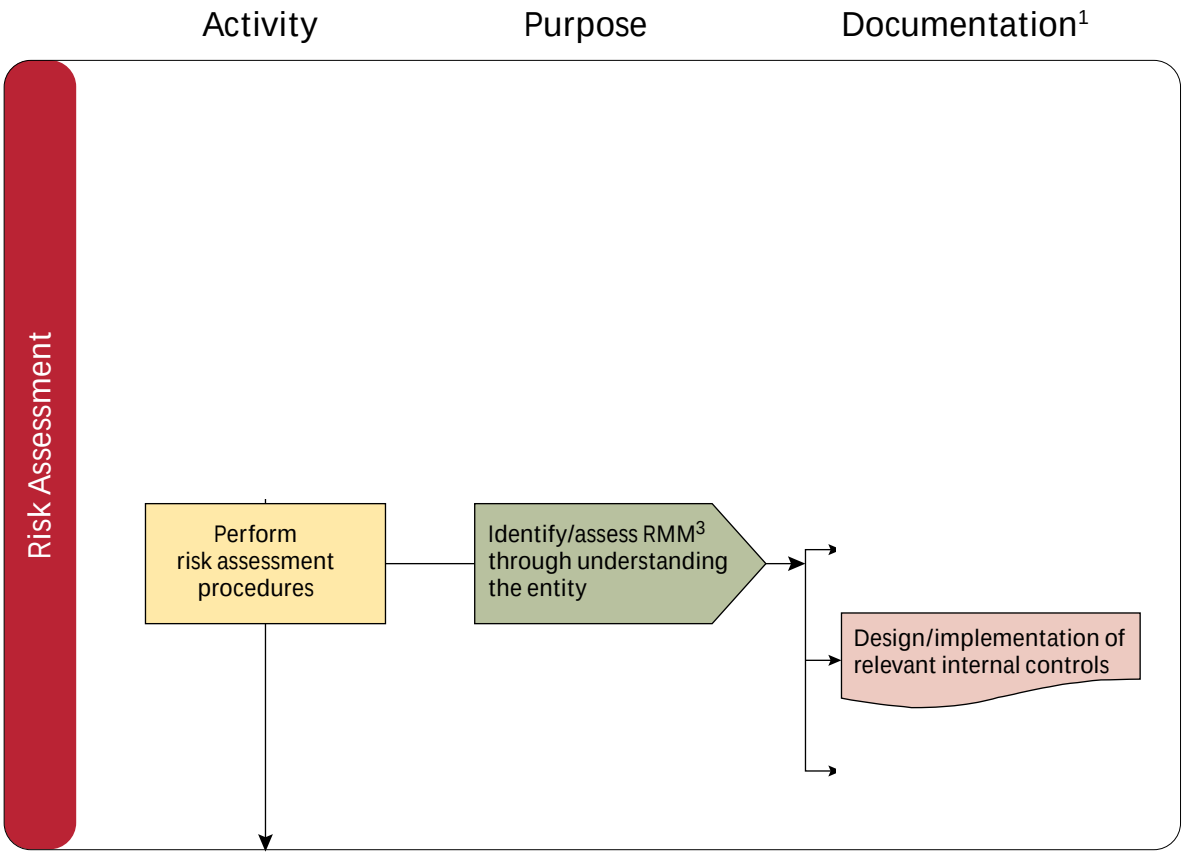
Revenue recognition policies on sales are fairly straightforward and the majority of sales made by Kumar are to Dephta Furniture, Inc. The audit work performed on cutoff and related party transactions addressed any potential for fraud through inappropriate revenue recognition.

Prepared by:FJ Date: December 9, 20X2

3FWJFXFE Date: January 5, 20X3

Chapter Content	Relevant ISAs
Guidance on the steps involved in understanding internal control relevant to the audit: t &WBMVBUJOH DPOUSPM EFTJHO BOE JNQMFNFOUBUJPO BO t %PDVNFOUBUJPO VTJOH UXP QPTTJCMF BQQSPBDIFT	315

Exhibit 11.0-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
315.4	For purposes of the ISAs, the following terms have the meanings attributed below: (a) Assertions—Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur. (b) Business risk—A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies. (c) Internal control—The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.
315.12	The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A42-A65)
315.14	The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether: (a) Management, with the oversight of those charged with governance, has created and NBJOUBJOFE B DVMUVSF PG IPOFTUZ BOE FUIJDBM CFIBW (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A69-A78)
315.15	The auditor shall obtain an understanding of whether the entity has a process for: B *EFOUJGZJOH CVTJOFTT SJTLT SFMFWBOU UP öOBODJBI C &TUJNBUJOH UIF TJHOJöDBODF PG UIF SJTLT D "TTFTTJOH UIF MJLFMJIPPE PG UIFJS PDDVSSFODF BOE (d) Deciding about actions to address those risks. (Ref: Para. A79)
315.18	The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: (a) The classes of transactions in the entity's operations that are significant to the financial TUBUFNFOUT (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to UIF HFOFSBM MFEHFS BOE SFQPSUFE JO UIF öOBODJBM T (c) The related accounting records, supporting information and specific accounts in the öOBODJBM TUBUFNFOUT UIBU BSF VTFE UP JOJUJBUF SF includes the correction of incorrect information and how information is transferred to the HFOFSBM MFEHFS 5IF SFDPSET NBZ CF JO FJUIFS NBOVB (d) How the information system captures events and conditions, other than transactions, that BSF TJHOJöDBOU UP UIF öOBODJBM TUBUFNFOUT (e) The financial reporting process used to prepare the entity's financial statements, including TJHOJöDBOU BDDPVOUJOH FTUJNBUFT BOE EJTDMPTVSFT (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A81-A85)

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
315.19	The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including: (Ref: Para. A86-A87) B $PNNVOJDBUJPOT CFUXFFO NBOBHFNFOU BOE UIPTF DI (b) External communications, such as those with regulatory authorities.
315.20	The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A88-A94)
315.21	In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A95-A97)
315.22	The auditor shall obtain an understanding of the major 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 remedial actions to deficiencies in its controls. (Ref: Para. A98-A100)

11.1 Overview

This chapter addresses the scope of work required to understand internal control relevant to the audit. Volume 1, Chapter 5 addresses the nature of internal control and provides a detailed description of the five components of internal control. Volume 2, Chapter 12 outlines a four-step approach to internal control evaluation.

Internal control refers to the processes, policies, and procedures designed by management to ensure reliable financial reporting and the preparation of financial statements in accordance with the applicable accounting framework. Internal control addresses such matters as management's attitude toward control, competence of key people, risk assessment, accounting, and other financial information systems in use, as well as the traditional control activities.

The auditor is required to obtain an understanding of internal control on all audit engagements. This applies to any size of entity, even where the auditor has already decided that an entirely substantive approach would be the appropriate response to the risks of material misstatement.

Obtaining a sufficient understanding of internal control (relevant to the audit) involves the performance of risk assessment procedures to identify the controls that will directly or indirectly mitigate material misstatements. The information obtained will assist the auditor in:

t "TTFTTJOH UIF SFTJEVBM SJTL JOIFSFOU BOE DPOUSPM SJT
BOE BTTFSUJPO MFWFMT BOE

t %FTJHOJOH GVSUIFS BVEJU QSPDFEVSFT UIBU BSF SFTQPOT

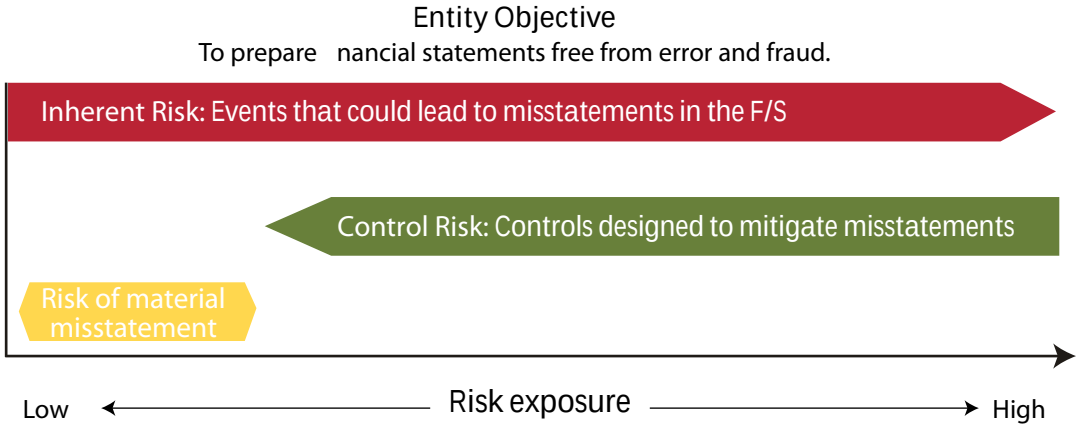
However, not all control activities are relevant to the audit and therefore do not require understanding. The auditor is only concerned with evaluating those controls that mitigate a risk of a material misstatement (caused by fraud or error) in the financial statements. Control activities that are not relevant can be scoped out of the audit altogether.

11.2 Risk and Control

The relationship between risk and control can be illustrated as follows.

Exhibit 11.2-1

The inherent risk bar represents the business and fraud risk factors that could result in the nancial statements being materially misstated (before any consideration of internal control). The control risk bar re ects the control procedures put into e ect by management to mitigate the inherent risks. The extent to which the control risk bar does not completely mitigate the inherent risks is often called management's residual risk.



Inherent business and fraud risks are identified during the risk identification and risk assessment phase. Management mitigates such risks by designing and implementing internal controls and procedures that will reduce such risks to an acceptably low level. The amount of risk left over, after internal controls have been designed and implemented, is the risk of material misstatement (sometimes referred to as residual risk).

Ideally, management would design sufficient controls to ensure that the residual risk is reduced to an acceptably low level for both internal management purposes and for the external audit. In practice, some managers will tend to have a high tolerance for risk (i.e., less controls are in place, resulting in a higher residual risk), and some managers (often in the public sector) will tend to be conservative and design controls to reduce risk to almost nothing.

$0 / 4 * % &03* /15

The sole purpose of a control is to mitigate risk. A control without a risk to mitigate is obviously redundant. So, a risk has to exist before it can be mitigated by a management control. However, some auditors ignore this fact. They start their evaluation of internal control by documenting the system and controls that exist before taking the time to identify what risks actually require mitigation. This approach can result in a lot of unnecessary work in documenting processes and controls, which may later prove to be totally irrelevant to the audit objectives.

11.3 Pervasive and Speci c Internal Controls

Internal controls can be broadly categorized as pervasive (or entity-level) controls that address pervasive risks, and specific (transactional) controls that address specific risks. The differences between these controls are illustrated below.

Exhibit 11.3-1

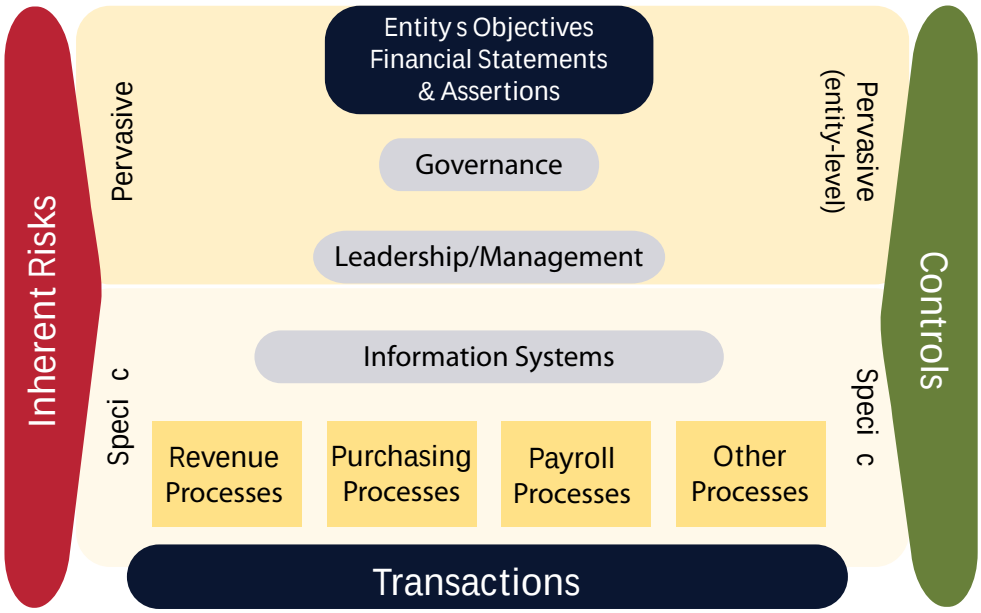


Exhibit 11.3-2

	Description
Pervasive (Entity- - F W F M $ P O U S P M T	Pervasive (entity-level) controls address governance and general management, and serve to establish the overall control environment or "tone at the top." Typical control processes include human resources, fraud, risk assessment (management override), general IT management, preparation of financial information (including financial statements and underlying estimates, etc.), and the ongoing monitoring of operations. In small entities, these controls will refer primarily to management's attitudes toward integrity and control. A solid understanding of the pervasive elements of internal control provides an important foundation for assessing relevant controls over financial reporting at the transactional (business process) level. For example, if there are poor controls over data integrity at the entity level, this will impact the reliability of all information produced by systems such as sales, purchases, and payroll.

	Description
4 Q F D J ö D 5 S B O T B D U J P O R M Controls	Transactional (business process) controls are specific processes/controls that are designed to ensure that: t 5SBOTBDUJPOT BSF BQQSPQSJBUFMZ SFDPSEFE TUBUFNFOUT t "DDPVOUJOH SFDPSET BSF NBJOUBJOFE JO SFB SFøFDU BMM UIF USBOTBDUJPOT BOE EJTQPTJUJ t 3FDFJQUT BOE FYQFOEJUVSFT BSF NBEF PO MZ PG NBOBHFNFOU BOE t 6OBVUIPSJ[FE BDRVJTJUJPO VTF PS EJTQPTJU detected on a timely basis. Transactional control processes include routine transactions (such as revenues, purchases, and payroll) and non-routine transactions (such as purchasing equipment or the costs involved in starting a new line of business).

11.4 The Five Internal Control Components

The various types of internal control that exist within an entity have been divided into five key components, as illustrated below.

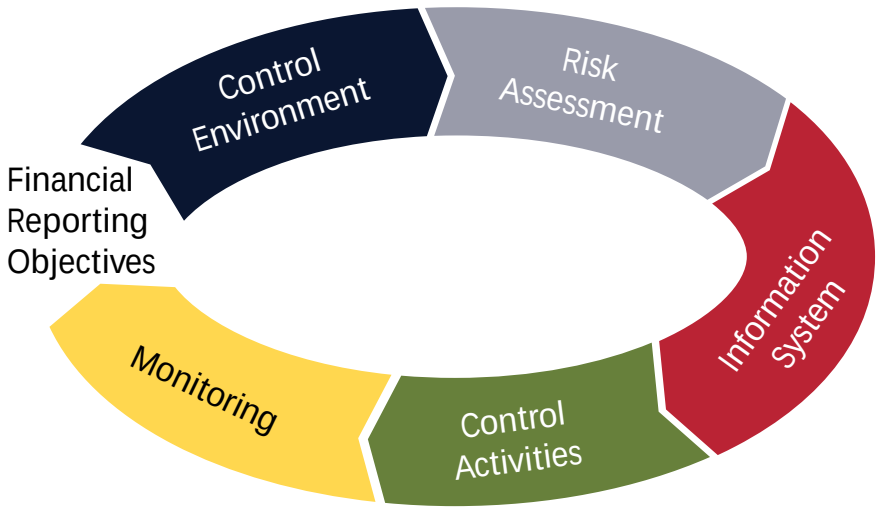
Each of these components is to be addressed by the auditor as:

t 1BSU PG UIF VOEFSTUBOEJOH PG UIF JOUFSOBM DPOUSPM

t *OGPSNBUJPO GPS DPOTJEFSJOH IPX UIF EJòFSFOU BTQFDU

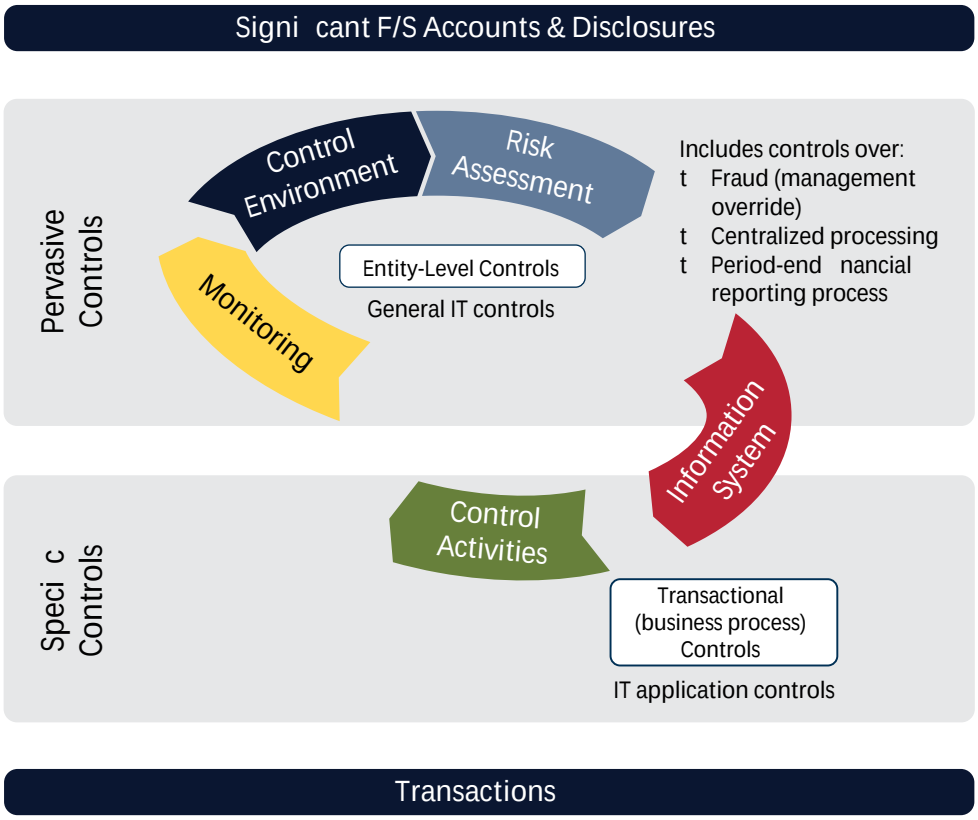
Exhibit 11.4-1 below outlines the five components of internal control that can be used by management to reduce the risks of material misstatement in the financial statements. The circle indicates the ongoing nature of the various components in achieving the entity's financial reporting objectives.

Exhibit 11.4-1



The interrelationships of the five components between the pervasive (entity-level) controls and the specific transactional (business process) controls are illustrated below.

Exhibit 11.4-2



Pervasive entity-level controls collectively provide the appropriate foundation for all the other components of internal control, because poor entity-level controls can render even the best business process controls ineffective. For example, an entity may have an effective purchasing system, but if the bookkeeper/ accountant is incompetent (i.e., it is a poor control environment), a wide variety of errors could occur and possibly result in a material misstatement in the financial statements. Management override and poor "tone at the top" (that primarily occur at the entity level) are common themes in bad corporate behavior.

$0 / 4 * % &03* /15

How an entity actually designs and implements its internal control will vary with an entity's size and complexity. In smaller entities, the owner-manager may perform functions that address several of the components of internal control.

11.5 Internal Control in Smaller Entities

In smaller entities, there are often few employees, which may limit the extent to which:

t 4FHSFHBUJPO PG EVUJFT JT QSBDUJDBCMF BOE

t "O BQQSPQSJBUF QBQFS USBJM PG EPDVNFOUBUJPO JT BWB

Internal control in such entities often derives from the control environment (management's commitment to ethical values, competence, attitude toward control, and its day-to-day actions) as opposed to specific controls over transactions. Evaluating the control environment is quite different from traditional control

activities, as it involves an assessment of the behavior, attitudes, competence, and actions of management. Such assessments are often documented in a memo or with a questionnaire.

The presence of a highly involved owner-manager is often an internal control strength and a control weakness. The control strength is that the person (assuming his/her competence) will be knowledgeable about all aspects of operations, and it is highly unlikely that material misstatements will be missed. The control weakness is the opportunity provided for that person to override the internal control for his/her own benefit.

$0 / 4 * % &03* /15

*E F O U J G Z U I F Q F S W B T J W F F O U J U Z M F W F M D P O U S P M T
In the audit of small entities, there is a temptation to assume that internal control is nonexistent, and therefore, not worth understanding. However, any entity that wants to continue operating will have some form of internal control. For example, what business manager does not care whether the cash receipts are deposited in the bank, or that goods shipped are invoiced?

$P O T J E F S I P X U I F Q F S W B T J W F F O U J U Z M F W F M D P O U S P M T D P
In cases where the owner-manager or equivalent approves transactions and carefully reviews financial results, the control can have the effect of preventing or detecting misstatements occurring at the assertion level. If reliance on such a control would reduce the need for other substantive procedures, consider whether such controls could be evidenced, such as by a signature on a report or a reconciliation to indicate review or approval. Such evidence could then be used to test the operating effectiveness of the control.

11.6 Absence of Internal Control

In virtually all entities, there is some form of internal control, such as the competence of the owner-manager (control environment). It may be informal and unsophisticated, but it is still internal control. An entity that does not mitigate any of the major risks it faces (through control components such as the control environment, risk assessment, information systems, control activities, or monitoring) is unlikely to stay in business for long.

Where there are not many control activities that can be identified, the auditor would consider whether:

- *U J T Q P T T J C M F U P B E E S F T T U I F S F M F W B O U B T T F S U J P O T C Z T V C T U B O U J W F Q S P D F E V S F T P S
- 5 I F B C T F O D F P G D P O U S P M B D U J W J U J F T P S P G P U I F S D P N Q P obtain sufficient appropriate audit evidence.

Other matters that would raise questions as to whether the audit should be conducted would include:

- $P O D F S O T B C P V U N B O B H F N F O U T J O U F H S J U Z O P O F U I J D B M control. Deficiencies in the control environment tend to undermine controls that exist in other control D P N Q P O F O U T *U B M T P S B J T F T U I F S J T L P G N B O B H F N F O U N J T
- $P O D F S O T B C P V U U I F D P O E J U J O O B E S E M J B C J M J U Z P G B O appropriate audit evidence will be available to support an unqualified opinion.

If these or similar concerns are present, the auditor should consider the need to modify the auditor's report or withdraw from the engagement altogether.

If withdrawal is chosen, the auditor would consider his/her professional and legal responsibilities, including any requirement to report to the persons who made the audit appointment and to regulatory authorities. The auditor would also discuss the withdrawal and the reasons with the appropriate level of management and those charged with governance.

11.7 Controls to Prevent Fraud (Anti-Fraud Controls)

Management override can often be mitigated or slowed down in small entities by establishing and then documenting key policies and procedures. For example, a written policy that says all non-routine journal entries require approval would empower the bookkeeper to ask the manager to approve proposed journal entries. It would not prevent management override from occurring, but would act as a deterrent. If anti-fraud policies and procedures are not in operation, the risk of management override will need to be addressed by the auditor through performing other audit procedures.

Note: Controls that address compliance with regulations that are not relevant to the audit (where non-compliance would not result in a material misstatement in the financial statements) do not need to be addressed in the audit.

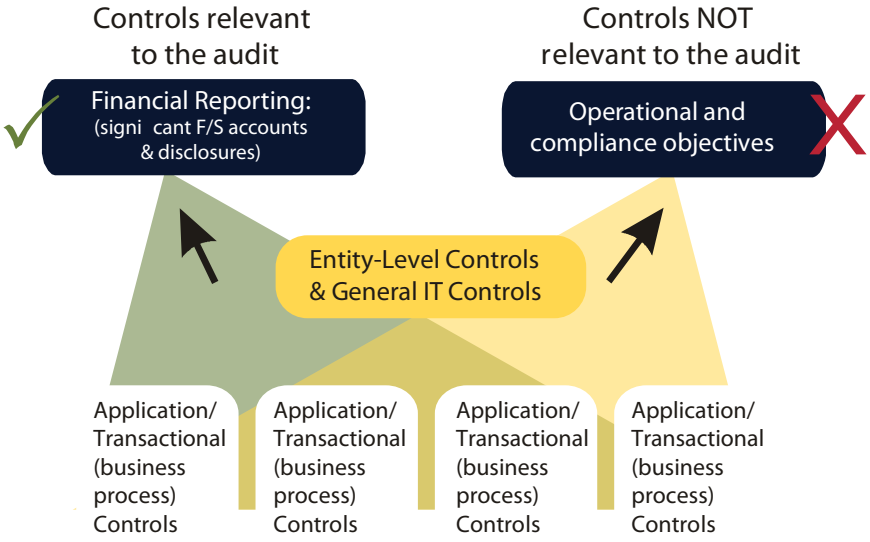
11.8 Internal Controls Relevant to the Audit (the scope of understanding)

Not all controls are relevant to the audit. The auditor is only concerned with understanding and evaluating those controls that would mitigate a risk of a material misstatement (due to fraud or error) in the financial statements. This means that certain types of controls can be scoped out of the audit altogether, as illustrated in the following exhibit. These are controls that:

t %P OPU ESJWF öOBODJBM SFQPSUJOH TVDI BT PQFSBUJPOB SFHVMBBUJPOT

t &WFO JG OPO FYJTUFOU B NBUFSJBM NJTTUBUFNFOU JO UIF

Exhibit 11.8-1



In some cases, there may be some overlap between financial controls and controls relating to operations and compliance objectives. Examples include controls that pertain to data the auditor evaluates or uses in applying other audit procedures such as:

- %BUB SFRVJSFE GPS BOBMZUJDBM QSPDFEVSFT F H QSPEV
- $POUSPMT UIBU EFUFDU OPO DPNQMJBODF XJUI MBXT BOE S
- 4BGFHVBSEJOH PG BTTFU DPOUSPMT UIBU QFSUBJO UP öOBC
- $POUSPMT PWFS UIF DPNQMFUFOFTT BOE BDDVSBDZ PG JOG calculating key performance measures.

Controls that would always be relevant to the audit include those that mitigate the following risks.

Exhibit 11.8-2

	Description
4JHOJöDBOU 3JTLT	Significant risks are identified and assessed risks of material misstatement that, in the auditor's judgment, require special audit consideration.
3JTLT UIBU $BOOPU &BTJMZ #F Assessed by Substantive Procedures	These are identified and assessed risks of material misstatement for which substantive procedures alone would not provide sufficient appropriate audit evidence.
0UIFS 3JTLT PG .BUFSJBM .JTTUBUFNFOU	These are identified and assessed risks of material misstatement that, in the judgment of the auditor, could potentially result in material misstatements occurring.

The auditor's judgment about whether a particular control is relevant to the audit is influenced by:

- ,OPXMFEHF BCPVU UIF QSFTFODF BCTFODF PG DPOUSPMT JE If a particular risk has already been addressed (such as by the control environment, information system, FUD UIFSF JT OP OFFE UP JEFOUJGZ BOZ BEEJUJPOBM DPO
- 5IF FYJTUFODF PG NVMUJQMF DPOUSPM BDUJWJUJFT UIBU B BO VOEFSTUBOEJOH PG FBDI PG UIF DPOUSPM BDUJWJUJFT S
- 5IF OFFE UP UFTU UIF PQFSBUJOH FòFDUJWFOFTT PG DFSUB practical way to test sales completeness (i.e., by performing substantive procedures), a test of the PQFSBUJOH FòFDUJWFOFTT PG DPOUSPMT XPVME CF SFRVJSF
- 5IF JNQBDU UIBU UFTUJOH UIF PQFSBUJOH FòFDUJWFOFTT P reduction) of substantive testing required.

Professional judgment is required to determine whether an internal control, individually or in combination with others, is in fact relevant.

$0 / 4 * % &03* /15

5PQ EPXO BOE SJTL CBTFE

The auditor's approach to understanding internal control should be from the top down. The first step is to identify the relevant entity-level and transactional risks, and then determine whether management's response is appropriate.

A solid understanding of entity-level controls provides an important basis for assessing relevant controls over financial reporting at the transactional (business process) level. For example, if there are poor controls over data integrity at the entity level, this will impact the reliability of all information produced by systems such as sales, purchases, and payroll.

& Y B N Q M F

The top-down and risk-based approach to understanding internal control involves:

- t *EFOUJGZJOH UIF CVTJOFTT QSPDFTTFT JOWPMWFE JODMVEJ
- t %FUFSNJOJOH GPS FBDI QSPDFTT JEFOUJöFE XIFUIFS B NB TUBUFNFOUT DPVME QPTTJCMZ PDDVS PS XIFUIFS PUIFS GE
- t 4DPQJOH PVU PG UIF BVEJU UIPTF QSPDFTTFT BOE DPOUSP

For example, a biscuit production company may have the following processes that drive the sales revenue figure:

- t 5IF NBJO TBMFT PSEFS TZTUFN DBQUVSFT EFUBJMT BOE UI telephone. This accounts for 70% of sales.
- t i8JOEPX TBMFTw PDDVS XIFO DVTUPNFST CVZ CSPLFO CJTD production facility. These account for 2% of sales.
- t *OUFSOFU TBMFT‰PSEFST BSF QMBDFE POMJOF BOE QBJE C
- t 5IF BDDPVOUJOH TZTUFN DBQUVSFT EFUBJMT PG BMM UZQI

In this situation, the window sales are unlikely to result in a material misstatement in the financial statements and may therefore be scoped out of the audit. However, before this decision is made, it would still be prudent to either:

- t *ORVJSF BCPVU UIF FYJTUFODF PG DPOUSPMT PWFS UIF XJC recorded, and that there is no deliberate breaking of biscuits for sale at reduced prices to related QBSUJFT PS
- t 1FSGPSN BO BOBMZUJDBM SFWJFX PG UIF CSFBLEPXO PG T deviated from the expected 2% of sales.

11.9 Case Studies—Identifying Relevant Controls

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Note that the following step is often carried out as part of the planning process.

Since not all business processes and controls are relevant to the audit, it is important to understand which financial statement areas and controls could have a material impact on the financial statements.

Determining which financial statement areas and related business processes are in scope involves using overall materiality as a guide to identify:

- 8IBU öOBODJBM TUBUFNFOU BSFBT BSF PS DPVME CF NBUF
- 8IBU FOUJUZ MFWFM DPOUSPMT BOE CVTJOFTT QSPDFTTFT E

Immaterial balances, transactions, business processes, and controls where no material misstatements are likely to result can be scoped out of any further consideration in the audit. However, before scoping an area out, consider:

- 5IF QPTTJCMF BDDVNVMBUJPO PG JNNBUFSJBM NJTTUBUFNF NBUFSJBM NJTTUBUFNFOU BOE
- 8IFUIFS UIF öOBODJBM TUBUFNFOU BSFB JT VOEFSTUBUFE E

$BTF 4UVEZ "‰%FQIUB 'VSOJUVSF *OD

	*EFOUJGZ BOZ 1SPDFTTFT 5IBU .JUJHB
Pervasive risks	Annual business planning cycle, management/owner monthly meetings, that include reviews of financial information, the code of conduct for staff, IT budgets, day-to-day involvement of management in operations, human resource policies and general IT controls
Cash and cash equivalent	Receivables, receipts process, investment of short-term (30 to 60-day) deposits at bank, bank reconciliations, and cash management
Trade and other receivables	Revenue, receivables, receipts process, valuation of overdue accounts, asset sales
Inventories	Purchases, payables, payments process, inventory management, stock taking, valuation of obsolete inventory
Property, plant, and equipment	Purchases, payables, payments process, calculation of amortization, capitalization of assets, asset sales
Bank indebtedness	Receivables, receipts process, bank reconciliation, and cash management
Trade and other payables	Purchases, payables, payroll, payments process, capitalization of assets
Income tax payable	Income tax provision preparation
Interest-bearing loan	Finance charges, bank reconciliation process
Capital and reserves	Issuance/redemption of capital, dividends
Sales	Revenue, receivables, receipts process (including cash scrap sale, Internet sales, catalog, and custom sales orders)
Cost of goods sold	Purchases, payables, payroll, payments process, inventory adjustments
Distribution costs	Purchases, payables, payroll, payments.
Administrative costs	Purchases, payables, payroll, payments
Depreciation	Depreciation and amortization calculations
Finance cost	Finance charges, bank reconciliation process
Income taxes	Income tax provision preparation

Prepared by: FJ Date: February 18, 20X3

3 F W J F Date: March 5, 20X3

.FNP UP 'JMF 4DPQJOH NBUFSJBM öOBODJBM TUBUFNFOU BSF

&OUJUZ -FWFM BOE (FOFSBM *5

t 3BK QSFQBSFT BO BOOVBM CVEHFU FBDI QFSJPE GPS UIF C
t 3BK DPNNVOJDBUFT XJUI UIF CBOL NBOBHFS RVBSUFSMZ XIFC
t 3BK VTVBMMZ SFWJFXT UIFTF XJUI 4VSBK BOE +BXBE TJOD
appreciates their input and Jawad's accounting and financial knowledge.

There is no formal IT structure or process. Raj decides what software and hardware to replace on an as-needed basis. Although Raj ensures that Ruby backs up the accounting data weekly, there is no disaster recovery plan or documented IT process.

.BUFSJBM öOBODJBM TUBUFNFOU BSFBT

With the exception of cash and cash equivalents, which seem to fluctuate from period to period, all FSAs on the financial statements are material and in scope. Therefore, the following business processes will need to be examined as part of our audit:

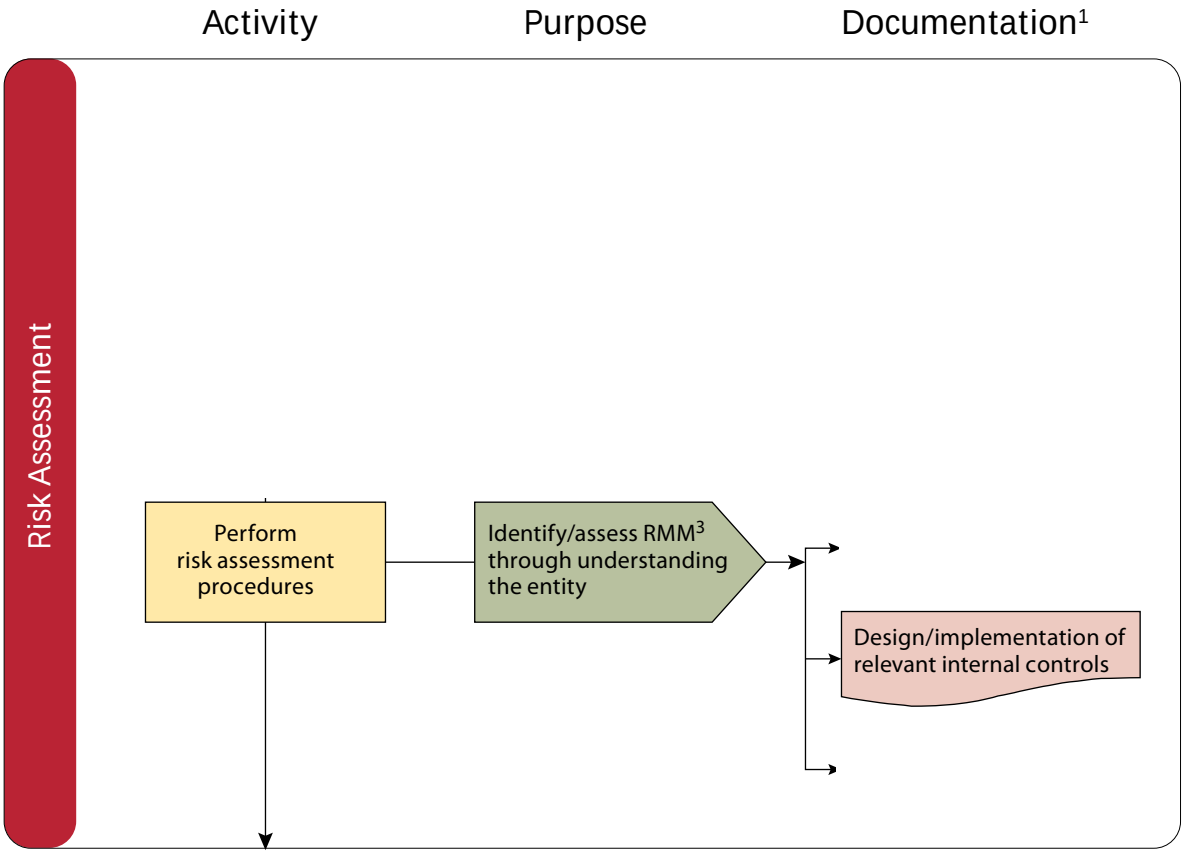
#VTJOFTTQSPDFTT	.BUFSJBM 'JOBODJBM 4UBUF
Receivables/receipts	Revenue, trade receivables & other, cash and cash equivalents
Valuation of overdue accounts receivable	Trade receivables & bad debt expense
Sales process (cash sales, sales orders)	Revenue
Purchases, payables, payments	Trade payables & other, property, plant and equipment, inventories, income statement expense categories
Payroll	Payroll expenses
Taxes payable and remittances	Income, payroll, and sales taxes
Inventory valuation and management	Purchases and inventories
Bank account reconciliations	Cash and cash equivalents, interest-bearing loan, interest expense
Calculation of depreciation and amortization	Property, plant, and equipment, and depreciation/ amortization expense

Prepared by: FJ Date: February 18, 20X3

3FWJFXFE Date: March 5, 20X3

Chapter Content	Relevant ISA
Guidance on the four key steps involved in evaluating control design and implementation, and on documenting the results.	315

Exhibit 12.0-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
315.13	When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A66-A68)
315.29	If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A124-A126)
315.32	The auditor shall include in the audit documentation: (a) The discussion among the engagement team where required by paragraph 10, and the TJHOJöDBOU EFDJTJPOT SFBDIFE (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control DPNQPOFOUT TQFDJöFE JO QBSBHSBQIT UIF TPVSDF VOEFSTUBOEJOH XBT PCUBJOFE BOE UIF SJTL BTTFTTNF (c) The identified and assessed risks of material misstatement at the financial statement level BOE BU UIF BTTFSUJPO MFWFM BT SFRVJSFE CZ QBSBHSB (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30. (Ref: Para. A131-A134)

12.1 Overview

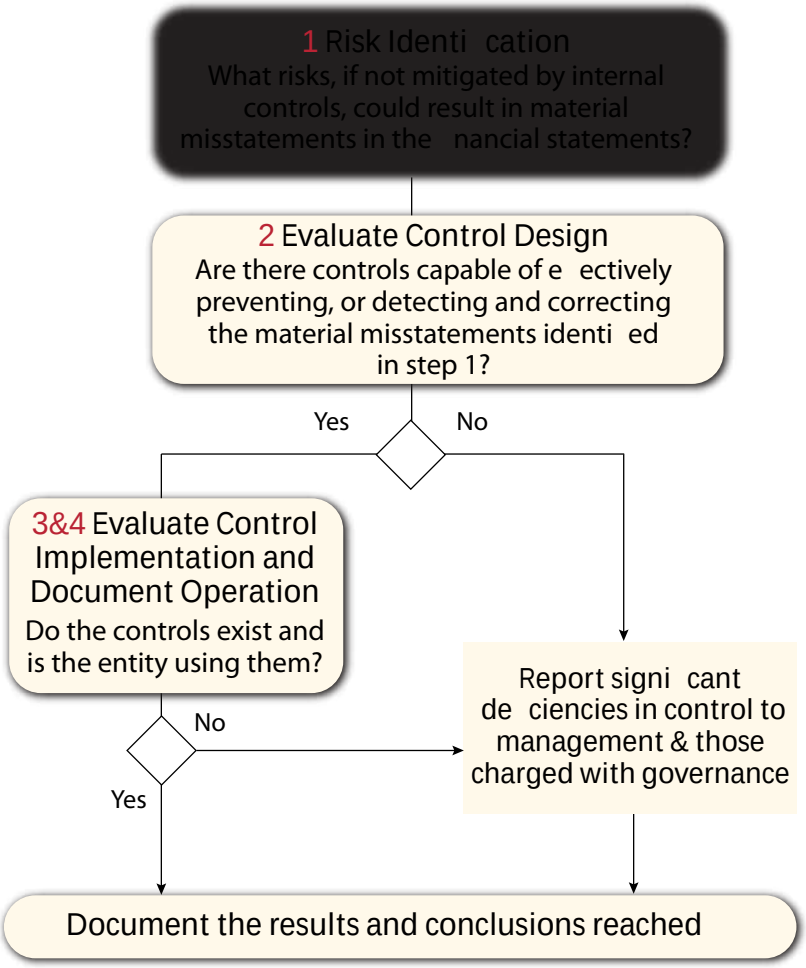
Regardless of whether tests of controls will ultimately be performed to gather audit evidence, it is still necessary for the auditor on every engagement to evaluate control design and implementation. This involves a four-step process, which can be summarized as follows.

Exhibit 12.1-1

	Description
Step 1 What Risks Require .JUJHBUJPO	Identify the inherent risks of material misstatement (business and fraud risks), and whether they are pervasive risks affecting all assertions, or specific risks that affect particular financial statement areas and assertions.
Step 2 Do the Controls Designed by .BOBHFNFOU .JUJHBUF UIF 3JTL	Identify what business processes are in place (if any). t *OUFSWJFX FOUJUZ QFSTPOOFM UP JEFOUJGZ X in Step 1 above. t 3FWJFX SFTVMUT BOE BTTFTT XIFUIFS UIF DPOU t $PNNVOJDBUF BOZ TJHOJöDBOU EFöDJFODJFT J control to management and those charged with governance. In larger entities, this step may require reference to or preparation of some system documentation (see Step 3 below) to provide some context regarding the operation of certain controls.
4UFQ Are the Controls 5IBU .JUJHBUF UI 3JTLT 'BDUPS 0QFSBUJPO	Observe or inspect the operation of relevant internal controls to ensure that they have indeed been implemented. Note that inquiry of management is not sufficient to evaluate whether a relevant control has in fact been implemented. This step can often be combined with Step 2 above.

	Description
Step 4) B T U I F 0 Q F S B U J P O of Relevant $ P O U S P M T #F F O Documented?	This step can consist of a simple narrative description of the major processes (prepared by the entity's management or auditor), describing the operation of the relevant internal controls identified. This documentation does not have to include: t " E F U B J M F E E F T D S J Q U J P O P G U I F C V T J O F T T Q S U I F F O U J U Z P S t *O U F S O B M D P O U S P M T U I B U N B Z F Y J T U C V U B S F

Exhibit 12.1-2



Note: Regardless of how well a control is designed and implemented, it can only provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting due to certain inherent limitations. These are described below.

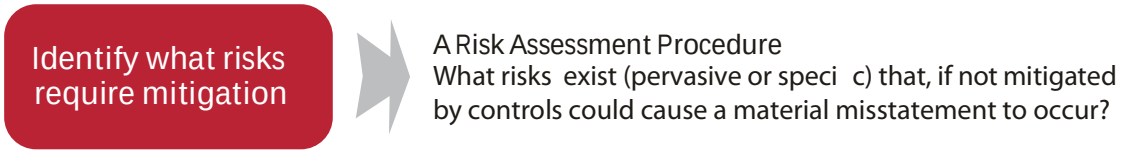
Exhibit 12.1-3

	Description
Internal Control Limitations	t) V N B O K V E H N F O U T B O E T J N Q M F I V N B O G B J M V S F t $ J S D V N W F O U J P O P G J O U F S O B M D P O U S P M C Z U I I t * O B Q Q S P Q S J B U F N B O B H F N F O U P W F S S J E F P G J O terms of a sales contract or overriding a customer's credit limit.

Volume 2, Chapter 11 addresses the understanding of internal control required. Volume 1, Chapter 5 addresses the nature of internal control and provides a detailed description of the five components of internal control.

12.2 Step 1—What Risks Require Mitigation?

Exhibit 12.2-1



Before the auditor begins to document the controls that may exist, the first step is to identify and then assess the significant and other risk factors that are present. Otherwise, the internal control evaluation will take place without an understanding of what risks need to be mitigated by internal control.

The identification of risks has been addressed in Volume 2, Chapter 8. Risks requiring mitigation can be pervasive, relating to many financial statement areas and assertions, or specific, relating to particular financial statement areas and assertions.

The following exhibit summarizes some typical sources of risk and the types of control that could mitigate such risks.

Exhibit 12.2-2

When a listing of risk factors by business process has been prepared, it would be useful (but not required) to:

- &MJNJOBUF BOZ SJTL GBDUPS UIBU XPVME CF VOMJLFMZ UP NJUJHBUFE BU BMM $POUSPMT UIBU BEESFTT TVDI SJTLT XP
- $VTUPNJ[F UIF XPSEJOH PG UIF SJTL GBDUPST UP NBLF JU S
- &OTVSF UIBU BMM SFMFWBOU BTTFSUJPOT IBWF CFFO BEESF
- $POTJEFS XIFUIFS UIFSF BSF BOZ BEEJUJPOBM SJTLT FOUJU material misstatement if not mitigated.

$0 / 4 * % &03* /15

Some entities may use an internal control framework (such as that published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)) that provide generic listings of internal control objectives and internal control procedures. If such a tool is used in the audit, the same steps outlined above would be followed:

- 3FNPWF UIF DPOUSPM PCKFDUJWFT PS SJTL GBDUPST UIB FWFO JG OP JOUFSOBM DPOUSPM FYJTUFE
- "EE BOZ PUIFS BEEJUJPOBM DPOUSPM PCKFDUJWFT SJTL C NJTTUBUFNFOU GPS UIF FOUJUZ JG OPU NJUJHBUFE BOE
- *EFOUJGZ UIF öOBODJBM TUBUFNFOU BSFBT BOE BTTFSUJP

12.3 Step 2—Do the Controls Designed by Management Mitigate the Risk?

Exhibit 12.3-1

Evaluating whether a control has been designed properly by management involves an assessment of whether the controls identified (individually or in combination with other controls) will actually mitigate the risk factor. This involves considering whether the control(s) is capable of effectively:

- t 1SFWFOUJOH NBUFSJBM NJTTUBUFNFOUT GSPN PDDVSSJOH J
- t %FUFDUJOH BOE DPSSFDUJOH NBUFSJBM NJTTUBUFNFOUT BO

It is recommended that an evaluation of control design begin with the pervasive controls. These types of controls form the all-important foundation for assessing the design and operation of specific (transactional) controls.

At this point, some auditors (particularly when auditing larger and more complex entities) may find it helpful to obtain some information, preferably prepared by the entity, that describes the business process, the way paper flows through the entity, and where controls exist. However, this is not a specific requirement in the ISAs.

There are two common ways to match internal controls to the risk factors (or control objectives) that they are designed to mitigate. For the purposes of this Guide, these approaches have been called:

- t 0OF SJTL UP NBOZ DPOUSPMT BOE
- t .BOZ SJTLTDPOUSPMT

One-Risk-to-Many Controls

Under this approach, each risk factor is considered by itself. All the controls that address that particular risk factor are identified. This approach is particularly useful for mapping the pervasive (entity-level) risk factors to controls. The approach is illustrated below.

Exhibit 12.3-2

3JTL $PODLSFDPMVNW F	Assertion	.JUJHBUJOHDPOUSPMT
1. Risk factor	C	1. Control procedure A 2. Control procedure B 3. Control procedure C 4. Control procedure D

3 J T L $ P O C U K S P D M U J W F	Assertion	. J U J H B $ U P J O U H S P M T
2. Risk factor	EA	1. Control procedure E 2. Control procedure F 3. Control procedure G 4. Control procedure H
3. Risk factor	A	1. Control procedure I 2. Control procedure J 3. Control procedure K 4. Control procedure L
4. Risk factor	CA	1. Control procedure M 2. Control procedure N 3. Control procedure O 4. Control procedure P

This one-risk-to-many controls approach has often been used for mapping all types of control, including transactional controls. However, because a single transactional control can often address more than one risk (and therefore get repeated many times in this approach), the many-to-many matrix (see Exhibit 12.3-4) is generally considered more effective for transactional controls.

The following example illustrates how the one-risk-to-many controls approach can work. An objective of the control environment is the need for management, with the oversight of those charged with governance, to create and maintain a culture of honesty and ethical behavior. This objective stated as a risk factor could mean that management has not created or maintained a culture of honesty and ethical behavior.

Some of the controls that management may design and implement to address this pervasive risk could include:

- .BOBHFNFOU DPOUJOVBMMZ EFNPOTUSBUFT UISPVHI XPSET TUBOEBSET
- .BOBHFNFOU SFNPWFT PS SFEVDFT JODFOUJWFT PS UFNQUB EJTIPOFTU PS VOFUIJDBM BDUT
- " DPEF PG DPOEVDU PS FRVJWBMFOU FYJTUT UIBU TFUT PVU
- &NQMPZFFT DMFBSMZ VOEFSTUBOE XIBU CFIBWJPS JT BDDFQ XIFO UIFZ FODPVOUFS JNQSPQFS CFIBWJPS BOE
- &NQMPZFFT BSF BMXBZT EJTDJQMJOFE GPS JNQSPQFS CFIBW

The auditor would first read the risk or control objective and then identify, possibly from a list such as that above, what, if any, controls exist to mitigate the risk. The resulting documentation could take the following form.

Note: The column on control design outlines the steps the auditor could take to assess control design.

Exhibit 12.3-3

*OUFSOBM $POUSPM *$ Component	3JTL Design	$POUSPM Description	Control Design
Control Environment	No emphasis on integrity or ethics	Code of conduct is signed by employees each year and enforced through sta discipline.	Have read the Code and it does emphasize need for integrity and ethics.
	Incompetent employees could be hired	3FRVJSFE LOPXIFEHF BOE skills speci ed for each employee position.	Reviewed the job speci cations for key positions including accounting and they appear to be acceptable.
Risk Assessment	Management often surprised by predictable events	Business risks are identi ed and assessed each year as part of business planning.	Reviewed the business plan and risks have been identi ed, updated, and assessed.

Once the controls have been identified, the auditor would use professional judgment to conclude whether the control design is sufficient to address the risk factor.

When forming a conclusion on the control environment, the auditor is required by ISA 315.14 to evaluate whether:

- .BOBHFNFOU XJUI UIF PWFSTJHIU PG UIPTF DIBSHFE XJUI H DVMUVSF PG IPOFTUZ BOE FUIJDBM CFIBWJPS BOE
- 5IF TUSFOHUIT JO UIF DPOUSPM FOWJSPONFOU FMFNFOUT D the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

This wording could be used as the overall conclusion by the auditor on all entity-level controls. Such a conclusion will also have a major impact on the auditor's assessment of risk at the financial statement level.

Many-Risks-to-Many Controls

For specific and transactional risks, the most common approach to evaluating design is through the use of what is sometimes called a "control design matrix." These matrices enable the auditor to see at a glance:

- 5IF NBOZ UP NBOZ SFMBUJPOTIJQT UIBU FYJTU CFUXFFO SJT
- 8IFSF JOUFSOBM DPOUSPM JT TUSPOH
- 8IFSF JOUFSOBM DPOUSPM JT XFBL BOE
- 5IF LFZ DPOUSPMT UIBU BEESFTT NBOZ SJTLT BTTFSUJPOT B

An example of a simple control design matrix is illustrated below.

Exhibit 12.3-4

Process = Sales						
. B U F S J B M 3 J T L ' B D U P S T		Risk A	3 J T L Risk C		Risk D	, F Z Controls
	Assertions	C	EA	AC	CE	
Controls	Internal Control Component					
Procedure #1	Control Environment	D				
Procedure #2	Information Systems		D			
Procedure #3	Control Activity	P	P		P	Yes
Procedure #4	Monitoring	D				
Procedure #5	Control Activity		P		P	Yes
Procedure #6	Control Activity					
Procedure #7	Information Systems	D	D		D	
Is control design OK? That is, will the identi ed controls mitigate the risk factors?		Yes	Yes	No	Yes	

Key:

P = Prevent control

D = Detect and correct control

Note: The above matrix contains the following information:

- 3JTL GBDUPST UIBU JG OPU NJUJHBUFE DPVME SFTVM TUBUFNFOUT
- 5IF BTTFSUJPOT BEESFTTFE CZ UIF SJTL GBDUPST BOE
- 8IFSF UIF JOUFSOBM DPOUSPM QSPDFEVSF BEESFTTFT is recorded as either preventing (P) a misstatement or detecting (D) and then correcting a misstatement after it has occurred.

Such a matrix can also be expanded to include other information including:

- 5IF GSFRVFODZ XJUI UIF DPOUSPM JT PQFSBUFE F H DPOU
- 8IFUIFS UIF DPOUSPM JT NBOVBM PS BVUPNBUFE BOE
- 5IF FYQFDUFE SFMJBCJMJUZ PG UIF JOUFSOBM DPOUSPM PW assessing the competence (and independence from other functions) of the person who performs the control, whether the control is performed on a timely basis, and any history of errors occurring.

$0 / 4 * % &03* /15

. V M U J D Q P M O F Q S P M D F E V S F T

Note that any one control procedure by itself is unlikely to mitigate a key risk factor. Often, a combination of control activities, working together with other components of internal control (such as the control environment), will be sufficient to address the risk factor.

4 U B S U X J U I U I F S J T L T

Avoid the temptation to list all the known controls and then match them to risks. Risks come first, then controls to mitigate the risks. It is more efficient to address each risk (or control objective) in turn and then identify what controls exist to address that risk. Once enough controls have been identified to address the risk, there is no point in spending more time to identify any additional controls.

Matching controls with risks not only helps to evaluate control design, but will also identify key controls (over relevant assertions) that could potentially be tested. It will also help the auditor identify control deficiencies that may require:

- $ P N N V O J D B U J P O U P N B O B H F N F O U B O E U I P T F D I B S H F E X J U I H P O B U J M F M Z C B T J T T P U I B U D P S S F D U J W F B D U J P O D B O C F U
- % F W F M P Q N F O U P G B O B Q Q S P Q S J B U F B V E J U S F T Q P O T F

The control design matrix (see Exhibit 12.3-4) can be used to identify both control strengths and control deficiencies. This process is described below.

Exhibit 12.3-5

Identify	% F T D S J Q U J P O ‰ 6 T J O H U I F $ P O U S P M % F T J H O . B U
Internal Control % F ö D J F O D J F T	Look down each risk column (in the control design matrix above) to see what internal control procedures exist to mitigate the risks. If sufficient controls exist, then there is no control deficiency. Where few or no internal control procedures exist to mitigate the risk, a significant internal control deficiency may exist. Refer to Risk C in the matrix above, where it appears that a significant deficiency exists. In this case, the auditor would: t * O R V J S F B C P V U B O Z P U I F S J O U F S O B M D P O U S P M control procedures that might exist. If none exists, a significant deficiency may exist that would be communicated to management and those charged with H P W F S O B O D F B T T P P O B T Q P T T J C M F T P U I B U D F t $ P O T J E F S X I B U G V S U I F S B V E J U Q S P D E E V S F T N B risk identified. Compensating controls may be activities that indirectly impact on the risk factor. For example, the risk of shipping goods but not invoicing for them could be detected by the sales manager when he reviews sales results each quarter. Such a control would obviously not be sufficient by itself to mitigate the risk.

Identify	%FTDSJQUJPO‰6TJOH UIF $PNNPO %FTJHO .BU
Internal Control Strengths	Look across the rows of the control design matrix above to identify internal control procedures that would prevent or detect and correct misstatements arising from a number of risk factors. Note that Control Procedure 3 in the example matrix above addresses three risks and three assertions. This is an example of a type of control (often referred to as a key control) that, if considered reliable, could be considered for testing operational effectiveness, particularly where this testing could be used to reduce other more detailed tests.

12.4 How to Identify Relevant Internal Controls

Controls are usually identified through discussion (interviews) with the person(s) who are responsible for managing the risk or the particular process. In smaller entities, this will often be the owner-manager or the senior manager. A typical approach for identifying controls would be as follows.

Exhibit 12.4-1

Action	Description
Identify the Inherent Risks	Identify the pervasive (entity-level) and specific (transactional) risks that require mitigation through internal control to prevent or detect and correct material misstatements.
Ask about Internal Control 1 S P D F E5V B U Address the Inherent Risk (Address Each Risk Factor, One at a Time)	Ask the owner-manager or the responsible person what internal control procedures exist in the entity to mitigate each particular risk factor one by one. Document the controls identified in the words of the person being interviewed. When (based on professional judgment) enough controls have been identified to effectively mitigate the risk, stop asking for any more controls. There is no need to list all of the other controls that may exist to mitigate the risk, unless specifically requested for another purpose.
Document the Results	The controls identified can be documented in a number of ways. They can be listed under each risk factor they address, or listed on a control matrix and linked to all the various risk factors they address. The key is to ensure that the control procedures identified are linked to the risk factor they were designed to mitigate. This enables an assessment to be made as to whether the controls identified do actually mitigate the risk. If the control matrix is used: t 3FDPSE UIF JOUFSOBM DPOUSPM QSPDFEVSFT J indicate (where they intersect with the risk) whether they would prevent or EFUFDU BOE DPSSFDU QPUFOUJBM NJTTUBUFNFC t $POTJEFS XIFUIFS UIF DPOUSPM XPVME BMTP C factors. It is quite possible that some internal control procedures will prevent or detect a number of the risk factors. Where controls have not been identified to address a risk, the auditor would immediately alert management to the control deficiency (likely significant) that may need to be addressed.

$0 / 4 * % &03* /15

Avoid using generic controls

Avoid the temptation to use generic lists of internal control activities that are appropriate for the so-called "typical" entity. Listings of "standard" or "typical" controls can take time to read and understand, and are often too complex or simply irrelevant for smaller entities. Instead, use them as a reference source, but only when needed. It is much better to document the nature of each control identified using the client's own description.

. V M U J U B T L

Evaluating control design can be combined with control documentation (see Step 3 below) and with the inspection/observation of documents to support control implementation (see Step 4 below). For example, if there is a policy identified that no non-routine journal entries can be made without authorization, ask to see the actual policy (assess control design) and some journal entries for evidence of approval (control implementation).

Risk management

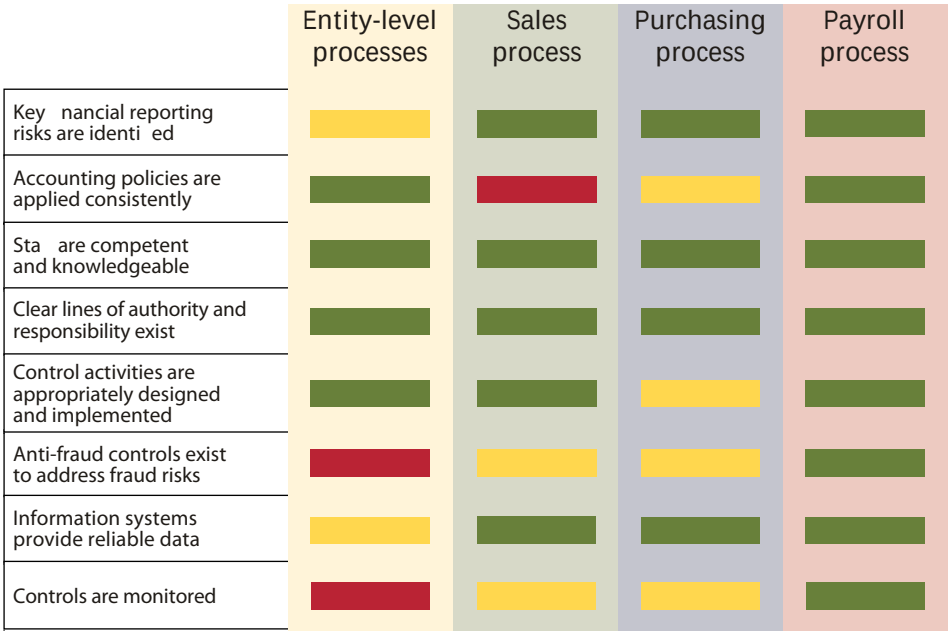
Many entities assign risk management responsibilities by process (such as sales or purchasing) instead of by risk. As a result, there may be a number of important risk factors that fall between departments (such as sales, purchasing, and accounting), and no one is directly accountable. If risks are not specifically identified and responsibility assigned to someone, there is often a lot of finger pointing when something goes wrong. Staff may blame each other by saying something like, "I thought that risk was being managed by Mary or Jack, or the accounting, IT, or sales department," etc.

Concluding on Control Design

The final step in assessing control design is to draw a conclusion on whether the controls identified actually mitigate the particular risk factor. This requires the use of professional judgment. For each relevant assertion or risk factor, consider whether management's response is sufficient to reduce the risk of material misstatement to an acceptably low level. If the control design matrix approach is used, the bottom row of the matrix could be used to document the conclusion as to whether the controls are sufficient or not to mitigate each risk factor.

A summary of the overall control evaluation (that addresses the five control components) is set out in the following exhibit.

Exhibit 12.4-2



Key:

Green = the underlying risks have been appropriately mitigated

Yellow = some problems may exist

Red = potentially significant deficiencies

$0 / 4 * % &03* /15

For smaller entities, there is an even simpler way of assessing transactional controls. First, identify the risk factors (see Step 1 above) and the assertion(s) affected. Then, instead of mapping identified controls to each individual risk factor, identify controls that address the assertions affected by the risk.

If no controls are identified for a particular assertion, a substantive audit response would need to be developed. If the controls identified are expected to operate reliably, the audit response could include a test of relevant key controls. For example, the risk of unrecorded sales addresses the completeness assertion. Identification of relevant controls could be limited to those that address the completeness assertion in general, rather than the one specific risk.

12.5 Step 3—Are Controls That Mitigate the Risk Factors in Operation?

Exhibit 12.5-1

Inquiry of management alone is not sufficient to evaluate the design of internal control procedures or to determine whether they have been implemented. This is because people may genuinely believe or hope that certain controls exist, when in fact they do not. A documented description of controls (however good) that do not exist or do not operate is of no value to the audit.

Some of the reasons for observing internal control in action are:

- $IBOHF 1SPDFTTFT
  Processes change over time, resulting from revised/new products or services, efficiencies in operation, DIBOHFT JO QFSTPOOFM BOE JNQMFNFOUBUJPO PG OFX TVQ
- 8JTIGVM LOPXMFEHF
  The entity's personnel may explain to the auditor how a system shouldoperate, rather than how it BDUVBMMZ PQFSBUFT JO QSBDUJDF BOE
- -BDL PG LOPXMFEHF
  Some aspects of the system may have been inadvertently overlooked in obtaining the understanding of internal control.

$0/4*%&3*/(

If there is any doubt about whether some controls identified in Step 2 above have not in fact been implemented, do not assess control design or document the operation of the controls until some work has been performed to determine that they exist and operate. Alternatively, do not take time to assess controls that are unlikely to be relevant to the audit or have been inappropriately designed.

Risk assessment procedures required to obtain audit evidence about control implementation would include those listed below.

Exhibit 12.5-2

	Description
Assessing Control Implementation	t *ORVJSJOH PG FOUJUZ QFSTPOOFM t 0CTFSWJOH PS SF QFSGPSNJOH UIF BQQMJDBU t *OTQFDUJOH EPDVNFOUT BOE SFQPSUT BOE t 5SBDJOH POF PS UXP USBOTBDUJPOT UISPVHI U financial reporting. This is often called a walkthrough.

Note: A walkthrough is not a test of the operating effectiveness of a control.

Implementation of controls provides evidence about whether a control was actually in operation at a particular point in time. It does not address operating effectiveness throughout the period being audited. Evidence of operating effectiveness (if this is part of the audit strategy being developed) would be achieved through a test of controls that gathers evidence about control operation over a period of time, such as a year.

Only when it has been established that the internal control relevant to the audit has been properly designed and implemented is it worth considering:

- 8IBU UFTUT PG UIF PQFSBUJOH FòFDUJWFOFTT PG DPOUSPMT JG
- 8IBU DPOUSPMT SFRVJSF UFTUJOH CFDBVTF UIFSF JT OP PUIFS X

$0 / 4 * % &03* /15

Ensure that the audit team has a clear understanding of the difference between control design, control implementation, and tests of controls. These are summarized as follows:

Control design
Have controls been designed that will mitigate the inherent risks?

Control implementation
Are the designed controls actually in operation? Control implementation procedures should be performed each period to identify any system changes.

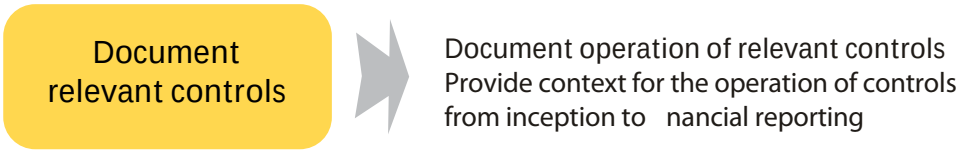
5FTUT PG DPOUSPMT
Did the controls operate effectively over a specified period of time? There is no requirement to test the operating effectiveness of controls unless there is no alternative way (such as in a highly automated and paperless system) to gain the necessary audit evidence. The decision to test the operating effectiveness of controls is therefore a matter of professional judgment.

%P OPU JHOPSF UIF MJOLBHF CFUXFFO DPOUSPM EFTJHO BOE
If there is any doubt about whether some of the controls identified in Step 2 above have in fact been implemented, do not assess control design until some work has been performed to determine if they exist and operate. Also, if the auditor concludes that control design is inadequate, there is no point going on and evaluating the control implementation. It is likely that a significant deficiency already exists.

Assess implementation every period
After the initial audit engagement, first evaluate the control implementation to determine what has changed. Use the control design documentation already obtained in the previous period as the starting point. If a change in internal control is identified, consider whether the revised or new controls continue to mitigate the risk factor, or whether there are now new risks that have to be mitigated.

12.6 Step 4—Has the Operation of Relevant Controls Been Documented?

Exhibit 12.6-1



The purpose of this step is to provide some information about the operation of the relevant controls identified in Step 2 above. The extent of documentation required is determined by professional judgment.

The resulting documentation will help the auditor to:

t 6OEFSTUBOE UIF OBUVSF PQFSBUJPO JOJUJBUJPO QSPDFT
performs the control, where the control is performed, how often and the resulting documentation) of
UIF JEFOUJöFE DPOUSPMT BOE

- %FUFSNJOF XIFUIFS UIF DPOUSPMT BSF MJLFMZ UP CF SFMJ
  be tested as part of the audit response to assessed risks. If a decision is made to test the operating effectiveness of controls, this documentation will also help the auditor in designing the test, such as what population to use in selecting the sample, what control attributes to examine, who performs the control, and where the necessary documentation may be found.

> $0 / 4 * % &03* /15
>
> Documentation of controls does not have to be complex or comprehensive. There is no requirement for the auditor to document an entire business process, or to describe the operation of any controls that are not relevant to the audit.

Some of the matters to be considered when documenting relevant internal controls are identified in the exhibit below.

Exhibit 12.6-2

Documenting Relevant Internal Controls

-)PX TJHOJöDBOU USBOTBDUJPOT BSF JOJUJBUFE BVUIPSJ[F
- 5IF øPX PG USBOTBDUJPOT JO TVóDJFOU EFUBJM UP JEFOU
  DBVTFE CZ FSSPS PS GSBVE DPVME PDDVS BOE
- *OUFSOBM DPOUSPMT PWFS UIF QFSJPE FOE öOBODJBM SFQ
  estimates and disclosures.

The most common forms of documentation prepared by management or the auditor are:

- /BSSBUJWF EFTDSJQUJPOT PS NFNPSBOEB
- 'MPX DIBSUT
- " DPNCJOBUJPO PG øPX DIBSUT BOE OBSSBUJWF EFTDSJQUJ
- 2VFTUJPOOBJSFT BOE DIFDLMJTUT

The nature and extent of the documentation required is a matter of professional judgment. Factors to consider include:

- 5IF OBUVSF TJ[F BOE DPNQMFYJUZ PG UIF FOUJUZ BOE JUT
- "WBJMBCJMJUZ PG JOGPSNBUJPO GSPN UIF FOUJUZ BOE
- "VEJU NFUIPEPMPHZ BOE UFDIOPMPHZ VTFE JO UIF DPVSTF

The extent of documentation may also reflect the experience and capabilities of the audit team. An audit undertaken by a less experienced team may require more detailed documentation to assist them in obtaining an appropriate understanding of the entity than a team composed of more experienced individuals.

12.7 Updating Control Documentation in Subsequent Periods

The auditor may use documentation prepared or obtained in a prior audit period when planning the audit of a subsequent period. This will involve the following documentation.

Exhibit 12.7-1

	Description
6QEBUJOH Documentation Prepared in Previous Periods	$POUSPM B DPQZ PG UIF QSFWJPVT QFSJPE T XPSLJ point for updating in the current year. If nothing has changed, evaluate control implementation before design. If the control has been implemented and the SJTL EJE OPU DIBOHF UIF EFTJHO XJMM CF BDD t 6QEBUF UIF MJTUJOH PG SJTLT UIBU SFRVJSF N t *EFOUJGZ DIBOHFT JO JOUFSOBM DPOUSPM BU BDIJFWFE CZ QSPDFEVSFT UIBU BEESFTT DPOUS t 8IFSF DIBOHFT BSF JEFOUJöFE SJTL PS DPOUS DPOUSPMT IBWF CFFO EFTJHOFE BOE JNQMFNFO t 6QEBUF UIF MJOLBHF PG JOUFSOBM DPOUSPMT t 6QEBUF UIF DPODMVTJPOT PO DPOUSPM SJTL

Where the audit strategy is likely to involve reliance on the effective operation of certain controls (such as through tests of controls) and control changes have occurred, there will be a need to walk through transactions that were processed both before and after the change took place.

$0 / 4 * % &03* /15

$IBOHFT JO QFSWBTJWF FOUJUZ MFWFM DPOUSPMT

When updating control documentation, carefully consider the changes in pervasive (entity-level) controls. These changes could have a significant impact on the effectiveness of other specific (transactional) controls, and may affect the audit response to assessed risks. For example, management's decision to hire a qualified professional to prepare the financial statements may considerably reduce the risk of errors in the financial information and enhance the effectiveness of transactional controls that might previously have been undermined. Alternatively, management's failure to replace an incompetent IT manager or commit sufficient resources to address IT security risks may undermine other internal control procedures in effect. In either case, these changes could trigger a significant change in the appropriate audit response.

12.8 Written Representations about Internal Control

Written representations should be obtained from management acknowledging its responsibility for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

12.9 Case Studies—Internal Control Evaluation

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

The following extracts from internal control documentation provide an example of the information that would be obtained from using the four-step process described above.

Step 1 — Risk Identi cation

The first and most important step in evaluating internal control is to identify what risks need to be mitigated by internal control. This will include the risks identified as a result of obtaining an understanding of the entity, other pervasive risk factors and the usual transactional risk factors associated with business processes such as sales purchasing and payroll etc.

Step 2 — Control Design

The second step is to inquire about, and evaluate, the controls management has put in place to address the risks that have been identified in step 1 above.

Entity-Level Controls

The structured format below addresses each of the four steps outlined in this chapter. It can be used to document the following:

- t UIF SJTL GBDUPST UP CF BEESFTTFE CZ UIF WBSJPVT FMFN BCPWF
- t XIBU JG BOZ DPOUSPMT FYJTU UP NJUJHBUF UIF SJTLT $P
- t UIF FWJEFODF PCUBJOFE UIBU UIF DPOUSPMT JEFOUJöFE B JNQMFNFOUBUJPO TUFQ CFMPX BOE
- t UIF DPOUFYU BOE PQFSBUJPO PG UIF DPOUSPMT UIBU IBWF documentation – step 4 (below)).

Control Environment	Control & Y J T U P T S	Describe the Nature of Supporting Documentation . B O B H F N F O U	Describe Inquiries/ 0 C T F S W B U J P O T $ P O U S P M T J E F "Implemented
1. Risk: No emphasis is placed on need for integrity and ethical values			
Possible controls (choose those that apply):			
a) Management continually demonstrates, through words and actions, a commitment to high ethical standards.	Yes	Suraj and the management team consistently reinforce the need for adherence to safety and ethical standards through daily communication with employees.	Interviewed two employees, Jon and Amad, who con rmed.
b) Management removes or reduces incentives or temptations that might cause personnel to engage in dishonest or unethical acts.	Yes	Suraj accepted our recommendation last period and prepared a code of conduct outlining expected behaviors by sta .	Employees have been given a copy of the code of conduct and attended a meeting on May 13, where the guidelines were explained.
c) A code of conduct or equivalent exists that sets out expected standards of ethical and moral behavior.	Yes	See response to b) above.	Reviewed code of conduct.

Control Environment	Control & Y J T U P T S	Describe the Nature of Supporting Documentation . B O B H F N F O U	Describe Inquiries/ 0 C T F S W B U J P O T $ P O U S P M T J E F "in Dl Jne d
d) Employees clearly understand what behavior is acceptable and unacceptable and know what to do when they encounter improper behavior.	Yes	Employees have been disciplined in the past for improper behavior.	Suraj res people immediately if they are caught stealing or acting unethically. Two such cases occurred last year among temporary workers.
e) Employees are always disciplined for improper behavior.	Yes	Suraj will not tolerate illegal or unethical behavior among employees, customers or suppliers.	Noted that a new employee X B T R V J D L M Z ö S F E B being caught stealing o ce supplies.
f) Other (explain).	No		
2. Risk: Incompetent employees may be hired or retained			
Possible controls (choose those that apply):			
a) Company personnel have the competence and training necessary for their assigned duties.	Yes	All sta are trained on the job B O E B E F R V B U F M Zemployees, Jon and A	Interviewed two Tpvoe s Jwho: Tad F Emad,
b) Management specifies the requisite knowledge and skills required for employee positions.	Yes	Management is skilled in manufacturing, sales, and administration. Ravi and Parvin o er advice on business, marketing, and legal issues.	t $ M F B S M Z V O E F S their roles and responsibilities in the absence of a written job description.
c) Job descriptions exist and are effectively used.	No		t * O E J D B U F E U I B receive instruction whenever a machine or process changes.
d) Management provides personnel with access to training programs on relevant topics.	No		t 3 F D F J W F Q S B J T things go better than expected, and are told immediately when a job was not done well.
e) Adequate staffing levels are maintained to effectively perform required tasks.	Yes	There were no vacancies during year in any of the positions that a ect nancial reporting.	
f) Initial and ongoing matching of staff skills to their job descrip-tions.	No		* O R V J S J F T P G B E N J (Mirelli and Cli) indicated that sta ng levels remained constant during period.
g) Staff are compensated and rewarded for good performance.	No	Employees are encouraged when they do a good job. There is no bonus structure other than for salespeople.	

Control Environment	Control & Y J T U P T S	Describe the Nature of Supporting Documentation . B O B H F N F O U	Describe Inquiries/ 0 C T F S W B U J P O T $ P O U S P M T J E F "implemented
h) Other (explain).	No		
3 J T L . B O B H F N F O U I B T B Q P P S B U U J U V E F U P X B S E J O U F S O B M			
Possible controls (choose those that apply): Management demonstrates positive attitudes and actions toward:			
a) The establishment and maintenance of sound internal control over financial reporting, (including management override and other fraud): – Appropriate selection/ application of accounting policies, – Information-processing controls, and – The treatment of accounting personnel.	Yes	Management is very responsive to recommendations that are not costly or disruptive to implement, and has a good attitude towards internal control.	Reviewed the business plan, which included: t 4 B M F T B O E D B T forecast. t " O U J D J Q B U F E D expenditures. t % J T D V T T J P O P C recession may a ect their business in terms of sales and the possibility of one supplier going bankrupt. Our management letter recommendations have always been accepted if they were feasible.
b) Management emphasizes appropriate behavior to operating personnel.	Yes	See comments above on attitudes and the code of conduct.	Based on our employee interviews (see Step 2), employees understand X I B U J T S F R V J S F E rules should be followed.
c) Management has established procedures to prevent unauthorized access to, or destruction of, assets, documents, and records.	Yes		

Control Environment	Control & Y J T UPTS	Describe the Nature of Supporting Documentation . B O B H F N F O U	Describe Inquiries/ 0 C T F S W B U J P O T $ P O U S P M T J E F "in Dulnent
d) Management analyzes business risks and takes appropriate action.	Some	Although risk management is informal, business risks are discussed at management meetings and re ected in the business plan.	During our interview with Jawad, he indicated that Suraj was open to discussing issues and that he did not feel pressured to manipulate the nancial statements. In Suraj's words, "The numbers are what they are, whether they are good this month or bad."

Business Process or Transactional Controls

The above control design matrix addresses two of the four steps. It matches the transactional risks with identified controls, and could also be used to cross-reference work on implementation.

Step 3—Control implementation

The third step is to determine whether the controls exist and are in use by the entity.

Extract from the revenue/receivables control implementation procedures
Make inquiries of the personnel processing the transaction.

Persons interviewed:

Karla Date February 16, 20X3

Dameer Date February 17, 20X3

Maria Ho Date February 17, 20X3

Describe the procedures performed related to the transaction. Address initiation, authorization, recording in the accounting records, and reporting in the financial statements.	System works as described in the systems documentation. See WP 530 for copies of documents that demonstrate the internal controls in action. However, we noted Maria Ho is a new employee and knows little about the system at present.
Describe the process for any information transfers from one person (process owner) to the next.	There is a handover from sales to accounting. Based on the walkthrough, the transfer worked well.
Note the frequency and timing of the internal control procedures performed.	Noted on the control design matrix.
Identify any general IT controls required to protect the transaction data files and ensure the proper functioning of application internal controls.	General IT controls are minimal due to small size of entity.
Document the procedures in place to cover illnesses and vacations of personnel. If vacations have not been taken in last 12 months, document why.	There was a sales clerk vacancy for four months during the period before Maria was hired. This meant less segregation of duties during that time.
Ask about the extent and nature of errors found in the past period.	Most errors were due to mistakes in pricing, which is mostly a manual process at present.
Ask whether any person has been required to deviate from documented procedures.	0 O S F R W B T E C Z U I T B M B T O B H P S C T U B O U J reduce the price on a bedroom set for a friend was denied.

Step 4—Control documentation

Extract From Business Process Documentation Using a Narrative Approach—
Dephta Furniture, Inc.

V T J Q1LFSTPTD FRevenue/receivables/receipts system

Key Risks to be Addressed and Relevant Control Procedures

1. ***Goods shipped/services performed not invoiced***
   When the sales order is signed by the customer for approval, the order is entered into the accounting system, which automatically assigns a sequential number. When the order is ready for shipment, a shipping document is prepared, entered into the system and matched with the order. An invoice is then prepared by Karla from the accounting system, which automatically assigns a sequential number. It is a strict rule that no shipments can be made without the shipping document number being entered into the system. The system can then track which orders have been filled and which ones are still pending by delivery date.

2. ***Revenues incorrectly/not recorded (i.e., cash sales) in the accounts***
   Sales orders are prepared for each order received and entered into the accounting system, which automatically assigns the order a sequential number. The only exception is furniture sold directly from the shop or other small items on hand.

3. ***Related-party transactions not identi f ed***
   No controls in place at present.

4. ***Revenue recognition policies not followed***
   Revenue is recorded when invoice is submitted. All orders over 500 €, or where the sales price is below the minimum sales price, must be reviewed and approved by Arjan.

5. ***Fictitious sales/sales credits recorded in accounts***
   All orders over 500 €, or where the sales price is below the minimum sales price, must be reviewed and approved by Arjan.

6. ***Goods shipped/services provided to a bad credit risk***
   Arjan does not do a credit check on customers unless he does not know them or the order is large. He relies mostly on his previous experience with the customer when granting credit.

7. ***Sales/services recorded in wrong accounting period***
   Karla prepares a month end report of revenue and cash receipts for the month. This is reviewed by Suraj.

8. ***Receipts are partially or not deposited/recorded (fraud or error)***
   Cheques received are listed, totaled and reviewed before deposit. Karla prepares the daily deposit slips but Jawad makes the cash deposit to ensure functions are segregated.

9. ***Receipts are credited to the wrong account (fraud or error)***
   Could be noticed during the review of monthly sales and receivables.

10. ***Receipts are recorded in wrong accounting period***
Karla checks for proper cut off each month to ensure receipts are recorded in the correct period.

11. ***No allowance is recorded for doubtful or uncollectible balances***
Accounts over 60 days are followed up for payment but no allowance is made for doubtful accounts other than at year end.

12. ***Overdue receivables are not followed up on a timely basis***
Jawad prepares an aged accounts receivable listing and gives the listing to Suraj for his review. Accounts over 60 days are followed up each month and comments are made on the listing as to when the customer has agreed to pay the balance. For customers who are over 90 days and have not made alternative payment arrangements, future sales are made on a cash-on-delivery basis.

See separate memo 545-6 (not included) for controls over Internet sales.

Step 1 - Risk Identi cation

The first and most important step in evaluating internal control is to identify what risks need to be mitigated by internal control. This will include the risks identified as a result of obtaining an understanding of the entity, other pervasive risk factors and the usual transactional risk factors associated with business processes such as sales purchasing and payroll etc.

Step 2 — Control Design

The second step is to inquire about, and evaluate, the controls management has put in place to address the risks that have been identified in step 1 above.

Pervasive (Entity-Level) and General IT Controls

The format below addresses each of the 4 steps outlined in this chapter. It can be used to document the following:

- t UIF SJTL GBDUPST UP CF BEESFTTFE CZ UIF WBSJPVT FMFN BCPWF
- t XIBU JG BOZ DPOUSPMT FYJTU UP NJUJHBUF UIF SJTLT $P
- t UIF FWJEFODF PCUBJOFE UIBU UIF DPOUSPMT JEFOUJöFE B JNQMFNFOUBUJPO TUFQ CFMPX BOE
- t UIF DPOUFYU BOE PQFSBUJPO PG UIF DPOUSPMT UIBU IBWF documentation – step 4 (below)).

Entity-Level Controls	
Risks to Consider	**Relevant Controls**
Control Environment: t /P FNQIBTJT QMBDFE PO JNQPSUBODF PGFE GPS integrity and ethical values. t /P DPNNJUNFOU UP FNQMPZFF DPNQFUFODF t *OFòFDUJWF NBOBHFNFOU PWFSTJHIU CZ UIPTF charged with governance. t .BOBHFNFOU IBT B QPPS BUUJUVEF UPXBSE JOUFSOBM control and/or managing business risks. t *OFòFDUJWF JOBQQSPQSJBUF PSHBOJ[BUJPOBM TUSVDUVSF for planning, controlling, and achieving objectives. t /P QPMJDJFT QSPDFEVSFT UP FOTVSF FòFDUJWF)3 management.	Raj continually communicates the need for integrity and ethical dealings in day-to-day communications with employees and by his actions. He has a good attitude for internal control—has implemented audit recommendations in past that were feasible. No formal governance structure, but Raj meets with Suraj and Jawad (Dephta) regularly.

Entity-Level Controls	
Risks to Consider	**Relevant Controls**
Do controls mitigate the risk factors?	Yes
Describe inquiries/observations to ensure controls identified were implemented.	Interviewed Ruby, who con rmed Raj's commitment to treating suppliers and customers ethically and fairly. Reviewed the minutes from the last meeting which had been prepared by Jawad.
Risks assessment: t . B O B H F N F O U J T P G U F O T V S Q S J T F E P S J O E W F O U T U I B U X F S F not previously identified/assessed or is continually reacting to events rather than planning ahead.	Business plan prepared annually. Raj monitors monthly cash ows and sales trends.
Do controls mitigate the risk factors?	Yes
Describe inquiries/observations to ensure controls identified were implemented.	Reviewed a copy of the business plan, which did highlight the potential for the economy to impact sales. Reviewed a folder containing monthly cash ows given to Raj. Evidence of Raj's review by comments on the E P D V N F O U T B O E D I B O H F T S F R V F T U F
Financial reporting risks: t & W F O U T B O E D P O E J U J P O T P U U F S U I B U S B O T B D U J P O T that are significant to the financial statements may O P U C F D B Q U V S F E P S S F D P S E F E t 1 P P S P W F S T J H I U D P O U S P M P S W J T J P O T B N H S F Q P S U J O H journal entries, and preparation of significant estimates/disclosures could result in material N J T T U B U F N F O U T J O U I F öO B O D J B M T U B U F N F O U T B O E t 4 J H O J öD B O U N B U U F S T S F M B U J O H U P öO B O D J B M S F Q P S U J O H may not be communicated to the board of directors or external parties such as bankers or regulators.	Raj meets with Suraj and Jawad (Dephta) to review nancial statements and business plans. Raj reviews nancial statements but only reviews journal entries when he has time. (Risk increased by lack of segregation of duties, and gives Raj ability to book entries undetected.)
Do controls mitigate the risk factors?	No. Control weaknesses include the risk of management override and the lack of segregation of duties in such a small entity.
Describe inquiries/observations to ensure that controls identified were implemented.	Reviewed a folder containing the monthly nancials given to Raj. However, no evidence seen that Raj actually reviewed the statements.
Fraud prevention: t . B O B H F N F O U I B T O P U D P O T J E F S F E P S B T T F T T F E U I F risks of fraud occurring (including management override).	Raj keeps cash and valuables locked. Raj is involved in every step of the operations, including production, so oversight of all operations minimizes fraud risk.
Do controls mitigate the risk factors?	/ P 7 B M V B C M F T B S F L F Q U T B G F C V U bit this year, which reduced the extent of management oversight. In addition, the bookkeeper is known to have personal nancial problems.
Describe inquiries/observations to ensure that controls identified were implemented.	Inspected where the cash is kept locked and veri ed that only Raj has the key.

(FOFSBM *5 $POUSPMT	
Risks to Consider	**Relevant Controls**
Risks to consider: t /P QPMJDJFT QSPDFEVSFT FYJTU UP FOTVSF FòFDUJWF *5 NBOBHFNFOU PS *5 TUBò TVQFSWJTJPO t /P BMJHONFOU FYJTUT CFUXFFO CVTJOFTT PCKFDUJWFT SJTLT BOE *5 QMBOT t 3FMJBODF JT QMBDFE PO TZTUFNT QSPHSBNT UIBU are inaccurately processing data or processing JOBDDVSBUF EBUB BOE t 6OBVUIPSJ[FE BDDFTT UP EBUB 1PTTJCMF EFTUSVDUJPO of data, improper changes, unauthorized or non-existent transactions, or inaccurate recording of transactions.	No IT policies and procedures. IT expenses and capital purchases part of annual budget (if foreseen). Raj ensures that software is up to date and that Ruby runs a back-up of the data.
Do controls mitigate the risk factors?	Yes, given small size of operations.
Describe inquiries/observations to ensure controls identified were implemented.	Reviewed the annual budget with an IT expense line. No major capital purchases were planned for the period.

Business Process or Transactional Controls

This form (revenue, receivables, receipts) addresses two of the four steps in the process. It matches the transactional risks by assertion with the relevant internal control procedures (RICPs). It could also be used to cross-reference work on the implementation of controls.

Entity: Kumar & Co. Period ended: December 31, 20XX

Step 1 - Describe the 5SBOTBDUJPO BMM		Assertions affected	Step 2 - Describe the RICPs *G NVMUJQMF DPOUSPMT FYJTU consider using the control EFTJHOFE BOE JNQMFNFOUFE	Evaluate control Design	*NQMFN	Residual 3JTL UJPO
1	Goods shipped/ services performed not invoiced.	C	Shipping log is matched to the sales log each week to ensure all shipments were invoiced.	OK	545-2	L
2	Revenues partially or not recorded (i.e., cash sales).	CA	Bookkeeper reconciles sales invoices issued to revenues recorded in accounting records each month.	OK	545-2	L
3		CE	Raj reviews monthly sales, A/R and cash receipts journals. (Note: few customers, majority of sales are to Cambridge).	OK	545-2	L

4	Revenue recognition policies not followed.	CEA	Revenue is recorded when goods are shipped and invoiced. However no real controls over cut off.	Partial	545-2	M
5	Revenue/receipts recorded in wrong accounting period.	A	Review by Ruby and Raj of the sales each month	Partial	545-2	M
6	Receipts are partially/not deposited or recorded.	CA	Undeposited revenue would likely be noticed by Raj in his monthly review of receivables	No	No	M
7	No allowance for doubtful or uncollectible balances.	V	Made at year end only	No	No	H
8	Related-party transactions are not identified.	CEAV	Sales to Dephta are recorded in a separate account and reviewed by Raj monthly. But other Related Parties not identified	Partial	545-2	M
9						

Use professional judgement (based on a review of the above information) to assess the risks of material misstatement (RMM) by assertion.

Assertion	3 . .	Describe the Audit Procedures (such as tests of detail P S U F T U T P G D P O U S P M U I B U S F T Q P O W	W/P Ref B
Completeness	Low	See the sales and receivables audit program.	705 - C.100
Existence	Low	See the sales and receivables audit program.	705 - C.100
Accuracy	Moderate	Perform additional work on cut off and revenue recognition, Details are on audit plans for sales and receivables	705 - C.100
Valuation	Moderate	Carefully review allowance for doubtful accounts as outlined in C.100	705 - C.100

Note : RMM at the assertion level will be based on the “assertions affected” by transactional risks (above) and the extent of “residual risk” remaining after mitigation.

Step 3—Control implementation

Transactional control implementation

Extract from the revenue/receivables control implementation procedures

Persons interviewed:

Ruby Date February 22, 20X3

Raj Date February 22, 20X3

Describe the procedures performed related to the transaction. Address initiation, authorization, recording in the accounting records, and reporting in the financial statements.	System works as described in the systems documentation. See WP 535 for copies of documents that demonstrate the internal controls in action.
Describe the process for any information transfers from one person (process owner) to the next.	There is a handover from sales to accounting. Based on the walkthrough, the transfer worked well.
Note the frequency and timing of the internal control procedures performed.	Noted on the control design matrix.
Identify any general IT controls required to protect the transaction data files and ensure the proper functioning of application internal controls.	General IT controls are minimal due to small size of entity.
Document the procedures in place to cover illnesses and vacations of personnel. If vacations have not been taken in last 12 months, document why.	As a part-time employee, Ruby catches up on all record-keeping whenever she gets back to the o ce. Due to the minimal number of transactions, this has been su cient.
Ask about the extent and nature of errors found in the past period.	. P T U F S S P S T X F S F E V F U P N J T U B L ordered and shipped. The sales and order log matching is Raj's control to catch those errors and appears to be working e ectively in our walk-through testing.
Ask whether any person has been required to deviate from documented procedures.	None noted.

Step 4—Internal control documentation

Note: the controls are identified in bold type.

& Y U S B D U ' S P N # V T J O F T T 1 S P D F T T % P D V N F O U B U J P O 6 T J O H B / B S , V N B S $ P

V T J O 1F STPTD Revenue/receivables/receipts system

Sales orders

Sales orders are prepared for each order received and entered into the accounting system, which automatically assigns the order a sequential number. The only exception is furniture sold directly from the shop or other small items on hand.

Raj maintains an order log that tracks the date of the order, the amount, the type of product, date promised, price, etc. He also maintains a sales log with customer name, order details, price, etc. Raj N B U D BF OTE F W J F X T

the order and sales logs at the end of the month for accuracy.

When items are assembled and ready for shipment, Ruby prepares an invoice, which is sent along with the order to the customer.

Shop sales

For all sales out of the shop, invoices are prepared at the time of sale by Raj and entered into the accounting system. The system automatically generates an invoice number for each sale. Invoices are given to customers.

The majority of the shop sales are for cash, so there is little credit risk.

Accounts receivable

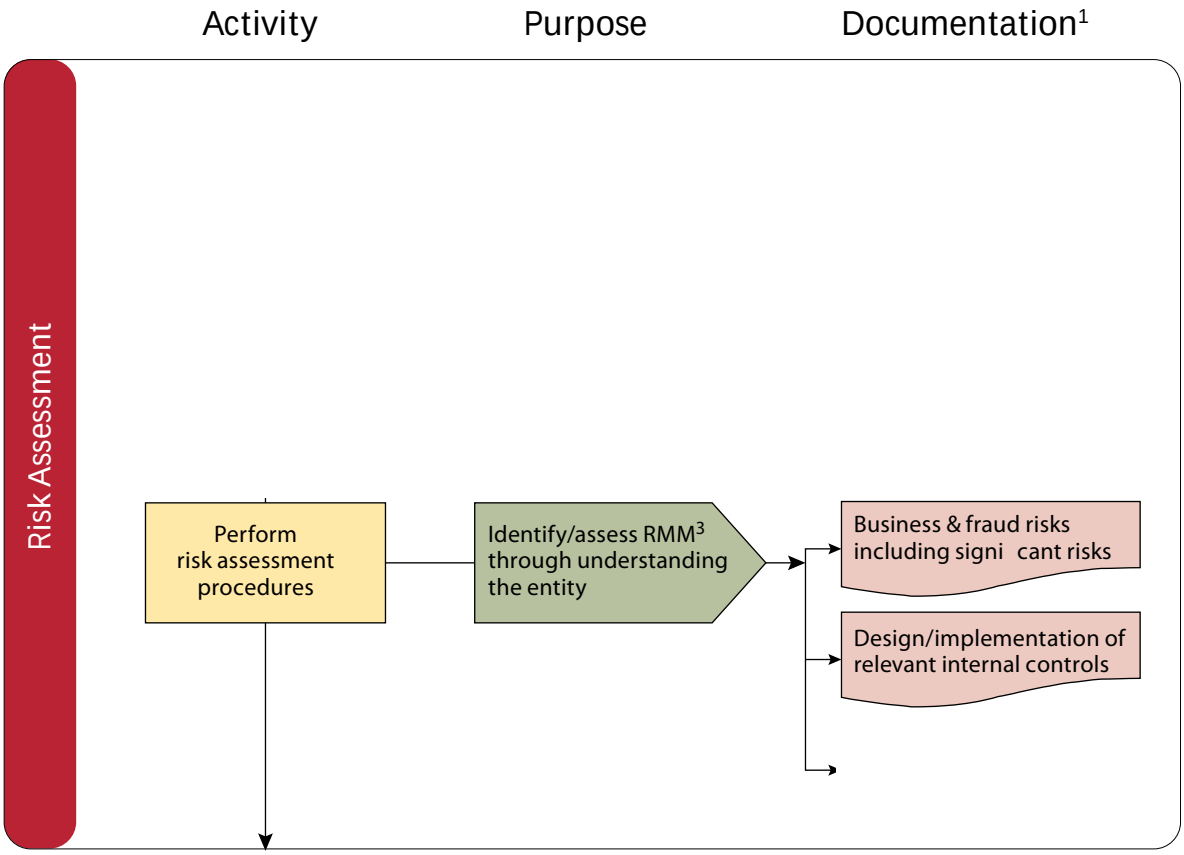
Ruby opens all of the mail and segregates the payments received for deposit. Raj goes to the bank on his way home and makes the deposit. Ruby then enters the payments into the accounting system and applies the payment to the invoices indicated.

Ruby prepares an aged accounts receivable listing and gives the listing to Raj for review.

Accounts P W F S E B Z T B S F G P M M P X F E V Q C Z 3 V C Z each month, and comments ar
when the customer has agreed to pay the balance.

Chapter Content	Relevant ISA
Guidance on communicating deficiencies identified in internal control that, in the auditor's professional judgment, merit the attention of management and those charged with governance.	265

Exhibit 13.0-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
260.10	For purposes of the ISAs, the following terms have the meanings attributed below: (a) Those charged with governance—The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager. For discussion of the diversity of governance structures, see paragraphs A1-A8. (b) Management—The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.
265.6	For purposes of the ISAs, the following terms have the meanings attributed below: (a) Deficiency in internal control—This exists when: (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely CBTJT PS (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing. (b) Significant deficiency in internal control—A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. (Ref: Para. A5)
265.7	The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A4)
265.8	If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5-A11)
265.9	The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12-A18, A27)
265.10	The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27) (a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be JOBQQSPQSJBUF UP DPNNVOJDBUF EJSFDUMZ UP NBOBHF Para. A14, A20-A21) (b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. (Ref: Para. A22-A26)

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
265.11	The auditor shall include in the written communication of significant deficiencies in internal control: B " EFTDSJQUJPO PG UIF EFöDJFODJFT BOE BO FYQMBOBU Para. A28) (b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29-A30) (i) The purpose of the audit was for the auditor to express an opinion on the financial TUBUFNFOUT (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness PG JOUFSOBM DPOUSPM BOE (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

13.1 Overview

During the course of the audit, deficiencies in internal control may be identified. This may occur as a result of understanding and evaluating internal control (see Volume 2, Chapters 11 and 12), in making risk assessments, performing audit procedures, or from other observations made at any stage of the audit process.

There is no restriction on what control deficiencies can be communicated with those charged with governance and with management. However, where an identified deficiency is assessed by the auditor as being significant, the auditor would first discuss it with management, and is then required to communicate it (and any other significant deficiencies) in writing to those charged with governance.

Some of the more common control deficiencies are listed in the exhibit below.

Exhibit 13.1-1

1PUFOUJBM $POUSPM %FGJDJFODJFT	
Pervasive (Entity- - FWFM $PNQPOFOUT	Weak control environment (entity-level) controls such as ineffective oversight, poor attitude toward internal control, or instances found of management override or fraud
	Changes in personnel that have resulted in key positions being unfilled, or where current personnel (such as in accounting) are not competent to perform the required tasks.
	Deficiencies identified in general IT controls.
	Inadequate controls implemented to address significant non-routine events such as the introduction of a new accounting system, the automation of a system such as sales, or the acquisition of a new business.

1 P U F C O U E $ P W S I D J F O D J F T	
Pervasive (Entity- - F W F M $ P O L S I M T (con E	Inability by management to oversee the preparation of the financial statements. This could include the lack of: t (F O F S B M N P O J U P S J O H D P O U S P M T T V D I P W F S T J t $ P O U S P M T P W F S U I F Q S F W F O U J P O B O E E F U F D U t $ P O U S P M T P W F S U I F T F M F D U J P O B O E B Q Q M J D B t $ P O U S P M T P W F S T J H O J ö D B O U U S B O T B D U J P O T X t $ P O U S P M T P W F S T J H O J ö D B O U U S B O T B D U J P O T P C V T J B F O T E T t $ P O U S P M T P W F S U I F Q F S J P E F O E ö O B O D J B M S F non-recurring journal entries).
	Significant deficiencies previously communicated to management or those charged with governance remain uncorrected after some reasonable period of time.
4 Q F D J ö D 5 S B O T B D U J P O B M Controls	An ineffective management response to identified significant risks (e.g., absence of controls over such a risk).
	Misstatements were detected by the auditor when they should have been prevented, or detected and corrected, by the entity's internal control.
	The existing internal controls were not: t 4 V ó D J F O U U P N J U J H B U F U I F S J T L Q P P S E F T J H O t 0 Q F S B U J O H B T E F T J H O F E Q P P S J N Q M F N F O U B U J training, lack of staff competence, or inadequate resources to perform the required tasks.

13.2 Fraud

If evidence is obtained that fraud exists or may exist, the matter should be brought to the attention of the appropriate level of management as soon as is practicable. This should be done even if the matter might be considered inconsequential.

The appropriate level of management is a matter of professional judgment, but would be at least one level above the persons who appear to be involved with the suspected fraud. It would also be affected by the likelihood of collusion and the nature and magnitude of the suspected fraud. Where the fraud involves senior management, communication is also required with those charged with governance. This may be made orally or in writing.

$0 / 4 * % &03* /15

'SBVE QFSQFUSBUFE CZ UIF PXOFS NBOBHFS PS UIPTF DIBSHFI

When fraud occurs at the very top of an organization, there is no one within the entity to whom it can be reported. In these situations, the auditor may obtain legal advice to determine the appropriate course of action in the circumstances. The purpose of obtaining such advice is to ascertain what steps (if any) are necessary in considering the public-interest aspects of the identified fraud.

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

13.3 Assessing the Severity of a De ciency

A significant deficiency is defined as a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

In evaluating internal control (see Volume 2, Chapter 12), it is suggested that risk factors that are unlikely to result in a material misstatement in the financial statements be eliminated (scoped out) from the auditor's understanding of internal control. If this guidance is followed, most of the control deficiencies identified by the auditor are likely to be significant.

The criteria for determining whether a deficiency is significant or not is similar to that for any other risk (see Volume 2, Chapter 9). Professional judgment is used to assess the likelihood that a misstatement could occur, and the potential magnitude of the misstatement if it did occur. If a misstatement has in fact occurred, the assessment would be based on the extent of the actual misstatement.

Less serious or even minor control deficiencies may also be identified during the course of the audit. These could result from interviews with management and staff, observation of internal controls in operation, performing further audit procedures, and any other information that may be obtained. It is a matter of professional judgment whether these matters are of sufficient importance to be reported to management and those charged with governance.

Some matters that could be considered by the auditor in assessing the severity of a deficiency are outlined in the following exhibit.

Exhibit 13.3-1

	*EFOUJGZJOH B 4JHOJöDBOU %FöDJFODZ
%FöDJFODZ Assessment Criteria	Likelihood of deficiencies leading to material misstatements in the financial statements in the future.
	The susceptibility of an asset or liability to loss or fraud.
	The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
	The financial statement amounts exposed to the deficiencies.
	The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
	The importance of the controls to the financial reporting process.
	The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
	The interaction of the deficiency with other deficiencies in internal control.

13.4 Smaller Entities

When assessing control deficiencies in smaller entities, the auditor would pay attention to the following factors.

Exhibit 13.4-1

	Consider
Control in a Small Entity	Controls may operate with less formality and with less evidence of their performance than in larger entities.
	Certain types of control activities may not be necessary at all. The risks may be mitigated through the controls applied by senior management (e.g., entity-level controls, such as the control environment, that would prevent or detect a specific error from occurring).
	There will be fewer employees, which may limit the extent to which segregation of duties is practicable. This can be offset by the owner-manager exercising more effective oversight (e.g., entity-level controls such as the control environment) than is possible in a larger entity.
	Greater potential exists for management override of controls.

In addition, the communication of deficiencies with those charged with governance may be less structured than in the case of larger entities.

13.5 Documenting Control De ciencies

There are no specific requirements in the ISAs as to how control deficiencies are to be documented. The extent of documentation is a matter requiring professional judgment. Where the audit team is less experienced, more detailed documentation and guidance may be required than where the team consists of highly experienced individuals.

A possible approach to documenting deficiencies as they are identified is outlined below. This documentation can be used for:

- %JTDVTTJOH EFöDJFODJFT XJUI NBOBHFNFOU
- "TTFTTJOH UIF TFWFSJUZ PG UIF EFöDJFODJFT
- $POTJEFSJOH UIF OFFE GPS BOZ BEEJUJPOBM BVEJU QSPDF
- 1SFQBSJOH UIF SFRVJSFE DPNNVOJDBUJPO UP NBOBHFNFOU

An example of such documentation is illustrated below (without the references to supporting and other working papers).

Exhibit 13.5-1

What is the risk factor or assertion a ected?	Describe the EFöDJFODZ UIBU MFOET UP / P	What is the potential e ect on the	4JHOJöDBOU EFöDJFODZ	Audit response
Management has not considered or assessed the risks of fraud occurring.	Members of the management team trust each other and are reluctant to introduce costly policies, etc. that address the risk of fraud.	Management could override controls and materially manipulate the financial statements.	Yes	See the specific procedures performed on journal entries, related parties, and revenue recognition.
Sales/services recorded in wrong accounting period.	There are no controls to prevent this from occurring and we found a number of cutoff errors in our tests of details.	Revenues could be materially misstated in the financial statements.	Yes	See the additional procedures performed relating to cut off.
Poor oversight and documentation to support the preparation of estimates.	The client provides virtually no back-up documents to support their estimates.	Given the size of the estimates, an error could result in a material error in the financial statements.	Yes	Obtain evidence to support the assumptions and perform the calculations again.

$0 / 4 * % &03* /15

3 F D P S E E F ö D J F O D J F T J O B T J O H M F Q M B D F

Designate one particular audit form to record pertinent details of control deficiencies as they are identified. This will ensure that all identified deficiencies are recorded on a consistent basis and in one place. If scattered through the file, deficiencies could be missed. This could result in an incomplete audit response to the risks involved, and incomplete communication to management and those charged with governance.

Describe the implications

When documenting deficiencies, take time to describe the implications of the deficiency ("what could go wrong") and the proposed audit response (if any) to the unmitigated risk.

What is the recommended course of action?

Providing management with a recommended course of action to correct identified control deficiencies is not a requirement. However, recommendations can be useful for management in determining the appropriate course of corrective action. Where recommendations are likely to be provided to management, document the suggestions for improvement at the same time that the deficiencies are recorded. If this step is left until later, it may lead to additional time being incurred to become acquainted with the facts again.

13.6 Oral Discussions with Management

Before issuing a written communication, it is generally considered best practice to discuss the findings orally (such as a discussion based on a draft letter) with the appropriate person or level of management, and possibly with those charged with governance. The appropriate person is the one who can evaluate the deficiencies and take the necessary remedial action. This step helps the auditor to ensure that the findings are factually correct and appropriately worded in the circumstances. It may also enable the auditor to obtain a preliminary indication of management's response to the findings.

For significant deficiencies, the appropriate level of management would be the highest in the entity, such as the owner-manager, chief executive officer, or chief financial officer (or equivalent). For other deficiencies, the appropriate level may be operational management with direct involvement in the control areas affected. Note that, if all of those charged with governance are also involved in managing the entity, communication with the most senior management may not adequately inform all those with governance responsibilities.

If the deficiency is directed at management directly (e.g., a question about its integrity or competence), it would not be appropriate to discuss this with management directly. The discussion of such findings would normally be with those charged with governance.

$0 / 4 * % &03* /15

If a significant deficiency is directed at the conduct or competence of the owner-manager or those charged with governance, there is no higher level in the entity to whom to report the findings. In these situations, the auditor would consider his/her ability to continue performing the audit. This may involve the auditor seeking legal advice.

The discussion with management provides an opportunity to discuss the findings and obtain management's reaction before the findings are finalized and communicated in writing, as illustrated below.

Exhibit 13.6-1

	#FOFöUT
%JTDVTTJPOT XJUI .BOBHFNFOU	Alerts management, on a timely basis, to the existence of deficiencies.
	Opportunity to obtain relevant information for further consideration, such as: t $POöSNBUJPO UIBU UIF EFTDSJQUJPO PG UIF EF UIF FYUFOU PG BO BDUVBM NJTTUBUFNFOU JT B t &YJTUFODF PG PUIFS QPTTJCMZ DPNQFOTBUJOH t .BOBHFNFOU T SFBDUJPO BOE VOEFSTUBOEJOH UIE EFöDJFODJFT t &YJTUFODF PG FYDFQUJPOT BSJTJOH GSPN UIF noted.
	Obtain a preliminary management response to the findings.

13.7 Written Communications

Significant deficiencies are to be reported in writing. This reflects the importance attached to such matters, and may assist management and those charged with governance in fulfilling their various responsibilities.

The requirement to communicate significant deficiencies in writing applies to all sizes of entity, including owner-managed and very small entities. Communicating such matters in writing ensures that those charged with governance have indeed been informed of the problems.

As soon as practicable after concluding that significant deficiencies exist, the auditor would discuss them with management and then communicate them in writing to those charged with governance. Although not required, the communication letter may also contain some suggested recommendations for remedial action. By taking these steps, management can take corrective action on a timely basis.

13.8 Management's Response to the Communication

It is the responsibility of management and those charged with governance to respond appropriately to the auditor's communication about significant deficiencies in internal control, and any recommendations for remedial action. This may take the form of:

t *OJUJBUJOH SFNFEJBM BDUJPO UP DPSSFDU UIF EFöDJFODJ
t " EFDJTJPO OPU UP UBLF BOZ BDUJPO .BOBHFNFOU NBZ BM IBT DIPTFO OPU UP SFNFEZ UIFN CFDBVTF PG UIF DPTUT PS
t /P BDUJPO BU BMM 5IJT NBZ CF JOEJDBUJWF PG B QPPS BU for assessing risk at the financial statement level. In some situations, such non-action may constitute a significant deficiency in itself.

Regardless of what action is taken by management, the auditor is required to communicate all significant deficiencies in writing. This includes significant deficiencies already reported in prior periods. It is not the

auditor's role to determine whether the cost of mitigating a deficiency outweighs the benefit to be obtained. However, some consideration of proportionality to the size of the entity and the application of common sense in the circumstances is appropriate.

If a previously communicated significant deficiency remains, the current period's communication may repeat the description or simply refer to the previous communication.

If the deficiency is not significant, there is no need to put it in writing or to repeat the communication in the current period. However, it may be appropriate for the auditor to re-communicate the other deficiencies if there has been a change in management, or if new information has come to the auditor's attention.

Content of Communication

The communication of significant deficiencies would normally include:

- %FTDSJQUJPO PG UIF OBUVSF PG FBDI TJHOJöDBOU EFöDJFO RVBOUJGZ UIPTF FòFDUT
- "OZ TVHHFTUJPOT GPS SFNFEJBM BDUJPO PO UIF EFöDJFODJ
- .BOBHFNFOU T BDUVBM PS QSPQPTFE SFTQPOTFT BOE
- " TUBUFNFOU BT UP XIFUIFS PS OPU UIF BVEJUPS IBT VOEFS responses have been implemented.

Significant deficiencies may be grouped together for reporting purposes where it is appropriate to do so.

As additional context for the communication, the letter would also include the following:

- "O JOEJDBUJPO UIBU JG UIF BVEJUPS IBE QFSGPSNFE NPSF auditor might have identified more deficiencies to be reported, or concluded that some of the reported EFöDJFODJFT OFFE OPU JO GBDU IBWF CFFO SFQPSUFE BOE
- "O JOEJDBUJPO UIBU TVDI DPNNVOJDBUJPO IBT CFFO QSPWJ governance, and that it may not be suitable for other purposes.

Local Reporting Requirements

Laws or regulations in some jurisdictions may establish additional requirements for the auditor to communicate one or more specific types of deficiency in internal control identified during the audit. Where this occurs:

- 5IF SFRVJSFNFOUT PG *4" SFNBJO BQQMJDBCMF OPUXJUI BVEJUPS UP VTF TQFDJöD UFSNT PS EFöOJUJPOT BOE
- 5IF BVEJUPS XPVME VTF UIF EFöOFE UFSNT BOE EFöOJUJPOT accordance with the applicable legal or regulatory requirements.

13.9 Timing of the Written Communication

The auditor is required to communicate, in writing, significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. Factors to consider include:

- Would undue delay in the reporting of information cause it to lose its relevance?
- Would the information be an important factor in enabling those charged with governance to discharge their oversight responsibilities?

Unless local requirements specify a particular date, the latest date that a written communication may be issued is before the date of the auditor's report or shortly thereafter. As the written communication forms part of the audit file, this enables the auditor to complete the assembly of the final audit file on a timely basis.

$0 / 4 * % &03* /15

Where possible, communicate deficiencies in internal control well before the period-end audit work commences. Early notification could enable management to take corrective action that may assist the auditor by lowering the assessed risk of material misstatement at the financial statement or assertion level. For example, a recommendation to replace or redeploy an incompetent accountant/bookkeeper could significantly reduce the work required in reviewing the preparation of the period-end financial statements.

13.10 Case Studies—Communicating De ciencies in Internal Control

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Deficiencies in internal control are identified throughout all phases of the audit (risk assessment, risk response, and reporting), and the auditor must accumulate them for subsequent reporting to management. Significant internal control deficiencies (both in design and operation) would be reported to management using a letter such as the ones below.

Jamel, Woodwind & Wing LLP
55 Kingston St., Cabetown, United Territories 123-53004

March 15, 20X3
Suraj Dephta

Dephta Furniture Inc.
[Address]

3F "VEJU PG 9 'JOBODJBM 4UBUFNFOUT

Dear Suraj:

The objective of our audit was to obtain reasonable assurance that the financial statements were free of material misstatement. Our audit was not designed for the purpose of identifying matters to communicate. Accordingly, our audit would not usually identify all such matters that may be of interest to you, and it is inappropriate to conclude that no such matters exist.

During the course of our audit of Dephta Furniture, Inc. for the period ended December 31, 20X2, we identified the following deficiencies in internal control that, in our opinion, are significant. A significant deficiency or combination of deficiencies in internal control is one that, in our professional judgment, is of sufficient importance to merit the attention of those charged with governance.

6 O B V U I P S J [F E +P V S O B M &O U S J F T

There are currently no controls over manual journal entries made throughout the period. Without any segregation of duties and review controls over entries made, errors or misstatements can go undetected. Although our audit found no such material errors or misstatements, this current unrestricted and unmonitored access by all company personnel presents a risk to accuracy of the financial statements.

We recommend that proper segregation of duties be allocated based on roles and responsibilities. Further, a formalized review process should be established. All significant entries should be approved prior to entry, and a secondary review should be conducted by management on a monthly basis.

Poor Inventory Controls

There are currently very limited controls over inventory. Without proper controls, inventory could be incomplete, improperly valued, or stolen.

We recommend Dephta implement formalized controls over the tagging and periodic counting of inventory. Inventory records should be compared to actual products in the warehouse on a monthly basis. A visual inspection on a monthly basis of obsolete and damaged goods should also be performed to ensure that any inventory write-downs are recorded as required.

This communication is prepared solely for the information of management and is not intended for any other purpose. We accept no responsibility to a third party who uses this communication.

Yours truly,

Jamel, Woodwind & Wing, LLP

Jamel, Woodwind & Wing LLP
55 Kingston St., Cabetown, United Territories 123-53004

March 15, 20X3
Rajesh Kumar

Kumar & Co.
[Address]

3F "VEJU PG 9 'JOBODJBM 4UBUFNFOUT

Dear Rajesh:

The objective of our audit was to obtain reasonable assurance that the financial statements were free of material misstatement. Our audit was not designed for the purpose of identifying matters to communicate. Accordingly, our audit would not usually identify all such matters that may be of interest to you, and it is inappropriate to conclude that no such matters exist.

During the course of our audit of Kumar & Co. for the period ended December 31, 20X2, we identified the following deficiency in internal control that, in our opinion, is significant. A significant deficiency or combination of deficiencies in internal control is one that, in our professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Lack of Segregation of Duties

There is currently a lack of segregation of duties at Kumar & Co. The part-time bookkeeper has total access to and control over all the record-keeping at Kumar. Without separating duties across multiple employees, there is a risk that the bookkeeper may make unintentional or intentional errors that go undetected.

We recommend that Kumar & Co. consider hiring another part-time staff person to split functions with the bookkeeper. Given the small size of the organization and cost restraints, if that is not practicable, we recommend that Raj Kumar become more involved in the record-keeping aspect of the business to provide adequate oversight of the bookkeeper's work.

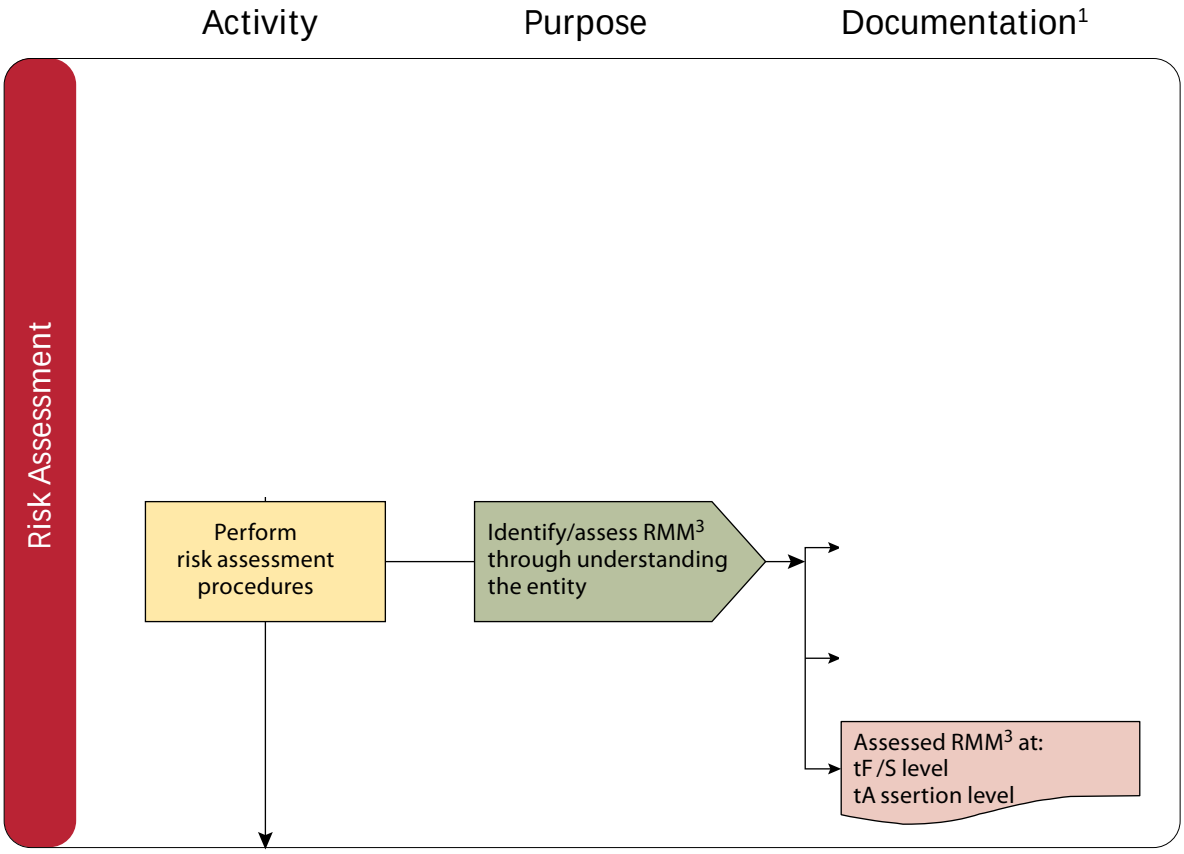
This communication is prepared solely for the information of management and is not intended for any other purpose. We accept no responsibility to a third party who uses this communication.

Yours truly,

Jamel, Woodwind & Wing, LLP

Chapter Content	Relevant ISA
Concluding the risk assessment phase of the audit by documenting the assessed risks at the financial statement and assertion levels.	315

Exhibit 14.0-1



Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
315.25	The auditor shall identify and assess the risks of material misstatement at: B UIF öOBODJBM TUBUFNFOU MFWFM BOE 3FG 1BSB " (b) the assertion level for classes of transactions, account balances, and disclosures (Ref: Para. A109-A113) to provide a basis for designing and performing further audit procedures.
315.26	For this purpose, the auditor shall: (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the DMBTTFT PG USBOTBDUJPOT BDDPVOU CBMBODFT BOE E Para. A114-A115) (b) Assess the identified risks, and evaluate whether they relate more pervasively to the öOBODJBM TUBUFNFOUT BT B XIPMF BOE QPUFOUJBMMZ B (c) Relate the identified risks to what can go wrong at the assertion level, taking account of SFMFWBOU DPOUSPMT UIBU UIF BVEJUPS JOUFOET UP UF (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.
315.32	The auditor shall include in the audit documentation: (a) The discussion among the engagement team where required by paragraph 10, and the TJHOJöDBOU EFDJTJPOT SFBDIFE (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control DPNQPOFOUT TQFDJöFE JO QBSBHSBQIT UIF TPVSDF VOEFSTUBOEJOH XBT PCUBJOFE BOE UIF SJTL BTTFTTNF (c) The identified and assessed risks of material misstatement at the financial statement level BOE BU UIF BTTFSUJPO MFWFM BT SFRVJSFE CZ QBSBHSE (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30. (Ref: Para. A131-A134)

14.1 Overview

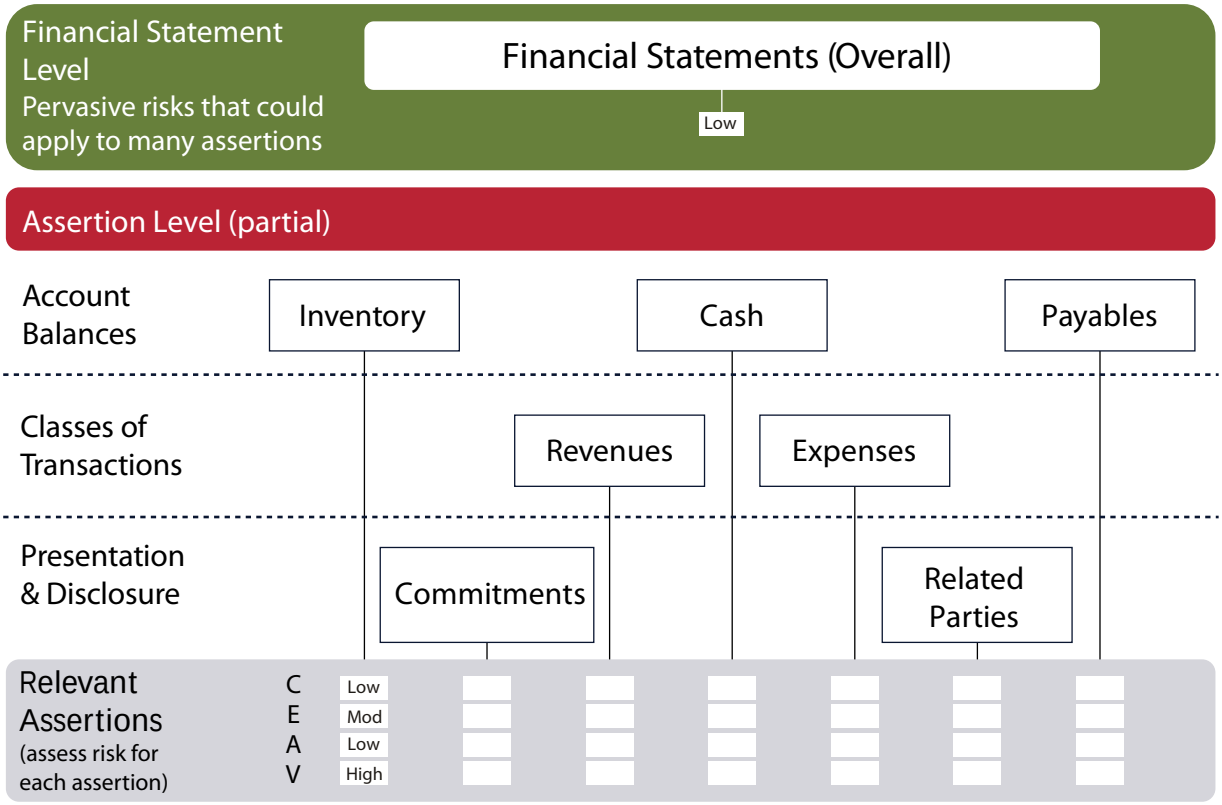
The final step in the risk assessment phase of the audit is to review the results of the risk assessment procedures performed, and then assess (or, if already assessed, summarize) the risks of material misstatements at:

- 5IF öOBODJBM TUBUFNFOU MFWFM BOE
- 5IF BTTFSUJPO MFWFM GPS DMBTTFT PG USBOTBDUJPOT BD

The resulting list of assessed risks will form the foundation for the next phase in the audit, which is to determine how to respond appropriately to the assessed risks through the design of further audit procedures.

The two levels of risk assessment are illustrated in the following exhibit:

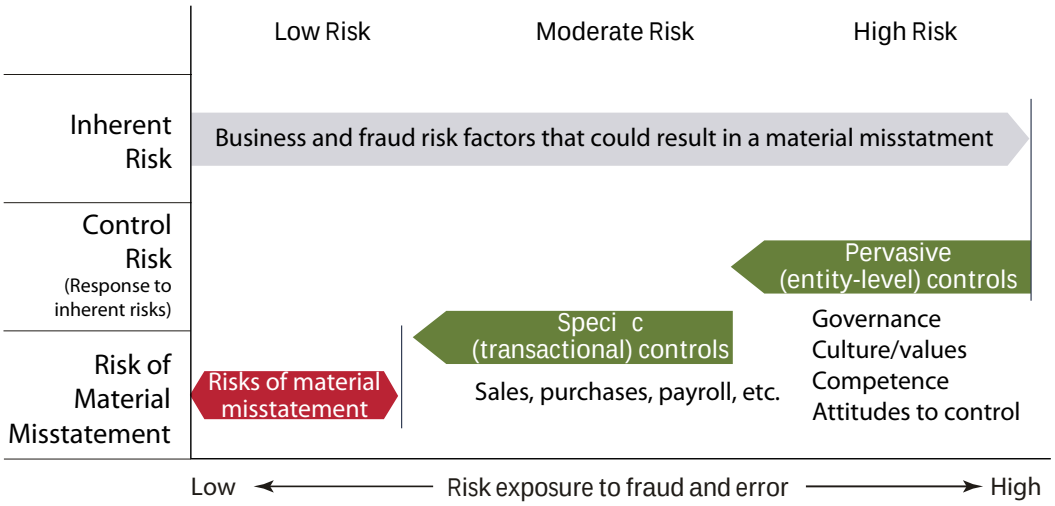
Exhibit 14.1-1



14.2 Audit Evidence Obtained to Date

The evidence obtained to date, by performing risk assessment procedures, consists of identification and assessment of inherent risks, and the design and implementation of internal controls that address those risks. What is left is the risk of material misstatement. This is simply the remaining risk after taking into account the effect of internal controls put in place to mitigate the inherent risks. This is illustrated in the exhibit below.

Exhibit 14.2-1



Note: The length of the horizontal bars in this exhibit is purely for illustrative purposes and would vary from entity to entity.

Sources of audit evidence that may be relevant in summarizing and assessing risks at the two levels are listed below.

Exhibit 14.2-2

Audit Evidence	Volume and Chapters
The overall audit strategy	V2 - 5
Materiality and identification of material financial statement areas and disclosures	V2 - 6
Audit team discussions	V2 - 7
Results of performing risk assessment procedures	V1 - 3 and V2 - 3 to 14
Inherent risk identification and assessment	V2 - 8 and 9
Significant risks	V2 - 10
Understanding and evaluation of internal control	V2 - 11 and 12
Significant deficiencies identified	V2 - 13

14.3 Summarizing the Various Risk Assessments

The purpose of assessing risks is to provide the foundation and a reference point for what is needed to respond appropriately with well-designed and efficient further audit procedures.

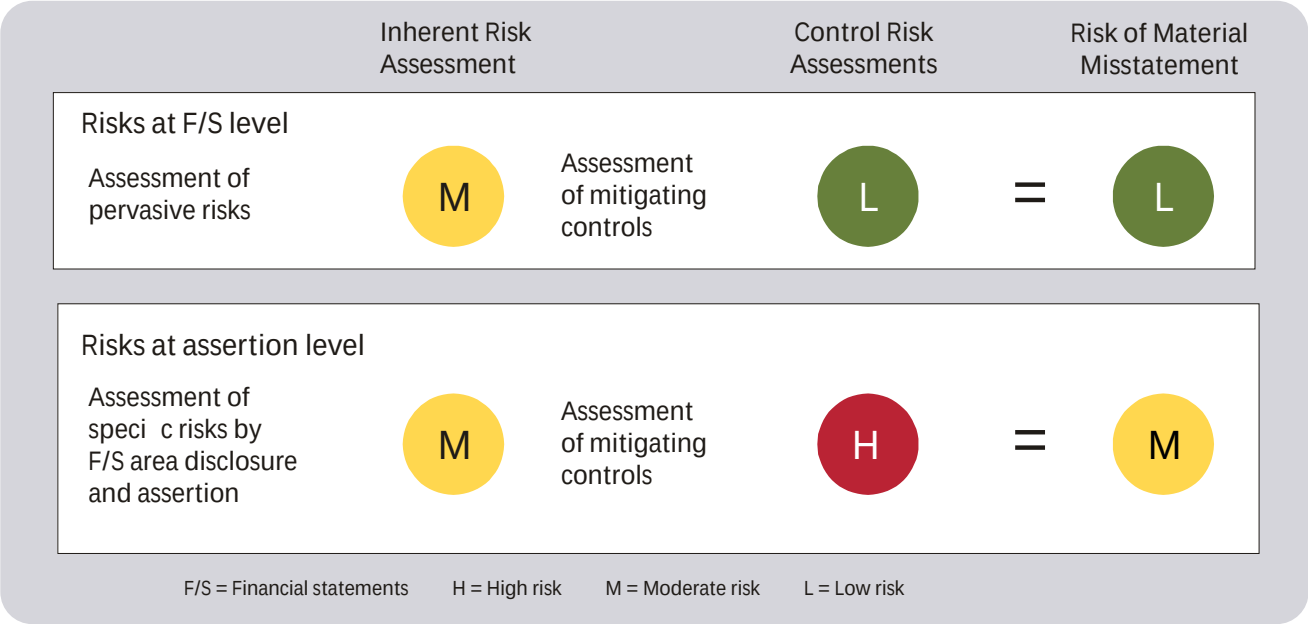
If risks identified to date have already been documented and assessed in a consistent manner, it will be relatively straightforward to review and summarize them.

The summary of assessed risks brings together the inherent risk factors identified and the evaluation of any internal control designed to mitigate such risks. This is illustrated in Exhibit 14.3-1.

Note: There is a moderate level of risk at the financial statement level which is mitigated by good entity-level and possibly other controls. The result is a low assessed risk at the financial statement level.

The summary of assessed risks at the assertion level is a combination of the assessment of inherent and control risks that apply to individual financial statement balances, transactions, and disclosures. In the case below, the inherent risks are moderate, and there are no relevant internal controls, so the control risk is high. The result is therefore a moderate residual risk for this particular assertion.

Exhibit 14.3-1



Notes:

- #FGPSF DPODMVEJOH UIFSF BSF OP QBSUJDVMBS SJTL GPS existence of other relevant factors, such as history of known errors, susceptibility of the asset/liability to fraud, potential for management override, and the previous period's experience.
- *G UIF BVEJUPS QMBOT UP SFMZ PO B DPOUSPM SJTL UIBU I substantive procedures), there need to be tests of the operational effectiveness of the controls to support such an assessment.
- *O TPNF DBTFT UIF FOUJUZ NBZ IBWF TPNF JOUFSOBM DPOU relevant to the audit and therefore no assessment has been made. In these cases, the control risk would be assessed as high.
- 4QFDJöD USBOTBDUJPOBM DPOUSPMT HFOFSBMMZ XPSL SF in a high assessed risk). This would imply that there is no assessment of control risk as being moderate. However, some auditors assess control risk as moderate when a control may not be totally reliable in operation, but is expected to work most of the time. This can often be the case in smaller entities.
- 5IF EFUFSNJOBUJPO PG SFTJEVBM SJTL SFTVMUJOH GSPN UI of professional judgment. The exhibit below shows various combinations of risk, but is not a substitute for professional judgment based on the particular circumstances.

Exhibit 14.3-2

Inherent Risk	Control Risk	Risk of material misstatement
H	H	H
H	M	M
H	L	M or L
M	H	M
M	M	M
M	L	L
L	H	M/L
L	M	L
L	L	L

, F ZH = High M = Moderate L = Low

$0 / 4 * % &03* /15

Document the reasoning behind risk assessments
When summarizing assessed risks, be sure to provide a short description of the reasons for each assessment or a cross-reference to where they can be found. This is often more important than the assessment itself, because it helps to design tailored and cost-effective responses.

Assessing inherent risks
Remember that the assessment of inherent risk is always completed before any consideration of controls that may mitigate the risk. Assuming most financial statement areas to be audited will exceed overall materiality, it is likely (in most instances) that the inherent risk of misstatement (before internal control) for most assertions will be high.

- P X S J T L G P S B M M B T T F S U J P O T
When a financial statement area has been assessed as low risk for all assertions, there is no need to repeat the same reasoning for each individual assertion. However, the reason why all the assessments are low would be documented.

14.4 Revision of Risk Assessments

The assessment of risk does not end at a point in time. New information may be gained as the audit progresses, and the performance of audit procedures may identify additional risks, or that internal control is not operating as intended. When this occurs, the original risk assessment should be revised and the impact on the nature and extent of further audit procedures considered.

14.5 Documentation

The summary of assessed risks can be documented in a number of ways. Three possible approaches are outlined below:

- " TUBOE BMPOF EPDVNFOU
  A separate document that summarizes the inherent and control risk assessments, and the key reasons for the combined risk assessments. This document could also be used for outlining (in general terms) the risk response.
- *ODMVEF XJUI UIF PWFSBMM BVEJU TUSBUFHZ BOE BVEJU QM
  The first part of each section of the audit plan (such as for receivables, payables, etc.) could outline the risk assessments and the impact on the planned audit procedures.
- *ODPSQPSBUF SJTL BTTFTTNFOUT BT QBSU PG UIF BVEJUPS
  In this case, the risk assessments, audit plans, and the results of work performed could all be documented in one comprehensive working paper for each financial statement area.

The form and extent of the documentation supporting risk assessments would be influenced by:

- 5IF OBUVSF TJ[F BOE DPNQMFYJUZ PG UIF FOUJUZ BOE JUT
- "WBJMBCJMJUZ PG JOGPSNBUJPO GSPN UIF FOUJUZ BOE
- 5IF BVEJU NFUIPEPMPHZ BOE UFDIOPMPHZ VTFE JO UIF DPVS

Other factors to consider when designing documentation include:

- &BTF PG VOEFSTUBOEBCJMJUZ
- $SPTT SFGFSFODFT UP UIF EFTJHO BOE JNQMFNFOUBUJPO P
- "CJMJUZ UP GBDJMJUBUF VQEBUJOH JO TVCTFRVFOU QFSJPE
- &BTF PG SFWJFX " SFWJFXFS TIPVME CF BCMF UP EFUFSNJC
  the resulting audit response was appropriate.

A well-documented summary of assessed risks will also be useful in the team planning meetings in subsequent periods where the nature of the risks and the audit response can be discussed.

An approach using a stand-alone document but closely linked to the audit plan is illustrated in the following exhibit. Note that this illustration uses the four “combined” assertions (used for the purposes of this Guide), as defined in Volume 1, Chapter 6.

Exhibit 14.5-1

Assessed Levels of Risk

		Assertions	IR	CR	3 . .	Document the key risks and other contributing factors to risk assessment
						The industry is in a general decline as new technologies emerge. However, sales are still strong and the entity is investing in R&D.
' J O B O D J B M Level		4 U B U P F N F M U	L		L	Management's attitude to internal control is good. Competent people ll the key positions.
						Management override possible but new policies in place should deter the most common practices.
						The governance board is made up of family members.
Assertion Level						
	FSA or financial statement disclosure					
1	Sales	C	H	L	M	Owner wants to save on taxes. Revenue recognition has been inconsistent.
		E	M	L	L	Relevant internal controls were identi ed. Tests of internal control for this assertion are a possibility.
		A	M	L	L	Relevant internal controls were identi ed and there has been no history of errors.
		V	NA	L	NA	
2	Receivables	C	L	L	L	Relevant controls were identi ed and there has been no history of errors.
		E	H	M	M	Salesperson's bonuses are based on recorded sales.
		A	L	L	L	Relevant internal controls were identi ed and there has been no history of errors.
		V	H	M	M	Recovery of receivables could be an issue in declining industry.
3	Inventory	C	L	L	L	Relevant controls were identi ed and there has been no history of errors.
		E	H	H	H	Inventory theft and poor physical internal control in warehouse.
		A	L	L	L	Relevant controls were identi ed and there has been no history of errors.
		V	H	H	H	New technology will make some parts and even whole products obsolete.

, F Z

H = High
M = Moderate
L = Low
D = Detect and correct control
NA = Not applicable
IR = Inherent risk
CR = Internal control risk
RMM = Risks of material misstatement (combined risk)
FSA = Financial statement area
P = Pervasive risks
C = Completeness
E = Existence
A = Accuracy
V = Valuation

Documentation of assessed risks could also make reference to:

t % F U B J M T P G T J H O J ö D B O U S J T L T U I B U S F R V J S F T Q F D J B M B U

t 3JTLT GPS XIJDI TVCTUBOUJWF QSPDFEVSFT BMPOF XJMM OF

14.6 Case Studies—Concluding the Risk Assessment Phase

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

The final step in the risk assessment process is to assess the combined risks of material misstatement at the financial statement and assertion levels.

The risk assessments can be summarized using an approach such as outlined below. Supporting information (where the assessments of inherent and control risk were documented) has not been shown. In practice, cross-references would be made to the supporting data.

$BTF 4UVEZ "‰%FQIUB 'VSOJUVSF *OD

Assessed Levels of Risk

		Assertions	IR	CR	3 . .	Document the key risks and other contributing factors to risk assessment
						Management's attitude to internal control is good and competent people ll the key positions.
'JOBODJBMUBUFNFOU Level		P	M	L	L	Management override is possible but we have not found any instances where this occurred and management's attitude toward control is good.
						The monthly meeting to review performance provides some accountability to management.
Assertion Level						
	FSA or financial statement disclosure					
1	Sales	C	H	L	M	Revenue recognition policies are inconsistent.
		E	L	L	L	Revenue recognition policies are inconsistent. Pressure to in ate sales due to sales bonuses and market pressures.
		A	L	L	L	Sales system operates well.
		V	NA	L	NA	
2	Receivables	C	L	L	L	No signi cant risks identi ed.
		E	H	M	M	Salespersons' bonuses are based on recorded sales.
		A	L	L	L	
		V	H	M	M	Large retailer receivables collection could be an issue if UIFSF JT DPODFSO PWFS QSPEVDU Additionally, despite the declining economy, no credit checks are performed before credit is granted.

, F Z

H = High	NA = Not applicable	FSA = Financial statement area	A = Accuracy
M = Moderate	IR = Inherent risk	P = Pervasive risks	V = Valuation
L = Low	CR = Internal control risk	C = Completeness	
D = Detect and correct control	RMM = Risks of material misstatement (combined risk)	E = Existence	

At this point, it would be good practice to prepare a communication for management that outlines the significant weaknesses identified in internal control.

Concluding the Risk Assessment Phase

Assessed Levels of Risk

		Assertions	IR	CR	3 . .	Document the key risks and other contributing factors to risk assessment
						Management's attitude to internal control is good and competent people ll the key positions.
' J O B O4DUJB LWF NFFWOFUM					M	Management override is possible due to pressures to meet bank covenants and minimize taxes. The bookkeeper's work was not reviewed by Raj on a consistent basis throughout the period. The bookkeeper appears disgruntled and may have opportunity to misstate the gures. Therefore, both unintentional error and intentional fraud could go undetected.
						The monthly meeting to review performance provides some accountability to management.
Assertion Level						
	FSA or financial statement disclosure					
1	Sales	C	H	L	M	Relevant internal controls were identi ed for this assertion.
		E	H	L	M	Relevant internal controls were identi ed for this assertion but related party transactions are of concern.
		A	H	L	M	Relevant internal controls were identi ed for this assertion but related party transactions are of concern.
		V	M	M	M	Potential for sales returns due to state of industry.
2	Receivables	C	H	L	M	Majority of receivables balance is with Dephta. No other speci c risks identi ed.
		E	H	M	M	Majority of receivables balance is with Dephta. No other speci c risks identi ed.
		A	M	M	M	Majority of receivables balance is with Dephta. No other speci c risks identi ed.
		V	H	M	M	The smaller customers may have di culty paying their bills in these tougher economic times.

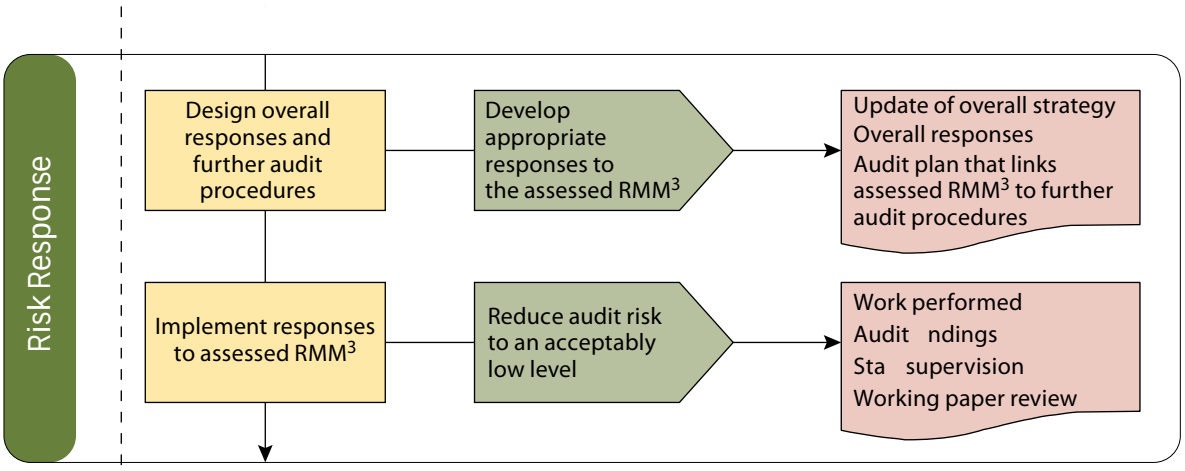
, F·Z

H = High
M = Moderate
L = Low
D = Detect and correct control
NA = Not applicable
IR = Inherent risk
CR = Internal control risk
RMM = Risks of material misstatement (combined risk)
FSA = Financial statement area
P = Pervasive risks
C = Completeness
E = Existence
A = Accuracy
V = Valuation

At this point, it would be good practice to prepare a communication for management that outlines the significant weaknesses identified in internal control.

Exhibit 15.0-1

Activity	Purpose	Documentation[1]

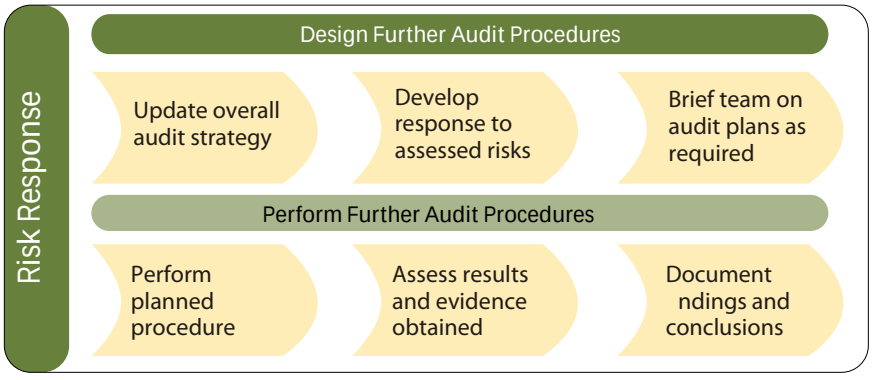


Notes:
1. Refer to ISA 230 for a more complete list of documentation required.
2. Planning (ISA 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	3 F M F W B O U &Y U S B D U T G S P N *4"T
330.5	The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1-A3)
330.6	The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4-A8)

The risk response phase includes the steps outlined below:

Exhibit 15.0-2

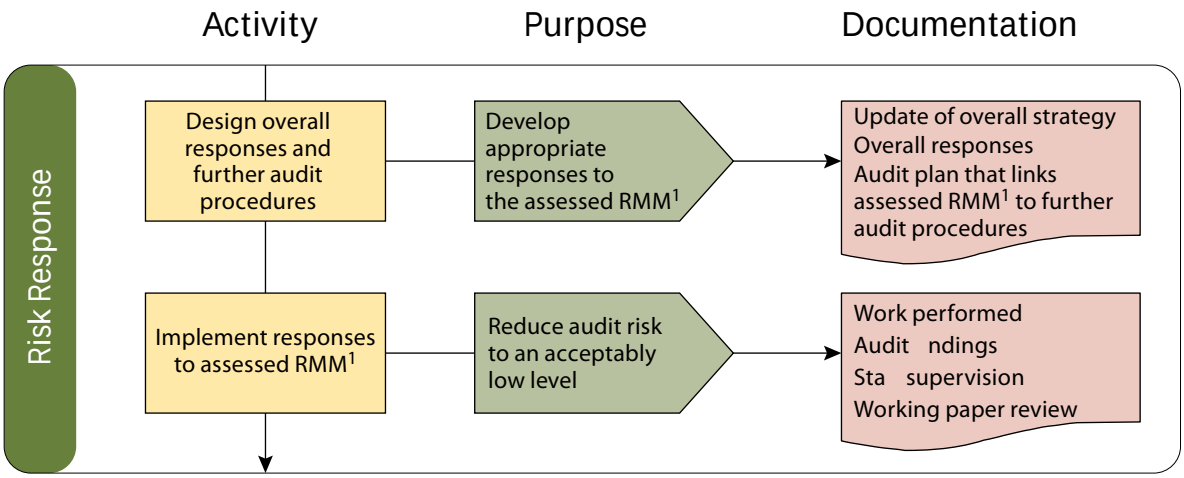


The basic concepts addressed in the risk response phase are listed below.

	Volume and Chapters
Responding to Assessed Risks	V1 - 9
Further Audit Procedures	V1 - 10
Accounting Estimates	V1 - 11
Related Parties	V1 - 12
Subsequent Events	V1 - 13
Going Concern	V1 - 14
Summary of Other ISA Requirements	V1 - 15
Audit Documentation	V1 - 16

Chapter Content	Relevant ISAs
How to plan an effective audit response to assessed risks.	260, 300, 330, 500

Exhibit 16.0.-1



Notes:
1. RMM = Risks of material misstatement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
260.15	The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: Para. A11-A15)
300.9	The auditor shall develop an audit plan that shall include a description of: (a) The nature, timing and extent of planned risk assessment procedures, as determined under ISA 315. (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA 330 (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs. (Ref: Para. A12)
300.10	The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A13)

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
300.11	The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A14-A15)
300.12	The auditor shall include in the audit documentation: B 5IF PWFSBMM BVEJU TUSBUFHZ C 5IF BVEJU QMBO BOE (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A16-A19)
330.5	The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1-A3)
330.6	The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4-A8)
330.7	In designing the further audit procedures to be performed, the auditor shall: (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including: (i) The likelihood of material misstatement due to the particular characteristics of the SFMFWBOU DMBTT PG USBOTBDUJPOT BDDPVOU CBMBO and (ii) Whether the risk assessment takes account of relevant controls (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive QSPDFEVSFT BOE 3FG 1BSB " " (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)
330.8	The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if: (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and FYUFOU PG TVCTUBOUJWF QSPDFEVSFT PS (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20-A24)
330.9	In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25)
330.10	In designing and performing tests of controls, the auditor shall: (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including: (i) How the controls were applied at relevant times during the period under audit. (ii) The consistency with which they were applied. (iii) By whom or by what means they were applied. (Ref: Para. A26-A29) (b) Determine whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30-A31)

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
330.15	If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.
330.18	Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. (Ref: Para. A42-A47)
330.19	The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48-A51)
330.20	The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process: B "HSFFJOH PS SFDPODJMJOH UIF öOBODJBM TUBUFNFOU and (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)
330.21	If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)
330.22	If substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing: B TVCTUBOUJWF QSPDFEVSFT DPNCJOFE XJUI UFTUT PG (b) if the auditor determines that it is sufficient, further substantive procedures only, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A54-A57)
330.24	The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. (Ref: Para. A59)
500.6	The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1-A25)
500.7	When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A26-A33)
500.10	When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52-A56)

16.1 Overview

In the risk response phase of the audit, the objective is to obtain sufficient appropriate audit evidence regarding the assessed risks. This is achieved by designing and implementing appropriate responses to the assessed risks of material misstatement at the financial statement and assertion levels.

The auditor would approach this task in various ways, such as:

t "EESFTTJOH FBDI BTTFTTFE SJTL JO UVSO BDDPSEJOH UP JU
EFTJHOJOH UIF BQQSPQSJBUF BVEJU SFTQPOTF JO UIF GPSN

- "EESFTTJOH UIF BTTFTTFE SJTLT CZ NBUFSJBM öOBODJBM TU XPVME UIFO EFTJHO BO BQQSPQSJBUF SFTQPOTF JO UIF GPS
- 4UBSUJOH XJUI B TUBOEBSE MJTU PG BVEJU QSPDFEVSFT GR and tailoring it (adding, modifying, and eliminating procedures) to design an appropriate response to the assessed risks.

Responding to assessed risks implies more than using a standard ("one size fits all") audit program which may address each assertion, but has not been tailored to address the assessed risk for the financial statement area by assertion for a particular entity. Audit programs should generally be tailored (to the extent necessary) to the entity's level of risk and its particular circumstances.

16.2 The Starting Point

The starting point for designing an effective audit response is the listing of assessed risks that was developed at the conclusion of the risk assessment phase of the audit (see Volume 2, Chapter 14).

Risks will have been identified and assessed at:

- 5IF öOBODJBM TUBUFNFOU MFWFM BOE
- 5IF BTTFSUJPO MFWFM GPS öOBODJBM TUBUFNFOU BSFBT BC

Smaller financial statement areas could be grouped together and treated as one larger area for developing an appropriate audit response.

Volume 1, Chapter 9 outlines possible responses to risks assessed at the two levels. The types of response required are summarized in the following exhibit.

Exhibit 16.2-1

16.3 Overall Responses

Pervasive risks at the financial statement level (risks such as a deficient control environment and/or the potential for fraud that could affect many assertions) are addressed through the design and implementation of an overall

response by the auditor, as illustrated in the following exhibit. Refer to Volume 2, Chapter 8 for additional information on pervasive risks.

Areas that the auditor would address in developing an overall response include determining:

- 5IF FYUFOU UIBU UIF BVEJU UFBN OFFET UP CF SFNJOEFE B
- 8IJDI TUBò UP BTTJHO JODMVEJOH UIPTF XJUI TQFDJBM TLJ
- 5IF FYUFOU PG TVQFSWJTJPO SFRVJSFE UISPVHIPVU UIF BV
- 5IF OFFE GPS JODPSQPSBUJOH TPNF FMFNFOUT PG VOQSFEJ QSPDFEVSFT UP CF QFSGPSNFE BOE
- "OZ HFOFSBM DIBOHFT UIBU OFFE UP CF NBEF UP UIF OBUVS could include the timing of procedures (interim or period-end), or new/extended procedures to address specific risk factors such as fraud.

Exhibit 16.3-1

Risk Assessment	1PTTJCMF 0WFSBMM 3FTQPOTF
An E ective Control Environment	This allows the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity. An overall response could include some audit procedures being performed at an interim date rather than at the period end.
An Ine ective Control Environment (De ciencies Exist)	This will likely require the auditor to perform some additional work such as: t "TTJHOJOH NPSF FYQFSJFODFE BVEJU TUBò t $POEVDUJOH NPSF BVEJU QSPDFEVSFT BU UIF QF t 0CUBJOJOH NPSF FYUFOTJWF BVEJU FWJEFODF t .BLJOH DIBOHFT UP UIF OBUVSF UJNJOH PS FY performed.

$0 / 4 * % &03* /15

Where possible, develop an initial assessment of risk at the financial statement level at the planning stage. This will enable an initial overall response to be developed that addresses matters such as what staff to assign (including those with specialist skills), the level of supervision needed, and what audit procedures are to be performed. This initial assessment of risk would require updating as the audit progresses, and corresponding changes would be made in the overall response.

However, this may not be possible in smaller entities that do not have interim or monthly financial information available for performing analytical procedures and identifying/assessing the risks of material misstatement. Unless limited analytical procedures can be performed or information can be obtained through inquiry to plan the audit, the auditor may need to wait until an early draft of the entity's financial statements is available.

16.4 Use of Assertions in Test Design

An assessment of the risks of material misstatement is required at the financial statement and assertion levels. The objective in designing an appropriate audit response is to obtain evidence that addresses the risk assessments

developed for each relevant assertion. Refer to Volume 1, Chapter 6 for more information about assertions.

When developing a response to specific transaction streams, the auditor would note that the assertions also provide the common link between internal control testing and substantive procedures. This is important for identifying when a combination of tests of controls and substantive procedures may be appropriate to reduce the risks of material misstatement to an acceptably low level.

For example, audit procedures for "existence" of inventory will focus on testing the validity of items already recorded as part of the inventory balance and the testing of controls that would mitigate the risk of there being non-existent items in the inventory balance. A test of "completeness" of inventory would focus on testing items not included in the inventory balance, but would provide possible evidence of missing items. This could include purchase orders for goods, and testing controls that would mitigate the risk of missing inventory.

16.5 Use of Materiality in Test Design

A key factor in considering the extent of an audit procedure deemed necessary is the performance materiality that has been established. Performance materiality is based on the materiality established for the financial statements as a whole, but may be modified to address particular risks relating to an account balance, transaction stream, or financial statement disclosure.

The extent of audit procedures judged necessary is determined after considering the performance materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. In general, the extent of audit procedures (such as a sample size for a test of details, or the level of detail necessary in a substantive analytical procedure) would increase as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk. See Volume 1, Chapter 7 and Volume 2, Chapters 6 and 17 for more information on the use of materiality in test design.

16.6 The Auditor's Toolbox

In developing the detailed audit plan, the auditor would use his/her professional judgment to select the appropriate types of possible audit procedures. Refer to Volume 1, Chapters 10 to 15 for a more detailed description of further audit procedures.

An effective audit program will be based on an appropriate mix of procedures that collectively reduce audit risk to an acceptably low level. For the purposes of this Guide, the various types of audit procedures available to the auditor have been categorized as illustrated in the following exhibit.

Exhibit 16.6-1

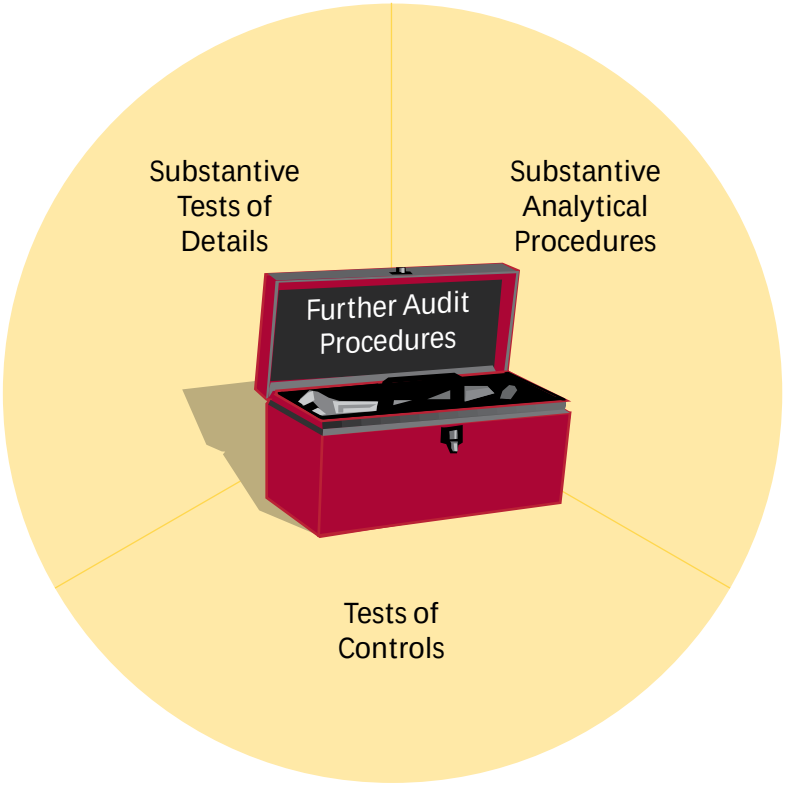


Exhibit 16.6-2

1 S P D F E V S F	Description
Substantive Procedures	Paragraph 18 of ISA 330 requires substantive procedures to be performed for each material class of transactions, account balance, and disclosure irrespective of the assessed risks of material misstatement (RMM). This reflects the fact that: t 5IF BVEJUPS T BTTFTTNFOU PG SJTL JT KVEHNFNBUFSJBM NJTTUBUFNFOU BOE t 5IFSF BSF JOIFSFOU MJNJUBUJPOT UP JOUFSOBoverride. Where the 3 . . JT W F, S Z M F X substantive procedures, for example tests of details or analytical review, may well be all that is required to obtain sufficient and appropriate evidence for a particular assertion.

1 S P D F E V S F	Description
- Analytical Procedures	Substantive analytical procedures involve evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. They require the development of precise expectations for certain amounts (such as sales) that, when compared to actual recorded amounts, would be sufficient to identify a misstatement. Analytical procedures can be categorized as follows: t 4 J N Q M F D P N Q B S J T P O T P G E B U B U I B U X P V M E U Z substantive procedures. These procedures would normally be combined with other tests of details at the assertion level. They would not provide sufficient audit evidence by themselves. t 1 S F E J D U J W F N P E F M T U I B U C Z U I F N T F M W F T P S or other substantive procedures) would be sufficient to reduce audit risk to an acceptably low level. For example, if an entity had six employees at fixed rates of pay throughout the period, it could be possible to estimate the total payroll costs for the period with a high degree of accuracy. Assuming the number of employees and the rates of pay were accurate, this procedure could provide the entire audit evidence for payroll. There may be no need for other substantive procedures (basic or extended) to be performed.
5 F T U T P G % F U B J M T	When addressing a significant risk through substantive procedures alone, those substantive procedures are required to include tests of details. See Volume 2, Chapter 10 for a more detailed description of significant risks and the appropriate audit response.
5 F T U T P G $ P O U S P M T	Where key controls are in place (that are likely to operate effectively) to address certain assertions, tests of controls may be performed to obtain the necessary evidence about an assertion. Tests of controls performed to reduce risk to a low level (requiring a larger sample size) may provide the majority of evidence required for a particular assertion. Alternatively, tests of controls could be performed to reduce risk to a moderate level (requiring a slightly smaller sample size). In this latter case, to obtain the required evidence, the auditor would supplement the tests of controls with substantive procedures that address the same assertion. Under certain criteria, internal controls need only be tested every third audit. Refer to the discussion on tests of controls in Volume 1, Chapter 10.5.

16.7 Developing the Responsive Audit Plan

Professional judgment and careful thought are required to develop an audit plan that responds appropriately to the assessed risks. The time spent developing an appropriate plan will almost certainly result in a more effective and efficient audit and less time being spent by staff.

There are three general steps the auditor would take in developing the plan:

- 3FTQPOE UP BTTFTTFE SJTLT BU UIF öOBODJBM TUBUFNFOU
- *EFOUJGZ BOZ TQFDJöD QSPDFEVSFT SFRVJSFE GPS NBUFSJ
- %FUFSNJOF XIBU BVEJU QSPDFEVSFT UPPMT GSPN UIF UPPM

Step 1—Respond to assessed risks at the nancial statement level

The first step is to develop an appropriate overall response to assessed risks at the financial statement level. Because these risks are pervasive, a moderate or high level of risk assessment will generally result in additional work being required for virtually every financial statement area. Refer to the discussion on overall responses in Volume 2, Chapter 16.3.

Step 2—Identify speci c procedures required for material nancial statement areas

Before developing the detailed response to assessed risks, the auditor may find it helpful to consider (for each material financial statement area) the questions set out in the exhibit below.

Exhibit 16.7-1

	'PS &BDI .BUFSJBM PS 1PUFOUJBMMZ .BUFSJBM
Questions to Consider When Developing an Appropriate Audit Response	Are there assertions that cannot be addressed by substantive tests alone? If so, tests of controls will be required. This may occur when: - 5IFSF JT OP EPDVNFOUBUJPO UP QSPWJEF BVEJ BT TBMFT DPNQMFUFOFTT PS - "O FOUJUZ DPOEVDUT JUT CVTJOFTT VTJOH *5 is produced or maintained other than through the IT system.
	Are internal controls over related transaction streams/processes expected to be reliable? If so, a test of controls may be possible unless the number of transactions is so small that substantive procedures would still be more efficient.
	Are substantive analytical procedures available (such as on related transaction streams)?
	Is an element of unpredictability required (to address fraud risks, etc.)?
	Are there “significant risks” (i.e., fraud, related parties, etc.) to be addressed that require special consideration?

Step 3—Determine the nature and extent of audit procedures required

The third step is to use professional judgment to choose the appropriate mix of procedures and extent of testing required to respond appropriately to the assessed risks at the assertion level.

Outlined below is one possible approach for determining the appropriate mix of procedures to address the existence of receivables at low, moderate, and high levels of assessed risk.

3FDFJWBCMFT ‰-PX -FWFM PG "TTFTTFE 3JTL

Performance materiality = 12,000

Planned Audit Response

"TTFTTFE 3JTL GPS Assertion	&YJTUF Low	Comments
Substantive Procedures	✓	These procedures would be considered adequate by themselves to address the assessed risk. They would include the typical tests of details and/or simple analytical procedures that would be performed in virtually any audit of receivables. These procedures would often be included in a standard audit program for receivables.

3FDFJWBCMFT‰.PEFSBUF -FWFM PG "TTFTTFE 3JTL

Performance materiality = 10,000€

Planned Audit Response

"TTFTTFE 3JTL GPS Assertion	&YJTUF Moderate	Comments
Substantive Procedures	✓	These procedures would be performed to address the existence risk in general (i.e. as for low risk, above) and also to: t "EESFTT UIF TQFDJöD SJTLT JEF FYJTUFODF PG SFDFJWBCMFT TV t 1FSGPSN TVóDJFOU UFTUT PG EF assessed risk to an acceptably low level.

If the entity had internal controls (such as over sales) that addressed the existence of receivables, an alternative to performing only substantive procedures would be a test of the operating effectiveness of such controls.

3 F D F J W B C M F T ‰) J H I - F W F M P G " T T F T T F E 3 J T L

Performance materiality = 10,000

Planned Audit Response

" T T F T T F E 3 J T L G P S Assertion	& Y J T U F High	Comments
Substantive Procedures	✓	These procedures would be performed to address the existence risk in general (i.e. as for low risk, above) and also to: t " E E S F T T U I F T Q F D J ö D S J T L T J E F F Y J T U F O D F P G S F D F J W B C M F T T V t 1 F S G P S N T V ó D J F O U U F T U T P G E F assessed risk to an acceptably low level..
5 F T U T P G $ P O U S P M T 0 Q F S B U J O H & ò F D U J W F O F T T	✓	Because the sample size required for a test of details that would have reduced risk to a low level, the internal controls that address existence would be tested to obtain a moderate level of risk reduction. This combined with the tests of details outlined above will reduce the assessed risk to an acceptably low level.

In the above example, it may also be possible to obtain the majority of required evidence from performing a test of controls that reduces the risk to an acceptably low level. This may eliminate the need for many of the substantive procedures.

When developing an audit strategy on particular account balances or transactions, the auditor would always consider the work performed on other parts of the transaction stream.

Another example is the completeness of sales for an entity that owns an apartment building and rents out the units.

3 F D F J W B C M F T ‰ . P E F S B U F - F W F M P G " T T F T T F E 3 J T L

Performance materiality = 6,000€

Planned Audit Response

" T T F T T F E 3 J T L G P S Assertion	& Y J T U F Moderate	Comments
Substantive 5 F T U T P G % F U B - J M T		In light of the substantive analytical procedure outlined below, these procedures may not be necessary at all, or limited to obtaining evidence to corroborate the assumptions used.
Substantive Analytical Procedures	✓	The known number of rental units is 64 and the rent is 1,000 a month for the 46 two-bedroom suites and 800 for the 18 one-bedroom suites. t 5 I F Q S F E J D U F E S F O U B M J O D P N F 724,800 . t " D U V B M J O D P N F S F D P S E F E J O U I was 718,800 , a difference of 6,000 . The difference was verified as being due to the fact that six of the two-bedroom units were vacant for a month during the year.

$0 / 4 * % &03* /15

"WPJE EFGBVMUJOH UP HFOFSJD PS TUBOEBSE BVEJU QSPDFEV
The most effective audit procedures are those that specifically address the causes of the assessed risks.

. V M U JBQTMF S U J P O T
Where possible, choose audit procedures that address multiple assertions. This will reduce the need for other tests of detail.

- P X SBTTLF B T
Use the information obtained from assessing the risks of material misstatement to reduce the need for substantive procedures in low-risk areas.

Consider using tests of controls

Use the information obtained about internal control to identify key controls that could be tested for operating effectiveness. Testing controls (some of which may only require testing once every three years) can often result in much less work than performing extensive tests of detail. See also Volume 2, Chapter 17.

% P OPU JHOPSF *5 DPOUSPMT
The sample size for testing an automated control can be as little as one item because an automated control is likely to operate in the same manner every time, making it representative of all other items in the population. However, this would be based on the assumption that the entity has effective general IT controls in operation.

Dual-purpose tests

Where tests of controls are planned on the same class of transactions as substantive tests, consider the potential for dual-purpose tests. This is where a test of controls is performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from a test of details, both objectives may be accomplished concurrently. For example, an invoice could be examined to determine whether it has been approved (a test of control) and whether the transaction was properly recorded in the accounting records (a test of details).

$POTJEFS XPSL QFSGPSNFE PO BMM QBSUT PG B USBOTBDUJPO
Take credit for work performed on other parts of the transaction stream. For example, a test of controls over sales completeness would provide evidence for the completeness of receivables.

Decide on audit strategy and procedures at the planning phase

Where possible, develop the nature and extent of audit procedures during the planning phase of the audit, a time at which the team can agree on the approach to be followed. This avoids junior staff having to design audit procedures by themselves or simply performing the same procedures as last year.

$0 / 4 * % &03* /15 continued

Remember to use analytical procedures
Analytical procedures are used in each phase of the audit.

- "U UIF CFHJOOJOH PG UIF BVEJU BOBMZUJDBM QSPDFEVSF
- %VSJOH UIF BVEJU BOBMZUJDBM QSPDFEVSFT BSF QFSGPS
  substantiate certain transaction streams and account balances.
- /FBS UIF FOE PG UIF BVEJU BOBMZUJDBM QSPDFEVSFT BS
  statements are consistent with the auditor's understanding of the entity, or to indicate a previously unrecognized risk of material misstatement due to fraud.

16.8 Responding to the Risk of Fraud

The risk of fraud (including management override) can exist in virtually any entity, and needs to be addressed when developing the audit plan. The first step is to assess the potential risk from fraud, and then to design an appropriate overall and detailed response.

Note: The auditor is required to treat assessed risks of material misstatement due to fraud as significant risks. A significant risk requires the auditor to:

- 0CUBJO BO VOEFSTUBOEJOH PG UIF FOUJUZ T SFMBUF UP TVDI SJTLT BOE
- 1FSGPSN TVCTUBOUJWF QSPDFEVSFT UIBU BSF TQFDJ

When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

In assessing the potential risk and appropriate response to fraud, the auditor would consider the following:

- 0WFSBMM SFTQPOTFT BMSFBEZ EFWFMPQFE UP BEESFTT SJT
- 4QFDJöD SFTQPOTFT BMSFBEZ EFWFMPQFE JO SFMBUJPO UP
- 5IF GSBVE TDFOBSJPT JG BOZ EFWFMPQFE EVSJOH UIF QMI
- 'SBVE SJTLT PQQPSUVOJUJFT JODFOUJWFT BOE SBUJPOBM QSPDFEVSFT
- 4VTDFQUJCJMJUZ PG DFSUBJO öOBODJBM TUBUFNFOU CBMBC
- "OZ LOPXO JOTUBODFT PG BDUVBM GSBVE JO UIF QBTU PS J
- 3JTLT SFMBUJOH UP NBOBHFNFOU PWFSSJEF

The following exhibit outlines some possible responses to the risks identified above.

Exhibit 16.8-1

0WFSBMM 3FTQPOTFT UP 'SBVE	
Pervasive Risks BU UIF 'JOBODJBM Statement Level	Consider need for: t JF JHIUFOFE QSPGFTTJPOBM TLFQUJDJTN XIFO F DPSSPCPSBUJOH BOE TVCTUBOUJBUF t 1FPQMF XJUI TQFDJBMJ[FE TLJMMT LOPXMFEHF t %FWFMPQNFOU PG TQFDJöD BVEJU QSPDFEVSFT t "O FMFNFOU PG VOQSFEJDUBCJMJUZ JO UIF TFM Consider adjusting the timing of certain audit procedures, using different sampling methods, or performing procedures on an unannounced basis.

4QFDJöD 3FTQPOTFT UP 1PUFOUJBM 'SBVE 3JTLT	
4QFDJöD 3JTLT BU the Assertion Level	Consider: t $IBOHJOH UIF OBUVSF UJNJOH BOE FYUFOU PG the risk. Examples include the following: – Obtain more reliable and relevant audit evidence or additional corroborative information to support management's assertions, – Perform a physical observation or inspection of certain assets, – Observe inventory counts on an unannounced basis, and – Perform further review of inventory records to identify unusual items, unexpected amounts, and other items for follow-up procedures. t 1FSGPSNJOH GVSUIFS XPSL UP FWBMVBUF UIF S estimates and the underlying judgments and assumptions. t *ODSFBTJOH TBNQMF TJ[FT PS QFSGPSNJOH BOBMZ t 6TJOH DPNQVUFS BTTJTUFE BVEJU UFDIOJRVFT – Gather more evidence about data contained in significant accounts or electronic transaction files, – Perform more extensive testing of electronic transactions and account files, – Select sample transactions from key electronic files, – Sort transactions with specific characteristics, and – Test an entire population instead of a sample. t 3FRVFTUJOH BEEJUJPOBM JOGPSNBUJPO JO FYU receivables confirmation, the auditor could ask for confirmation on the details of sales agreements, including the date of the agreement, any rights of return, and the delivery terms. However, consider whether a request for additional information might delay the response time significantly. t $IBOHJOH UIF UJNJOH PG TVCTUBOUJWF QSPDFI one near the period end. However, if a risk of intentional misstatement or manipulation exists, audit procedures to extend audit conclusions from an interim date to the period end would not be effective.

3JTLT 3FMBUFE UP .BOBHFNFOU 0WFSSJEF	
Source of Risk	Consider
Journal Entries	Identifying, selecting, and testing journal entries and other adjustments based on the following: t "O VOEFSTUBOEJOH PG UIF FOUJUZ T öOBODJBM implementation of internal control. t $POTJEFSBUJPO PG UIF ¦ $IBSBDUFSJTUJDT PG GSBVEVMFOU KPVSOBM – Presence of fraud risk factors that relate to specific classes of journal FOUSJFT BOE PUIFS BEKVTUNFOUT BOE – Inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity.
. B O B H F N F O U T Estimates	Reviewing estimates relating to specific transactions and balances to identify possible biases on the part of management. Further procedures could include the following: t 3FDPOTJEFSJOH UIF FTUJNBUFT UBLFO BT B XIF t 1FSGPSNJOH B SFUSPTQFDUJWF SFWJFX PG NBG assumptions related to significant accounting estimates made in the prior QFSJPE t %FUFSNJOJOH XIFUIFS UIF DVNVMBUJWF FòFDU amounts to a material misstatement in the financial statements.
4JHOJöDBOU 5SBOTBDUJPOT	Obtaining an understanding of the business rationale for significant transactions that are unusual or outside the normal course of business. This includes an assessment as to whether: t .BOBHFNFOU JT QMBDJOH NPSF FNQIBTJT PO UI USFBUNFOU UIBO PO UIF VOEFSMZJOH FDPOPNJD t 5IF BSSBOHFNFOUT TVSSPVOEJOH TVDI USBOTB t .BOBHFNFOU IBT EJTDVTTFE UIF OBUVSF PG BC XJUI UIPTF DIBSHFE XJUI HPWFSOBODF t 5IF USBOTBDUJPOT JOWPMWF QSFWJPVTMZ VOJ do not have the substance or the financial strength to support the transaction XJUIPVU BTTJTUBODF GSPN UIF FOUJUZ VOEFS B t 5SBOTBDUJPOT UIBU JOWPMWF OPO DPOTPMJEB purpose entities, have been properly reviewed and approved by those charged XJUI HPWFSOBODF BOE t 5IFSF JT BEFRVBUF EPDVNFOUBUJPO

3JTLT 3FMBUFE UP .BOBHFNFOU 0WFSSJEF	
Related Party Transactions	Obtain an understanding of the business relationships that related parties may have established directly or indirectly with the entity through: t *ORVJSJFT PG BOE EJTDVTTJPO XJUI NBOBHFN HPWFSOBODF t *ORVJSJFT PG UIF SFMBUFE QBSUZ t *OTQFDUJPO PG TJHOJöDBOU DPOUSBDUT XJUI t "QQSPQSJBUF CBDLHSPVOE SFTFBSDI TVDI BT U external business information databases. Based on the findings above: t *EFOUJGZ BOE BTTFTT UIF SJTLT PG NBUFSJBM QBSSUFZMBUJPOTIJQT t 5SFBU JEFOUJöFE TJHOJöDBOU SFMBUFE QBSUZ DPVSTF PG CVTJOFTT BT HJWJOH SJTF UP TJHOJ t %FUFSNJOF UIF OFFE GPS TVCTUBOUJWF BVEJU risks identified.
Revenue Recognition	Performing substantive analytical procedures. Consider computer-assisted audit techniques (CAATs) to identify unusual or unexpected revenue relationships or transactions.
	Confirming the relevant contract terms with customers (acceptance criteria, delivery and payment terms) and the absence of side agreements (such as offering a customer the right to return the goods immediately after the period end).

16.9 Risk of Misstatements in Presentation and Disclosure

Some assessed risks may arise from financial statement presentation and disclosures in accordance with the applicable financial reporting framework. As a result, specific procedures may need to be designed to respond appropriately to the risks involved.

These audit procedures would address whether:

- 5IF JOEJWJEVBM öOBODJBM TUBUFNFOUT BSF QSFTFOUFE JO BOE EFTDSJQUJPO PG öOBODJBM JOGPSNBUJPO
- 5IF QSFTFOUBUJPO PG öOBODJBM TUBUFNFOUT JODMVEFT BE uncertainties. This includes the form, arrangement, and content of the financial statements and their appended notes (including terminology used), the amount of detail given, the classification of items in UIF TUBUFNFOUT BOE UIF CBTFT PG BNPVOUT TFU GPSUI BC
- .BOBHFNFOU IBT EJTDMPTFE QBSUJDVMBS NBUUFST JO MJHI auditor is aware at the time of signing the auditor's report.

16.10 Determining Whether the Audit Plan Is Complete

Before concluding that the audit is complete, the auditor would consider whether the following factors have been appropriately addressed.

Exhibit 16.10-1

1 S P D F E V S F	Description
) B W F " M M . B S U F S J B M ' J O B O D J B M Statement Areas # F F O " E E S F T T F E	Substantive procedures are required to be designed and performed for all material classes of transactions, account balances, and disclosures. This is irrespective of the assessed risks of material misstatement.
* T I F S F B / F F E G P S & Y U F S O B M $ P O ö S N B U J P O T	Consider whether external confirmation procedures are to be performed as substantive audit procedures. Examples could include: t # B O L C B M B O D F T t 3 F D F J W B C M F T t * O W F O U P S J F T B O E J O W F T U N F O U T I F M E C Z U I J S t " N P V O U T E V F U P M F O E F S T t 5 F S N T P G B H S F F N F O U T t $ P O U S B D U T B O E t 5 S B O T B D U J P O T C F U X F F O U I F F O U J U Z B O E P U I F S External confirmation may also be used to address the absence of certain conditions. For example, there are no “side agreements on sales” that could affect revenue cut off.
Can Evidence 0 C U B J O F E J 1 S J P S 1 F S J P E T # F 8 T T E	Assuming the evidence does not address a significant risk and certain other criteria apply (such as no change in controls and no significant manual element in the control operation), the tests of operating effectiveness of controls may only need to be performed once every third audit (see Volume 1, Chapter 10.5 for more information).
* T I F S F B / F F E G P S B O " V E J U P S T & Y Q F S U	Is expertise in a field other than accounting or auditing required to obtain sufficient appropriate audit evidence?
) B T U I F ' J O B O D J B M Statement Closing 1 S P D F T T # F F O Addressed?	The following substantive procedures are required in relation to the financial statement closing process: t " H S F F J O H P S S F D P O D J M J O H U I F ö O B O D J B M T U B S F D P E E t & Y B N J O J O H N B U F S J B M K P V S O B M F O U S J F T B O E F course of preparing the financial statements.
) B W F 4 J H O J ö D B O U 3 J T L T # F F O Addressed?	For each risk assessed as significant, the auditor is required to design and perform substantive procedures (possibly supplemented by tests of controls). Substantive analytical procedures cannot be used alone and would be supplemented with tests of details. Where reliance is placed on internal controls over a significant risk, the auditor is required to test those controls in the current period.

1 S P D F E V S F	Description
Has Evidence 0 C U B J O F E G J M F * O U F S J N U J O H # F F O 6 Q E B U F E	Update interim substantive procedures by covering the remaining period. This would include: t 4 V C T U B O U J W F Q S P D F E V S F T D P N C J O F E X J U I U F T t 'V S U I F S T V C T U B O U J W F Q S P D F E V S F T U I B U Q S P W the audit conclusions from the interim date to the period end.
Have the Potential 3 J T L T P G ' S B V E # F F O " E E S F T T F E	For example, heightened professional skepticism, an element of unpredictability in the design of audit procedures, etc. (See Volume 2, Chapter 16.8.)

16.11 Documenting the Overall Response and Detailed Audit Plans

The overall responses may be documented as a stand-alone document or, more typically, as part of the overall audit strategy.

The detailed plan is often documented in the form of an audit program that outlines the nature and extent of procedures and the assertion(s) being addressed. Space can then be provided to record details about who performed each step, and the findings.

$0 / 4 * % &03* /15

5 J N J O H

Consider whether some of the planned further audit procedures can be carried out at the same time as the risk assessment procedures.

Changes to plan

If planned procedures need to be modified as a result of audit evidence or other information obtained, update the overall strategy and audit plan and provide the reasons for the change.

3 F W J F X

Ensure that audit procedures and related working papers are signed and dated by the preparer and the reviewer prior to the completion of the audit.

16.12 Communication of the Audit Plan

The overall audit strategy, overall responses, and the audit plan are entirely the auditor's responsibility. However, it is often useful to discuss some elements of the detailed audit plan (such as timing) with management. Such discussions often result in minor changes to the plan to coordinate timing and facilitate the performance of certain procedures.

The exact nature, timing, and scope of the planned procedures would not be discussed in detail with management, or changed or scaled back to accommodate a management request. Such requests could compromise the effectiveness of the audit, make audit procedures too predictable, and could constitute a scope limitation.

ISA 260 sets out a number of matters that the auditor is required to communicate with those charged with governance. (Refer to Volume 2, Chapter 5.3 for a listing of such matters.) These requirements are designed to ensure an effective two-way communication between or among the auditor, management, and those charged with governance.

$0 / 4 * % &03* /15

Auditors should consider having periodic, regular status updates with management to inform them of any preliminary findings, request any additional documentation, request any assistance required, and/or discuss other issues.

Any significant changes to the audit plan should also be communicated to management and those charged with governance.

16.13 Case Studies—The Responsive Audit Plan

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

The following case study examples outline the considerations and possible audit procedures that could be used in developing a detailed audit plan for accounts receivable. Since the purpose of the audit plan is to reduce the risk of a material misstatement to an acceptably low level, it is important to review the risks identified in the risk assessment phase for the revenue/receivables/receipts cycle.

$BTF 4UVEZ "‰%FQIUB 'VSOJUVSF *OD

According to the risk assessment in Volume 2, Chapter 14.6—Concluding the Risk Assessment Phase, the assessed risks were:

"TTFTTFE SJTLT BU öOBODJBM TUBUFNFOU	M F W F M (High, Moderate or Low)			
Assertions (Completeness, Existence, Accuracy, and Valuation)	C	E	A	V
Assessed risks at assertion level (High, Moderate, or Low)	L	M	L	M
Changes in assessed risks from the previous period. None				

Questions to be considered in developing the receivables audit plan:

Planning Considerations	Response
1. Are there assertions that cannot be addressed by substantive tests alone?	Completeness of sales will be addressed through a combination of tests of controls and analytical procedures. Note for next year—if the Internet sales continue to grow, additional tests of controls may be SFRVJSFE EVF UP UIF MPTT PG Q
2. Is internal control over related transaction streams/processes expected to be reliable? If so, could the controls be tested to reduce need/scope for other substantive procedures?	Tests of controls could be used to reduce the level of risk SFEVDUJPO SFRVJSFE GSPN PUIF (con rmations) in accounts receivable. But we are not totally certain as to the reliability of control operation, so only substantive procedures will be used.
3. Are there substantive analytical procedures available that would reduce need/scope for other audit procedures?	No.
4. Is there a need to incorporate an element of unpredictability or further audit procedures (such as to address fraud, risk, etc.)?	Some extended audit procedures will be performed to address the risks identi ed for management override.
5. Are there significant risks that require special attention?	There are some possible fraud risks (Volume 2, Chapter 9) in relation to revenue recognition. These will be addressed by suitably tailored substantive tests of details Valuation of accounts receivable is a speci c risk SFRVJSJOH TQFDJBM BUUFOUJPO SFWJFX PG TVCTFRVFOU QBZNFOU Need to be mindful of undisclosed related party transactions outside of the normal course of business throughout the audit.

Based on the auditor's professional judgment, an appropriate mix of procedures is required to reduce the risks of material misstatement (RMM) to an acceptably low level for relevant assertions (applicable to the receivable balance). The following is a sample audit response to the assessed level of risk for accounts receivable.

Summary of Proposed Audit Response (Check the applicable boxes under VCEA	C	E	A	V
A. Substantive tests of details - all material classes of transactions, balances and disclosure	X	X	X	X
B. Substantive tests of details - tailored to specific risks (sampling, fraud, signi cant risks, etc.)				X
C. Substantive analytical procedures (proof in total, etc.)		X		
D. Tests of controls (operating e ectiveness)	X			
Based on professional judgment, are the procedures outlined above sufficient to address the assessed risks? (Yes/No) If no, explain below.	Yes	Yes	Yes	Yes
Comments:				

A sample audit program that responds to the risks identified is outlined in the case study notes for Volume 2, Chapter 17.7.

$BTF 4UVEZ #‰ ,VNBS $P

According to the risk assessment in Volume 2, Chapter 14.6—Concluding the Risk Assessment Phase, the assessed risks were:

"TTFTTFE SJTLT BU öOBODJBM TUBUFNFOU	MFWFM (High, Moderate or Low			
Assertions (Completeness, Existence, Accuracy, and Valuation)	C	E	A	V
Assessed risks at assertion level (High, Moderate, or Low)	L	M	M	L
Changes in assessed risks from the previous period. None Increased risks related to related party transactions and possible fraud resulting from Raj's absence.				

Questions to be considered in developing the receivables audit plan:

Planning Considerations		Response
1.	Are there assertions that cannot be addressed by substantive tests alone?	No
2.	Is internal control over related transaction streams/processes expected to be reliable? If so, could the controls be tested to reduce need/scope for other substantive procedures?	Due to the small size of the company, there are limited controls. We obtained an understanding of internal control, but we will not test controls or place any reliance on them.
3.	Are there substantive analytical procedures available that would reduce need/scope for other audit procedures?	The completeness of sales will be addressed by a combination of substantive analytical review and tests of details.
4.	Is there a need to incorporate an element of unpredictability or further audit procedures (such as to address fraud, risk, etc.)?	Not considered necessary, as the receivables balance at year-end relates primarily to Dephta.
5.	Are there significant risks that require special attention?	The possibility of inconsistent revenue recognition or fraud will be addressed through suitably tailored substantive tests of details Need to be mindful of undisclosed related party transactions outside of the normal course of business throughout the audit.

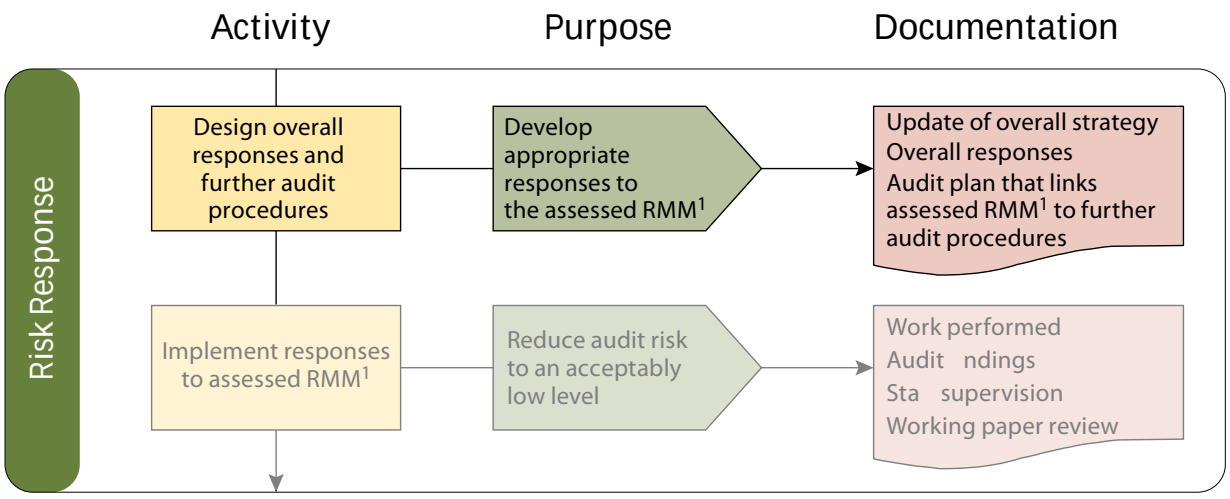
The following is a sample audit response to the assessed level of risk for accounts receivable.

Summary of Proposed Audit Response (Check the applicable boxes under CEAV)	C	E	A	V
A. Substantive tests of details - all material classes of transactions, balances and disclosure	X	X	X	X
B. Substantive tests of details - tailored to specific risks (sampling, fraud, signi cant risks, etc.)	X	X	X	
C. Substantive analytical procedures (proof in total, etc.)		X		
D. Tests of controls (operating e ectiveness)				
Based on professional judgment, are the procedures outlined above sufficient to address the assessed risks? (Yes/No) If no, explain below.	Yes	Yes	Yes	Yes
Comments: None				

A sample audit program that responds to the risks identified is outlined in the case study notes for Volume 2, Chapter 17.7.

Chapter Content	Relevant ISAs
Guidance on determining the extent of testing required to be responsive to the assessed risks of material misstatement.	330, 500, 530

Exhibit 17.0-1



Notes:
1. RMM = Risks of material misstatement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
330.12	If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall: (a) Obtain audit evidence about significant changes to UIPTF DPOUSPMT TVCTFRVFOU UP UIF (b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33-A34)

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
330.13	In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following: (a) The effectiveness of other elements of internal control, including the control environment, UIF FOUJUZ T NPOJUPSJOH PG DPOUSPMT BOE UIF FOUJU (b) The risks arising from the characteristics of the control, including whether it is manual or BVUPNBUFE D 5IF FòFDUJWFOFTT PG HFOFSBM *5 DPOUSPMT (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether UIFSF IBWF CFFO QFSTPOOFM DIBOHFT UIBU TJHOJöDBOUM (e) Whether the lack of a change in a particular control poses a risk due to changing DJSDVNTBODFT (f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)
330.14	If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and: (a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37-A39)
530.5	For purposes of the ISAs, the following terms have the meanings attributed below: (a) Audit sampling (sampling)—The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. (b) Population—The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. (c) Sampling risk—The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions: (i) In the case of a test of controls, that controls are more effective than they actually are, or in the Paragraph # Relevant Extracts from ISAs case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion. (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
530.5 (continued)	(d) Non-sampling risk—The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. (Ref: Para A1) (e) Anomaly—A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population. (f) Sampling unit—The individual items constituting a population. (Ref: Para A2) (g) Statistical sampling—An approach to sampling that has the following characteristics: J 3BOEPN TFMFDUJPO PG UIF TBNQ (ii) he use of probability theory to evaluate sample results, including measurement of sampling risk. A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling. (h) Stratification—The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value). (i) Tolerable misstatement—A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of risk reduction that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. (Ref: Para A3) (j) Tolerable rate of deviation—A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of risk reduction that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

17.1 Overview

Sufficient appropriate audit evidence may be obtained by selecting and examining the following.

Exhibit 17.1-1

4FMFDBUJPO&YBNJOBUJPO	NJOJOH
All Items (100% &YBNJOBUJPO	This is appropriate when: t 5IF QPQVMBUJPO DPOTUJUVUFT B TNBMM OVNCF t 5IFSF JT B TJHOJöDBOU SJTL BOE PUIFS NFBOT BVEJU FWJEFODF BOE t $""5T DBO CF VTFE JO B MBSHFS QPQVMBUJPO U calculation or other process.

4 F M F DBUOJKOYHB N J O J O H	
4 Q F D J ö D *U FNT	This is appropriate for: t)JHI WBMVF PS LFZ JUFNT UIBU DPVME JOEJWJE t "MM JUFNT PWFS B TQFDJöFE WBMVF t "OZ VOVTVBM PS TFOTJUJWF JUFNT PS öOBODJE t "OZ JUFNT UIBU BSF IJHIMZ TVTDFQUJCMF UP N t *UFNT UIBU XJMM QSPWJEF JOGPSNBUJPO BCPV FOUJUZ UIF OBUVSF PG USBOTBDUJPOT BOE JO t *UFNT UP UFTU UIF PQFSBUJPO PG DFSUBJO DP
Representative Sample of Items from the Population	This is appropriate for reaching a conclusion about an entire set of data (population) by selecting and examining a representative sample of items within the population. Sampling enables the auditor to obtain and evaluate audit evidence about specified characteristics. The determination of sample size may be made using either statistical or non-statistical methods.

The decision as to which approach to use will depend on the circumstances. The application of any one or combination of the above means may be appropriate in particular circumstances.

Choosing sampling as the most efficient method of obtaining the necessary risk reduction for an assertion has a number of advantages as illustrated below.

Exhibit 17.1-2

	#FOFöUT
6TF PG Representative Samples	Valid conclusions can be drawn. The auditor's objective is obtaining reasonable risk reduction and not absolute certainty.
	Results can be combined with results from other tests. Evidence obtained from one source can be corroborated by evidence obtained from another source to provide increased risk reduction.
	An examination of all of the data would not provide absolute certainty. For example, unrecorded transactions will never be detected.
	Cost savings. The cost of examining every entry in the accounting records and all supporting evidence would be uneconomical.

Volume 1, Chapter 10 outlines the nature and use of further audit procedures. This chapter focuses on the extent of testing and use of sampling techniques.

Sampling Techniques

Sampling does not have to be selected as an audit procedure but where it is used, all the sampling units in a population (such as sales transactions or receivables balances) are required to have a chance of selection. This is necessary to enable the auditor to draw reasonable conclusions about the entire population.

In any sample of less than 100% of the population, there is always the risk that a misstatement may not be identified and that it might exceed the tolerable level of misstatement or deviation. This is called sampling risk. Sampling risk can be reduced by increasing the sample size, while non-sampling risk can be reduced by proper engagement planning, supervision, and review.

There are two types of sampling commonly used in auditing, as set out below.

Exhibit 17.1-3

	Sample Attributes
Statistical Sampling	Sample is selected on a random basis. This means that every item in the population has a known (statistically appropriate) chance of being selected.
	Results can be mathematically projected. Probability theory can be used to evaluate the sample results, including measurement of sampling risk.
Non-Statistical or Judgmental Sampling	A sampling approach that does not have the characteristics outlined above for statistical sampling.

In determining the sample size, the auditor would determine the tolerable rate of deviation (exceptions) that would be acceptable.

t 4VCTUBOUJWF EJGGFSFODFT

Performance materiality (whether overall or for a specific item) is set in relation to overall materiality (whether overall or for a specific item, respectively). The tolerable misstatement level is set in relation to performance materiality (either overall or for the specific item, as the case may be). The higher the tolerable misstatement level is set, the smaller the sample size. The lower the tolerable level of misstatement is set, the larger the sample size. Note that the tolerable level of misstatement will often be the same as performance materiality.

t 5FTUT PG $POUSPMT

For tests of controls, the tolerable rate of deviation is likely to be very small, often allowing for no deviations or possibly only one. Tests of controls provide evidence as to whether the controls work or not. Consequently, they would only be used where the operation of the control was expected to be reliable.

17.2 Use of Sampling

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
530.6	When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. (Ref: Para. A4-A9)
530.7	The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. (Ref: Para. A10-A11)
530.8	The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12-A13)
530.9	The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
530.10	If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. (Ref: Para. A14)
530.11	If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. (Ref: Para. A15-A16)

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
530.12	The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. (Ref: Para. A17)
530.13	In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.
530.14	For tests of details, the auditor shall project misstatements found in the sample to the population. (Ref: Para. A18-A20)
530.15	The auditor shall evaluate: B 5IF SFTVMUT PG UIF TBNQMF BOE 3FG 1BSB " (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

Building a Foundation

Whenever statistical or non-statistical sampling techniques are being considered, the auditor would address and document the following matters.

Exhibit 17.2-1

'BDUPST UP Consider	Comments
1VSQPTF PG TUG	The starting point for the test design is to establish the purpose of the test and what assertions will be addressed.
Primary Source of Evidence?	What is the primary source of evidence for each assertion to be addressed, and what is secondary? This differentiation will help to ensure that audit effort is directed to the right place.
Previous &YQFSJFODF	What was the experience (if any) in performing similar tests in previous periods? Consider the effectiveness of the test, and the existence and disposition of deviations (errors), if any, found in the samples selected.
What Population?	Ensure that the population of items to be tested is appropriate to achieve the test objectives. Sampling will not identify or test items that are not already included within the population. For example, a sample of receivable balances may be used to test the existence of receivables, but such a population would not be appropriate for testing the completeness of receivables. Also consider the size of the population. In some cases, a statistical conclusion may not be drawn if the population to be tested is too small to sample.
What Sampling 6OJU UP 6TF	Consider the purpose of the test and the assertion being addressed. This decision will determine what items will be selected to test. Examples include sales invoices, sales orders, and customer account balances.

'BDUPST UP Comments	
Statistical or Non-Statistical?	Statistical conclusions can be drawn from statistical samples. Conclusions based on professional judgment can be made from judgmental non-statistical samples. Non-statistical samples are often used in combination with other audit procedures that address the same assertion.
%FöOJUJPO PG Deviation	Failure to properly define a deviation will result in time wasted by staff in reviewing minor exceptions that may not constitute a deviation. Also, determine how the reasons and implications of deviations found will be followed up by audit staff.
Any High-Value *UFNT UP &YBNJOF	If there are larger transactions or balances in the population that can be evaluated separately, it may result in smaller sample sizes from remaining items in the population. In some cases, the evidence gained from testing the larger transactions or balances may be sufficient to eliminate the need for sampling altogether.
6TF PG $""5T	Could computer-assisted audit techniques (CAATs) provide a better or more efficient result? For many tests, 100% of the population can be tested by CAATs (as opposed to just a sample), and custom reports can be prepared that identify unusual items for follow-up.
"OZ 4USBUJöDBUJPO Possible?	Consider whether the population can be stratified by dividing it into discrete subpopulations which have an identifying characteristic. For example, if a population contained a number of high-value transactions, the population (for a test of details) could be stratified by monetary value. This allows greater audit effort to be directed to the larger-value items, as these items may contain the greatest potential misstatement in terms of overstatement. A population may also be stratified according to a particular characteristic that indicates a higher risk of misstatement. When testing the adequacy of the allowance for doubtful accounts (valuation of accounts receivable), the receivable balances may be stratified by age. Where subpopulations are tested separately, the misstatements will be projected for each stratum separately. Projected misstatements for each stratum can then be combined to consider the possible effect of misstatements on the account balance or class of transactions.
What Precision is Required?	Performance materiality is often used as the basis for tolerable misstatement. This also represents the precision for a statistical test. Performance materiality would be set at an amount that allows for the possible existence of undetected and immaterial misstatements aggregating to a material amount.

'B D U P S T U P C $ P O T 1	$ P M F S E F S
8 I B U $ P O ö E F O D E Level is Required?	Confidence is the level of acceptable risk (detection risk) that the test will not produce accurate results. Is a high level of confidence (resulting in a larger sample) or a lower confidence level (resulting in a smaller sample) required? The confidence level required in a particular test will be based on factors such as: t & W J E F O D F P C U B J O F E G S P N P U I F S T P V S D F T T V D substantive procedures, and testing the operational effectiveness of related D P O U S P M t 5 I F J N Q P S U B O D F P G U I F ö O B O D J B M T U B U F N F O U overall materiality. For example, a 95% level of confidence indicates that if a particular test was performed 100 times (selecting representative transactions at random), the results would be accurate (within the margin of misstatement) 95 times out of the 100 tests. There is a risk that 5 tests out of the 100 will produce inaccurate results.

When statistical sampling is planned, the tolerable misstatement or deviation rate would also be addressed.

Exhibit 17.2-2

'B D U P S T U P C $ P O T 1	$ P M F S E F S
What is the 5 P M F S B C M F . J T T U B U F N F O U P S 5 P M F S B C M F Deviation Rate?	5 P M F S B C M F . J T T U B U F N F O U is used for substantive sampling tests of details to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and to provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality to a particular sampling procedure. Tolerable misstatement may be the same amount as or an amount lower than performance materiality.
	5 P M F S B C M F S B U F P G E F W J B U J P O is used for tests of controls where th deviation from prescribed internal control procedures to obtain an appropriate level of assurance. The auditor seeks to obtain an appropriate level of assurance that the set rate of deviation is not exceeded by the actual rate of deviation in the population.

17.3 Extent of Substantive Procedures (Using statistical sampling)

The greater the risks of material misstatement, the greater the extent of substantive procedures required. The extent of substantive procedures may be reduced by testing the operating effectiveness of internal control. However, if the results are unsatisfactory, the extent of substantive procedures may actually need to be increased.

Determining Sample Sizes—Monetary-Unit Sampling

The most common method of sampling for tests of details is monetary-unit sampling. Under this method, the probability of an item (for example, an accounts receivable balance) being selected for testing is directly proportional to the monetary value of the item. Thus, an accounts receivable balance of 6,000€ is three times as likely to be selected as an accounts receivable balance of 2,000€. Under this method, it would not be appropriate to select physical units such as every 50th invoice or transaction.

Although monetary-unit sampling may be the most common form of sampling used by auditors, there are a number of other sampling methods which could be more appropriate in certain circumstances. Discussion of these other sampling methods has not been included in this Guide.

Selection of Con dence Factors

When designing a substantive test, the auditor may find it useful to use three levels of risk reduction such as high, moderate, and low. The difference between the levels can be based on the confidence factor used for selecting the sample. The higher the confidence factor, the higher the sample size and the level of risk reduction obtained. This is illustrated in the following exhibit, which provides typical confidence levels to achieve high-, moderate-, and low-risk reductions.

Exhibit 17.3-1

Risk Reduction Required	$ P O ö E F O $DF-O ö E F Level	'B D U P $
High	95%	3.0
Moderate	80-90%	1.6 – 2.3
Low	65-75%	1.1 – 1.4

An effective set of audit procedures designed to respond to assessed risks and specific assertions may contain a mixture of tests of controls and substantive procedures.

The following table gives a partial list of confidence factors for various confidence levels. For example, if a 90% confidence level is required, the confidence factor to be used would be 2.3.

Exhibit 17.3-2

$ P O öE F O D F $ P O öE F O Level	'B D U P S
50%	0.7
55%	0.8
60%	0.9
65%	1.1
70%	1.2
75%	1.4
80%	1.6
85%	1.9
90%	2.3
95%	3.0
98%	3.7
99%	4.6

Selecting the Sample

Exhibit 17.3-3

. P O F U B S Z U	Description
Sample Selection Process	Remove the high-value and key items from the population.
	Compute the sampling interval.
	Select a random starting point for selecting the first item. The random starting point can range from 1 to the sampling interval. Each successive selection is made on the value of the previous selection plus one sampling interval.

Note: Ensure that the sample selection process, including the basis for selecting the random starting point (from a random number generator or using professional judgment), is appropriately documented.

Step 1—Calculate the sampling interval

The formula is as follows.

Sampling Interval = Performance Materiality (Tolerable Misstatement) ÷ Confidence Factor

If the sampling interval was 17,391 , the first account to be selected could be randomly chosen as the one containing the 10,000th . The second account selected would be the account containing the cumulative amount of 27,391st (starting point + sampling interval = 10,000 + 17,391). The third account selected would be the account that contained the cumulative amount of 44,782nd (27,391 + 17,391). This process would continue to the end of the population.

Step 2—Calculate the sample size

Sample sizes for the monetary-unit sampling of representative items are usually determined by the following formula.

Sample Size = Population to Be Tested ÷ Sampling Interval

The population to be tested should exclude any specific items removed for separate evaluation.

Step 3—Select the sample

Remove any high-value and key items from the population (for separate consideration) and compute the sampling interval (refer to Step 1 above). Then select a random starting point for selecting the first item. The random starting point can range from 1€ to the sampling interval. Each successive selection is made on the value of the previous selection plus one sampling interval.

The following three examples illustrate this process.

Example 1—Sampling Accounts Receivable Balances

Exhibit 17.3-4

Question	Response
1 V S Q P T F T P U G	To ensure the existence of accounts receivable by selecting a sample of receivable balances and sending confirmation letters
3 J T L T P G . B U F S J B M . J T T U B U F N F O U J O U J F 3 F M F W B O U Assertions	Existence = high risk
1 P Q V M B U J P O T U F E # F	Accounts receivable balances at period end
. P O F U B S Z V F P G 1 P Q V M B U J P O	177,203
4 Q F D J ö D * U F N T 4 V C K F D U U P 4 B M F & W B M V B U J P O	38,340
3 J T L 3 F E V D U J P O G S P N 0 U I F S 1 S P D F E V S F T	None
3 J T L 3 F E V D U J P O G S P N 0 U I F S Risk Assessment Procedures	Limited
$ P O ö E F O D F ' B D U P S U P # F 6 T F E 3 F E V D F G S P S J T L S F E V D U J P O H B J O F E G S P N P U I F S T P V S D F T	No other sources of risk reduction so 95% or 3.0 will be used
1 F S G P S N B O D F . B U F S J B M J U Z	15,000
& Y Q F D U F E % F W J B U J P O T J O 4 B N Q M F	None

Sampling Interval = 15,000 / 3.0 = 5,000

Sample Size = (177,203 - 38,340) / 5,000 = 28

In this example, the sampling interval was 5,000€. Therefore, if the first item chosen randomly was 436€, the next item would be in the transaction or balance that contained the cumulative amount of 5,436€. The third item would be in the transaction or balance that contained the cumulative amount of 10,436€, and so on until the 28 items have been selected.

Note: It is likely that the higher value items will be selected for testing (refer to the partial population of accounts receivable balances below).

Exhibit 17.3-5

	Accounts Receivable # B M B O D F	Cumulative 5 P U B M	Sampling Interval	Include in Sample?
Customer A	4,750	4,750	436	Yes
$ V T U P N F S #	3,500	8,250	5,436	Yes
Customer C	1,800	10,050	10,436	No
Customer D	2,700	12,750	10,436	Yes
Customer E	950	13,700	15,436	No
$ V T U P N F S '	2,580	16,280	15,436	Yes

Example 2—Sampling Accounts Receivable Balances

Exhibit 17.3-6

Question	Response
1 V S Q P T 5 F T P U G	To ensure the existence of receivables by selecting a sample of accounts receivable balances and sending confirmation letters
3 J T L T P G . B U F S J B M . J T T U B U F N F O U J O U I F 3 F M F W B O U Assertions	Existence = moderate risk
1 P Q V M B U J P O 5 F T U E # F	Accounts receivable balances at period end
. P O F U B S Z 4 V N 1 V F P G 1 P Q V M B U J P O	177,203
4 Q F D J ö D * U F N T 4 V C K F D U U P 4 F Q B S B U F & W B M V B U J P O	38,340
3 J T L 3 F E V D U J P O 5 F T U J O H E $ B S B M T	A low level of control risk has been established over related controls
3 J T L 3 F E V D U J P O G S P N 0 U I F S 1 S P D F E V S F T T V D I B T S J T L B T T F T T N F O U Q S P D F E V S F T	Limited
$ P O ö E F O D F 'B D U P S U P # F 6 T F E S F E W D F G P S S U J T L S F E V D U J P O H B J O F E G S P N P U I F S T P V S D F T	In light of other sources of evidence, a confidence factor of 70% (1.2) will be used
1 F S G P S N B O D F . B U F S J B M J U Z	15,000
& Y Q F D U F E % F W J B U J P O T J O 4 B N Q M F	None

Sampling interval = 15,000 / 1.2 = 12,500

Sample size = (177,203 - 38,340) / 12,500 = 12

Example 3—Sampling Purchase Invoices

Exhibit 17.3-7

Question	Response
1 V S Q P T 5 F T P U G	To ensure the existence and accuracy of purchases by selecting a sample of purchase invoices
3 J T L T P G . B U F S J B M . J T T U B U F N F O U J O U I F 3 F M F W B O U Assertions	Existence = low risk Accuracy = low risk
1 P Q V M B U J P O 5 F T U E # F	Purchase invoices for period
. P O F U B S Z 4 V N 1 V F P G 1 P Q V M B U J P O	879,933
4 Q F D J ö D * U F N T 4 V C K F D U U P 4 F Q B S B U F & W B M V B U J P O	46,876
3 J T L 3 F E V D U J P O 5 F T U J O H E $ B S B M T	None
3 J T L 3 F E V D U J P O G S P N 0 U I F S 1 S P D F E V S F T T V D I B T S J T L B T T F T T N F O U Q S P D F E V S F T	Moderately effective substantive analytical procedures

Question	Response
$POöEFODF5PBDUIFTF SFEVDF GPS SJTL SFEVDUJPO HBJOFE GSPN PUIFS TPVSDFT	In light of the other sources of evidence, a confidence factor of 80% (1.6) will be used
1FSGPSNBODF .BUFSJBMJUZ	15,000
&YQFDUFE %FWJBUJPOT JO	None

Sampling interval = 15,000€ / 1.6 = 9,375€

Sample size = (879,933€ – 46,876€) / 9,375€ = 89

As illustrated above, the sample sizes for substantive tests can become very large when examining transaction streams. It is often more efficient to test internal controls (where the sample size is smaller) or perform other types of audit procedures to obtain the required evidence.

Projecting Misstatements

The process is set out in the following exhibit.

Exhibit 17.3-8

Steps in 1SPKFDUJOH UIF &YUFOU PG .JTTUBUFNFOUT	
1.	Calculate the percentage of misstatement in each item. If the amount was found to be 50 but should have been 60 , the misstatement is 10 or 17% of the total.
2.	Add up the misstatement percentages, netting overstatements and understatements.
3.	Calculate the average percentage misstatement per item sampled by dividing the total misstatement percentages by the number of all items sampled (with and without misstatement).
4.	Multiply the average percentage misstatement by the total representative population monetary value (excluding high-value and key items). This results in the projected misstatement for the sample. Obviously, this excludes any misstatements found in high-value and key items previously removed from the sample.

For example, a sample of 50 items selected from a population of 250,000 contained the following three misstatements.

Exhibit 17.3-9

Correct Value	Audited Value	.JTTUBUFNFOU	UTTUBUFNF
500	400	100	20.00%
350	200	150	42.86%
600	750	(150)	(25.00%)
Total % error (sum of misstatement percentages)			37.86%
Average % misstatement: 37.86% ÷ 50 (sample size) =			0.7572%
1SPKFDUFE NJTTUBUFNFOU 0.7572% × 250,000 (population) =			

The projected misstatement is sometimes called “most likely error” (MLE).

$0 / 4 * % &03* /15

Anomalies

There may be a temptation to regard some misstatements/deviations (discovered in a sample) to be an anomaly (not representative of the population) and exclude them when projecting misstatements in the population. However, additional audit work is required, regardless of whether the misstatement/deviation is or is not representative of the population:

- *G UIF EFWJBUJPO JT SFQSFTFOUBUJWF PG UIF QPQVMBUJ cause, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.
- *G UIF EFWJBUJPO JT DPOTJEFSFE BO BOPNBMZ UIF BVEJU such misstatement or deviation is not representative of the population. This requires performing further audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Note that ISA 530.13 states that anomalies only occur in extremely rare circumstances.

17.4 Extent of Substantive Analytical Procedures

Substantive analytical procedures will either be the primary test of the account balance, or they will be used in combination with other tests of details that have been appropriately reduced in extent.

Volume 1, Chapter 10 outlines the two levels of risk reduction that can be gained from performing substantive analytical procedures. This risk reduction is highly effective (i.e., the primary test) and moderately effective.

Simple analytical procedures (such as a comparison of last year's results to this year) may help to identify an issue that needs to be followed up but provide little further audit evidence. This type of analytical procedure can be used in understanding the entity, performing risk assessment procedures, and reviewing the final financial statements.

When designing substantive analytical procedures, the auditor would:

- %FWFMPQ UIF BNPVOU PG EJòFSFODF GSPN UIF FYQFDUBUJP investigation. This should be influenced primarily by materiality and consistency with the desired level PG SJTL SFEVDUJPO
- $PNTJEFS UIF QPTTJCJMJUZ UIBU B DPNCJOBUJPO PG NJTTU USBOTBDUJPOT PS EJTDMPTVSF DPVME BHHSFHBUF UP BO V
- *ODSFBTF UIF EFTJSFE MFWFM PG SJTL SFEVDUJPO BT UIF S

Exhibit 17.4-1

Example of a Substantive Analytical Procedure

Questions	Response	
Describe the procedure to be performed and the expected outcome.	Multiply the rent charges per unit with the number of rental units to predict the revenue from apartments, and then compare result with the revenue recorded in the entity's accounting records.	
What is the value of the recorded amount or ratio?	278,000	
What assertions will be addressed?	Completeness, existence, and accuracy	
What performance materiality will be used?	10,000	
What amount of difference (between recorded amounts and expected values) is acceptable?	1%	
Remaining risk of material misstatement after procedure performed (i.e., moderate or low).	Low	
Describe details of each data element used J O D B M D V M B U J O H U I F F Y Q F D U F E V T F E E B U B F M F N F O U ö O B O D J B M B O E O P O ö O B O D J B M	Describe the procedures performed to evaluate the reliability of each data element used (consider source, comparability, nature, relevance, and controls over preparation).	WP Ref.
1. Rental units	We reviewed the oor plans and physically inspected the building for major changes.	
2. Rent per unit	We reviewed a sample of lease contracts to determine the rent payable.	
3.		
4.		
Provide details of the calculation, the expected outcome, and results of the comparison to the recorded amount or ratio: Number of rental units = 26 Rent per unit = 12,000 per year Calculation = 26 X 12,000 = ,000 . The di erence to the recorded amount is 34,000		
Where the difference (between recorded amounts and expected values) exceeds the acceptable value, explain what investigation was performed and the results (i.e., inquiries of management, obtaining additional evidence and performing other audit procedures). 8F JORVJSFE BCPVU UIF EJòFSFODF BOE WFSJöFE UIBU PO BWFSBHF VOJ the year, and one unit was not rented and used for meeting purposes and as an occasional accommodation for visitors. This accounts for 36,000 of the di erence leaving 2,000 unexplained. This is below the acceptable level described above.		
Conclusion: Test was successfully completed.		

$0 / 4 * % &03* /15

The use of "non-financial" data in a substantive analytical procedure can often enhance the result. Non-financial data could include information such as head counts, square footage for a retail store, or the number of specific products shipped.

When performing analytical procedures, it is imperative to set expectations (e.g., relationship with related balances, changes from prior period, etc.) and then compare those expectations to the financial statement information. Avoid the opposite approach of starting with the financial information and then attempting to explain variances using knowledge of the client and its environment. Analytical procedures are much stronger when they are created by expectations based on an understanding of the entity and its environment. However, the reliability of any "non-financial data" used needs to be established before its use in a substantive analytical procedure.

17.5 Tests of Controls—Operating E ectiveness

Audit procedures used to test controls consist of one or more of the four types outlined below.

Exhibit 17.5-1

5FTUT PG *OUFSOBM $POUSPM 0WFS 0QFSBUJOH &òFDUJWFC	
5ZQFT PG Procedures	Inquiries of appropriate personnel. (Remember, though, that inquiry alone is not sufficient to test the operating effectiveness of controls.)
	Inspection of relevant documentation.
	Observation of the entity's operations.
	Re-performance of the application of the control.

Pervasive (Entity-Level) Controls

Paragraph#	3FMFWBOU &YUSBDUT GSPN *4"T
315.14	The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether: (a) Management, with the oversight of those charged with governance, has created and NBJOUBJOFE B DVMUVSF PG IPOFTUZ BOE FUIJDBM CFIBW (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A69-A78)

Testing of the pervasive controls that exist at the entity level tends to be more subjective (such as testing the commitment to competence or understanding of entity policies on acceptable behaviors) than testing specific transactional controls. Yet these controls collectively provide the appropriate foundation for the other components of internal control.

The exhibit below sets out some possible methods for testing pervasive (entity-level) controls.

Exhibit 17.5-2

Control Environment	1PTTJCMF 5FTUT PG $POUSPMT
Communication and Enforcement of Integrity and Ethical Values	t 3FBE TUBUFNFOU PO UIF FOUJUZ T XFCTJUF BO t 3FWJFX DPNNVOJDBUJPOT UP TUBò t $PNQVDU JOUFSWJFXT XJUI B TBNQMF PG TUBò
Commitment to Competence	t 3FWJFX IJSJOH BOE öSJOH QPMJDJFT t 3FWJFX KPC EFTDSJQUJPOT BOE EPDVNFOUBUJPO
Participation by 5IPTF $IBSHFE With Governance	t 3FWJFX BOZ TFMG BTTFTTNFOUT NBEF t 3FWJFX RVBMJöDBUJPOT PG CPBSE NFNCFST BO t "UUFOE B NFFUJOH BT BO PCTFSWFS
.BOBHFNFOU Philosophy and 0QFSBUJOH 4UZMF	t 3FWJFX BOZ relevant documentation. t $PNQVDU JOUFSWJFXT XJUI B TBNQMF PG TUBò
0SHBOJ[BUJPOBM Structure	t 3FWJFX TUSVDUVSF JO MJHIU PG CFTU QSBDUJD
Assignment of Authority and Responsibility	t 3FWJFX BOZ EPDVNFOUBUJPO TVDI BT KPC EFTD
Human Resources Policies and Practices	t 3FWJFX QPMJDJFT BOE QSBDUJDFT BOE DPNQM t 3FWJFX FNQMPZFF öMFT GPS TUBò FWBMVBUJPO

Similar types of tests of controls could be designed to address other pervasive (entity-level) controls such as:

- t 3JTL BTTFTTNFOU
- t *OGPSNBUJPO TZTUFNT
- t .POJUPSJOH
- t 5IF QFSJPE FOE DMPTF QSPDFTT BOE
- t "OUJ GSBVE DPOUSPMT

The results of performing tests of pervasive controls can also be more difficult to document than internal control at the business process level (such as checking to see if a payment was authorized, which can be documented with a simple yes/no response). As a result, the evaluation of pervasive (entity-level and general IT) controls is often documented with memorandums to the file along with supporting evidence.

For example, to test whether management communicates the need for integrity and ethical values to all personnel, and enforces its policies, a sample of employees could be selected for interviews. The employees could be asked about communications they have received from management, what relevant policies and

procedures exist, what values they see demonstrated on a day-to-day basis by management, and whether the policies are indeed enforced. If the common response among the employees is that management has indeed communicated the need for integrity and ethical values and there are instances of where policies were enforced, then the test would be a success. Details of each employee's interview and supporting documentation (such as the entity's policies, communications, and enforcement actions) would then be recorded in a memo to file with the conclusions reached.

$0 / 4 * % &03* /15

5 J N J O H

It is preferable to test the pervasive (entity-level) controls early in the audit process. The results of testing these controls could impact the nature and extent of other planned audit procedures. For example, if it is found that management's attitude towards controls is not as good as expected, further procedures will be required in relation to account balances and classes of transactions.

Planning

Take time to determine the most appropriate way to test the pervasive (entity-level) controls. Consider using an appropriate combination of inquiry, observation, re-performance, and inspection tests.

Ask open-ended questions

Avoid asking yes/no questions. Instead, ask questions that may elicit information that you may not already know. For example, ask, "Have you ever been asked to depart from an established accounting policy or do something that made you feel uncomfortable?" Also remember to listen carefully to the person's response, and watch his or her body language for signs of unease or distress giving answers.

'P M M P X V Q P O P V U T U B O E J O H N B U U F S T

If management or a staff member refuses to supply requested information or you obtain unexpected information, ensure that it is appropriately followed up, and changes made if necessary in the overall audit strategy and planned procedures.

.P O J U P S J O H D P O U S P M T J O M B S H F S F O U J U J F T

Some larger entities have developed entity-level monitoring controls that provide evidence of the ongoing operation of entity-level controls. Where this occurs, consider whether reliance can be placed on these controls to reduce the overall extent of other testing required.

Although most pervasive (entity-level) and general IT controls will be tested through the exercise of professional judgment and objectively applied to the circumstances, there are some situations where use of a representative sample may be applicable. An example would be the availability of evidence that monthly financial reports were reviewed and appropriate action taken.

Transactional Controls—Attribute Sampling

Tests of controls provide evidence that a control is operating effectively throughout the period of reliance, which will be a specified period such as a year.

Because transactional controls either operate effectively or not, it is not worth testing the operation of controls that could ultimately prove unreliable. Unreliable controls are those where there is a likelihood that deviation will be found. Sample sizes for tests of controls are often small because they are based on no exceptions being found. Otherwise, the sample sizes required would be much larger.

Some of the factors to consider in assessing the reliability of controls are outlined below.

Exhibit 17.5-3

5FTU PG $POUSPMT %FTJHO	
'BDUPST UP Consider	Is it possible for the established procedures to have been circumvented by management (i.e., management override)?
	Is there a significant manual element involved in the control that could be prone to error?
	Is there a weak control environment?
	Are general IT controls poor?
	Is the ongoing monitoring of internal control poor?
	Have personnel changes occurred during the period that significantly affect the application of the control?
	Does the small number of staff involved in the control operation make meaningful segregation of duties impractical?
	Have changing circumstances necessitated the need for changes in the operation of the control?

Reliance on Indirect Internal Controls

Consider the need to obtain audit evidence supporting the effective operation of significant indirect internal controls. These are controls upon which other controls depend, such as non-financial information produced by a separate process, the treatment of exceptions, and periodic reviews of reports by managers. Where significant, evidence of the operating effectiveness of the indirect internal controls would be required. If any of the above factors are significant, it may be more effective to perform substantive procedures.

In designing tests of controls, the auditor should focus on the evidence that will be obtained with respect to the relevant assertions addressed (the points where misstatements could occur in the financial statements), as opposed to nature of the control itself. Controls are designed to mitigate risks and ensure, for example, the completeness of sales.

There are also a number of practical advantages in designing tests of controls that focus first on the assertion to be addressed. For example:

- 5IF DPOUSPMT UFTUFE DBO CF MJOLFE EJSFDUMZ UP UIF SJTUBUFNFOUT
- #FDBVTF UIF UFTU PCKFDUJWF JT OPU EFQFOEFOU PO TQFDrisks (or control objectives) can be tested. This enables unpredictability or variation in the testing to be VTFE BOE
- *U NBLFT JU FBTJFS UP FWBMVBUF BOE UFTU OFX DPOUSPMassertions.

Tests of controls are often designed to provide either a low or a moderate level of control risk (high or moderate level of risk reduction (confidence)) that the control being tested is operating effectively.

When designing tests of controls, the auditor may find it useful to consider the two levels of confidence to be gained from tests of controls:

t " IJHI MFWFM PG DPOöEFODF MPX MFWFM PG SJTL SFNBJOJ
DPNJOH GSPN UFTUT PG DPOUSPMT BOE

t " NPEFSBUF MFWFM PG DPOöEFODF NPEFSBUF MFWFM PG SJ
controls will be combined with other substantive procedures to address a particular assertion.

Attribute sampling is often used to test controls. This technique uses the smallest sample size capable of providing a specified chance of detecting a deviation rate that exceeds the tolerable rate of deviation.

Exhibit 17.5-4

	Advantages
Attribute/Discovery Sampling	Ideal for testing the operating effectiveness of internal controls that have already been assessed as highly reliable during the evaluation of control design and implementation.
	If any level of deviation is expected in the performance of a control, it is recommended that alternative approaches to gathering audit evidence be considered.
	If no deviations are found in such a test-of-controls sample, the auditor can assert that the control is operating effectively. If a deviation is found, it is usually more efficient to stop the procedure and perform alternative substantive audit procedures instead. Just one control deviation will likely cause a revision to the assessed level of control risk. To continue with a test after finding a deviation would require a significant extension of the sample size, and possibly no further deviations would be found.

Determining the Sample Size

Sample sizes are determined as illustrated below.

Sample Size = Confidence Factor ÷ Tolerable Deviation Rate

For testing the operating effectiveness of controls with minimal reliance on other work performed, a 90% confidence level (related confidence factor = 2.3) is often used (see Exhibit 17.3-2 for the confidence factor table). The maximum tolerable deviation rate could be 10%. The smallest sample size in this case would be 23, calculated as follows.

Confidence Factor (2.3) ÷ Tolerable Deviation Rate (0.1) = Sample Size of 23

Where other evidence (such as evidence from substantive audit procedures) has been obtained for a particular assertion, the confidence factor could be reduced so that only a moderate level of risk reduction is obtained through testing the operational effectiveness of a control. In such a case, a confidence level of 80% (related confidence factor = 1.61) could be used, resulting in the smallest sample size of 8. Some firms use slightly higher confidence factors, resulting in the smallest sample size of 10 items for a moderate level of risk reduction and 30 for a higher level of risk reduction.

Selecting the Sample

Sample selection is set out below.

Exhibit 17.5-5

	4UFQT UP 5BLF
Selecting the Sample	Determine the purpose of the procedure and the evidence it will provide in relation to the assertions underlying the control attributes to be tested.
	Select the appropriate population of items to achieve the test objective. This may differ based on the underlying assertion being addressed. For example, invoices might be selected for testing sales existence, but these documents would not provide evidence on sales completeness. In this instance, the better choice might be tracing order entry or shipping documents to an invoice, and then into the accounts receivable.
	Determine the smallest sample size necessary to provide the required level of risk reduction. This could be either moderate or high levels of risk reduction.
	Use a random number generator or other appropriate method to select the individual items to be checked. Every item in the population should have an equal chance of being selected.

Control Procedures that Operate Less than Daily

For selecting samples where the control does not operate daily, the following guidelines may be of assistance. However, the actual sample sizes used should always be based on professional judgment.

Exhibit 17.5-6

$POUSPM 0QFSBUFTSample		$PWFSBHF 1FSDF
Weekly	10	19%
Monthly	2-4	25%
Quarterly	2	50%
Yearly	1	100%

$0 / 4 * % &03* /15

When statistical sampling is used for testing the operating effectiveness of internal control, the sample size required does not increase as the size of the population grows. A random sample of as little as 30 items with no deviation found can provide a high level of confidence that the control is operating effectively.

When designing tests of controls, spend time to define exactly what constitutes an error or exception to the test. This will save time during the performance of the test or the evaluation of the results, and avoid doubts in determining what a control deviation is.

If any level of deviation is expected in the operating effectiveness of a control, it is recommended that alternative approaches to gathering audit evidence be considered.

A simple plan that can be used for attribute sampling is as follows:

Based on a 95% confidence rate (a 5% deviation rate), it is suggested that:

t " TBNQMF PG JUFNT XJUI OP EFWJBUJPOT XJMM QSPWJE
EFWJBUJPO JT GPVOE OP SJTL SFEVDUJPO DBO CF HBJOFE

t " TBNQMF PG JUFNT XJUI OP EFWJBUJPOT XJMM QSPWJE
deviation is found, only a moderate level of risk reduction can be gained. If more than one
EFWJBUJPO JT GPVOE OP SJTL SFEVDUJPO DBO CF HBJOFE

t " TBNQMF PG JUFNT BOE VQ UP POF EFWJBUJPO XJMM Q
deviations are found, only a moderate level of risk reduction can be gained. If more than two deviations are found, no risk reduction can be gained from testing of controls.

17.6 Evaluating Deviations

The process for evaluating deviations as set out below.

Exhibit 17.6-1

	4UFQT UP 5BLF
Evaluating Deviations	Identify deviations. Place each sample item into one of two classifications: “deviation” or “no deviation.”
	The nature and cause of each deviation should be carefully considered. For example, is there an indication of management override or possible fraud, or was the problem simply a result of the person responsible being on vacation?
	Consider sampling risk. If deviations have been found, consider if reliance on control effectiveness should be reduced, the sample size extended (see below), or alternative procedures performed.

$0 / 4 * % &03* /15

As stated above, there is little point in testing controls if deviations are likely to be found. This is because the only way to gain the required assurance is to expand the sample size. Then, if another deviation is found, the sample would have to be expanded again, and so on. It would be much better to perform alternative procedures rather than expand sample size.

One possible exception would be where a reason for a particular type of deviation can be clearly identified and taken into account in the test design. For example, deviations during a specific period, such as when the person who normally performs the control is on holiday, may be addressed instead by performing some substantive procedures.

The results of the sample can be evaluated by comparing the maximum tolerable deviation rate to what is called the upper deviation limit. The upper deviation limit is approximated by the formula below.

Upper Deviation Limit = Adjusted Confidence Factor ÷ Sample Size

An adjusted confidence factor could be based on the number of deviations found, as illustrated in the exhibit below.

Exhibit 17.6-2

	"EKVTUFE $POöEFODF 'BDUPS GPS /V				
$POöEFODF Required	-FWFM 1	2		4	5
95%	4.7	6.3	7.8	9.2	10.5
90%	3.9	5.3	6.7	8.0	9.3
80%	3.0	4.3	5.5	6.7	7.9
70%	2.4	3.6	4.7	5.8	7.0

For example, let's assume a sampling of 30 items (using a 90% confidence level and 10% maximum tolerable deviation rate) and two deviations were found. The upper deviation limit would be calculated as follows.

Adjusted Confidence Factor (5.3) ÷ Sample Size (30) = Upper Deviation Limit of 17%

The result at 17% is much higher than the maximum tolerable deviation rate of 10%, which would mean that reliance on control effectiveness would have to be reduced. If, however, it was decided to increase the sample size, it would have to be extended to 60 items and no further deviations found. This would reduce the upper deviation limit (as calculated below) to an acceptable level (i.e., close to the original limit of 10%).

Adjusted Confidence Factor (5.3) ÷ Sample Size (60) = Upper Deviation Limit of 9%

However, if a further deviation was found, it would require yet another extension in the sample to try for the desired results. This would probably not be an effective use of audit time, as yet another deviation could well be found.

Adjusted Confidence Factor (6.7) ÷ Sample Size (75) = Upper Deviation Limit of 9%

17.7 Case Studies—Extent of Testing

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

$BTF 4UVEZ "‰%FQIUB 'VSOJUVSF *OD

Determining the Extent of Testing

Designing Further Procedures—Accounts Receivable

The following is an outline of an audit program for accounts receivable. This program includes a statistical sample of accounts receivable.

%FQIUB 'VSOJUVSF *OD
"DDPV3FDFJWBCMF

Client: Dephta Furniture, Inc.

	Assertions Addressed	Work Completed by:	WP Ref.	Comments
130$&%63&4				
1. Analytical procedures Develop expectations for the period-end accounts receivable balances, based on information obtained from understanding the entity. Investigate significant changes or trends in the: t "DDPVOUT SFDFJWBCMF CBMBODF t "HJOH PG BDDPVOUT SFDFJWBCMF CZ customer. t %BZ T TBMFT JO BDDPVOUT SFDFJWBCMF t $SFEJU CBMBODFT JO BDDPVOUT receivable. t 0UIFS SFMFWBOU SBUJPT t 0UIFS SFMFWBOU JOGPSNBUJPO Document findings.	CEA	MAG	C.120	Accounts receivables have increased by 60% from the prior period. Debtor's days in accounts receivable have also increased from 39 days to 45 days.
2. Listing Obtain a detailed (and aged) listing of receivables at the period end: a) Check arithmetic accuracy and agree to general ledger.	E	MAG	C.110	

	Assertions Addressed	Work Completed by:	WP Ref.	Comments
b) Check names and amounts to subsidiary ledger. c) Ask staff dealing with receivables about any instances where: t " DVTUPNFS IBT CFFO HJWFO preferential treatment, t 5IF UFSNT PG TBMF IBWF CFFO modified, t 5SBOTBDUJPOT IBWF PDDVSSFE with related parties, or t 8IFSF JOUFSOBM DSFEJU MJNJUT have been significantly overridden.	E A	MAG MAG		Per discussion with Arjan and Karla, the sales terms do vary between customers but are approved by Arjan
" MMPXBODF GPS EPVCUGCVM BDDBRV OUC.120 Ensure that the allowance for doubtful accounts relates to specific accounts and is adequate: a) Review the aged accounts receivable trial balance and compare it to preceding periods.		DAG		Accounts receivable over 60 days have increased as a percentage of sales from the prior period. Review listing of overdue accounts with Arjan and obtain details of allowance.
b) Review payments received subsequent to period end (if possible, obtain an aged trial balance as at the period-end date with subsequent collections posted on it).	AV	MAG		
4. Cut o Perform and document cutoff procedures	A	MAG	C.115	Obtain listing of sales returns since as part of cuto testing. There were several large returns last year. Conditions for returns on contract sales reviewed as part of sales testing. See WP 503.1. All journal entries around period end reviewed on WP 626.
46#45"/5*7& 130$&%63&4‰4".1-*/(				
4 &YUFOEFE DPOöSNBUJPOA Select 15 confirmations of accounts as outlined in accounts receivable confirmation checklist. Summarize the results and investigate differences by examining supporting documentation and inquiry.	EA	MAG	C.200	

	Assertions Addressed	Work Completed by: J O J U J B R	WP Ref.	Comments
5 & 4 5 4 0 ' $ 0 / 5 3 0 - 4				None
& 9 5 & / % & % 1 3 0 $ & % 6 3 & 4 ‰ G P S T Q F D J ö D G S B V E S J T L T J E F O U J ö F E				
& " D D P V O U T S F D F J W B C M F E A D P O ö S A G B U J P O 1 a) Verify a sample of names, addresses, and fax/telephone numbers of customers selected to telephone or business directories to ensure that they are valid businesses. b) Consider reviewing websites or other online information about customers, in addition to sending a confirmation to verify account details and sales terms/conditions. Ask about any side deals or special terms. c) Consider accepting only original (signed) copies of confirmations.				Veri ed 5 names, addresses, fax numbers from the con rmation selected. No exceptions noted. Called 2 customers to verify and con rm details and the contract terms for contract sales. No exceptions noted.
& " M M P X B O D F G P S E P V C U V M B M A G P V O U 1 a) Test a sample of 10 subsequent payments to bank deposits. b) Review all credit memos issued after period end. Consider reviewing customer files or supporting documentation as appropriate. c) Review all write-offs of accounts receivable after period end to ensure that these were not doubtful in the prior period.				No exceptions noted. There were 2 credit memos issued after period end but these were not material. The customers returned the items since they were damaged upon arrival. It is not clear whether they were damaged in transport or already damaged when leaving the factory.

WP ref. = Working Paper Reference

Substantive Procedures—Sampling

The following illustrates the test design of a statistical sample for determining the existence and accuracy of the receivable balances. Invoices have been chosen as the source document for the customers chosen for confirmation, as certain retailers have indicated they will not confirm actual period-end balances.

A statistical sample (using monetary-unit sampling) will be performed to determine the existence and accuracy of receivables.

Question	Response
Purpose of test	To ensure the existence and accuracy of receivables by selecting a sample of receivable balances and sending con rmation letters

Question	Response
RMM in the relevant assertions	Existence = Moderate risk Accuracy = Low risk
Population to be tested	Accounts receivable balances at period end
Monetary value of population	177,203
Specific items subject to separate evaluation	38,340
Risk reduction obtained from testing the operational effectiveness of internal control	Moderate
Risk reduction from other procedures such as risk assessment procedures	Limited
Confidence factor to be used (reduced for risk reduction gained from other sources)	Test of controls planned for revenue/receivables/receipts; therefore, a con dence interval of 75%, or 1.4, will be used
Materiality	15,000
Expected deviations in sample	None

Estimating the Sample Size

Specific items will be tested separately. There are two related party receivables of 28,340€ and 10,000€ from Kalyani Dephta and Vinjay Sharma respectively that should be confirmed separately.

The remaining trade receivables balance of 138,863€ (177,203€ - 38,340€) will need to be tested for existence and accuracy using accounts receivable confirmations. Since some customers cannot confirm balances after the fact, accounts receivable confirmations will be based on confirming invoices and:

t 4 B N Q M J O H J O U F S W B M
Precision (materiality) ÷ confidence factor
15,000 ÷ 1.4 (75%) = 10,714

t 4 B N Q M F T J [F
Population to be tested ÷ sampling interval
Exclude specific items removed for separate evaluation
138,340 ÷ 10,714 = 13

Since the sampling units in this population are invoices, the sample consists of 13 invoices to be selected for confirmation, plus the two related party transaction balances identified above.

Selecting Invoices To Be Tested

To select the invoices and customers for confirmation, the invoices will be chosen using monetary-unit sampling. For the remaining trade receivables balance of 138,340€, a starting point of 913€ was chosen. Using the sampling interval of 10,714€, the 13 invoices were selected.

Determining the Extent of Testing

Designing Further Procedures—Accounts Receivable

Audit procedures program for Kumar:

Balance—Accounts Receivable (AR)

Basic procedures:

Procedure	Assertions	Work Completed by and WP Ref.	Comments
Analytical procedures Perform analytical procedures on the AR balance, aging, and key ratios, and compare trends and result to prior period.	CEA	C.110 LP	Day's sales in AR have increased to 106 days from 58 days two years ago. Majority of increase seems to be due to increases in Dephta AR.
Listing Obtain aged listing of AR and check arithmetic accuracy, agree to general ledger, and review the listing with Ruby for related party balances. Check the accuracy of the aging by reviewing 5 invoices, chosen judgmentally, and ensure the aging report is accurate.	A	C.105 LP C.105 LP	Listing agrees to general ledger and no errors found on the aging and arithmetic checks. No evidence noted.
" M M P X B O D F Obtain details for allowance with Raj and review the aging. Discuss the collectability of accounts over 90 days. Obtain a listing of subsequent payments to the end of our subsequent events testing.	V	C.120 LP	Reviewed listing with Raj. Only two accounts are over 90 days. Invoices over 90 days from Dephta totaled 10,590 . Per Raj, these are all collectible and will be paid soon. Some of the J O W P J D F T X F S F Q B J E T V C period end.
$ V U 0 ò Review a sample of 10 invoices before and after period end and document other cutoff procedures to ensure transactions were recorded in the correct period. Examine evidence that the goods were shipped prior to period end for transactions selected.	A	C.122 LP	No errors noted here and revenue testing regarding cut o . All journal entries around period end reviewed on WP 626.

Procedure	Assertions	Work Completed by and WP Ref.	Comments
$ P O ö S N B U J P O T Confirm all related party accounts. Judgmentally select accounts receivable balances (excluding related party balances above) for 60% coverage. Check a sample of names and addresses before sending confirmation to ensure that company information is accurate. Follow-up confirmations faxed back to us with a phone call to verify the confirmation details. Perform alternative procedures for confirmations not returned.	EA	C.130 LP	Con rmed Dephta receivable and also agreed balance to Dephta working paper le. Accounts-receivable con rmations only had a 45% response rate, so alternative procedures were performed.

Substantive Procedures—Sampling

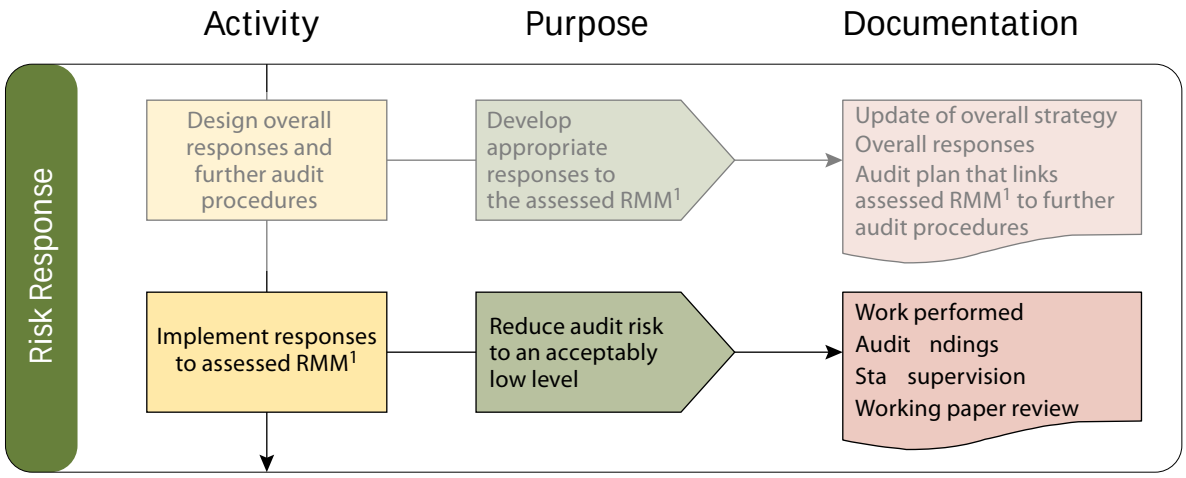
The sample of confirmations was extended for moderate level of risk. Reliance was placed on substantive procedures.

Extended/Other Substantive Procedures

Given the risk of management override, names and addresses were checked for a sample of confirmations sent. For any confirmation returned by fax, the confirmation details were confirmed with a telephone call to ensure their accuracy.

Chapter Content	Relevant ISAs
Guidance on proper and adequate documentation of the auditor's risk response in the audit working paper file.	230

Exhibit 18.0-1



Notes:
1. RMM = Risks of material misstatement.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
230.7	The auditor shall prepare audit documentation on a timely basis. (Ref: Para. A1)
230.8	The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2-A5, A16-A17) (a) The nature, timing and extent of the audit procedures performed to comply with the ISAs BOE BQQMJDBCMF MFHBM BOE SFHVMBUPSZ SFRVJSFNFOU C 5IF SFTVMUT PG UIF BVEJU QSPDFEVSFT QFSGPSNFE B (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8-A11)

Paragraph #	3 F M F W B O U &Y U S B D U T G S P N *4"T
230.9	In documenting the nature, timing and extent of audit procedures performed, the auditor shall record: B 5 I F J E F O U J G Z J O H D I B S B D U F S J T U J D T P G U I F T Q F D J öD J U C 8 I P Q F S G P S N F E U I F B V E J U X P S L B O E U I F E B U F T V D I X P S (c) Who reviewed the audit work performed and the date and extent of such review. (Ref: Para. A13)
230.10	The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. (Ref: Para. A14)

18.1 Overview

File documentation plays a critical role in the planning and performance of the audit. It provides the record that work was in fact performed, and it forms the basis for the auditor's report. It will also be used for quality control reviews, monitoring of compliance with ISAs and applicable legal and regulatory requirements, and possibly inspections by third parties.

The specific requirements and nature of audit documentation have been extensively addressed in Volume 1, Chapter 16 and are not repeated here. The following exhibit provides a checklist of some of the matters that would be addressed in completing the file.

Exhibit 18.1-1

Documentation Considerations	Yes/No
Has compliance with the firm's documentation requirements, as set out in the firm's quality control manual, been documented?	
Is the audit documentation well organized and complete, including clear links to where significant matters were addressed?	
Does file documentation indicate: t 8IP QFSGPSNFE UIF BVEJU XPSL BOE UIF EBUF TVDI XPSL X t 8IP SFWJFXFE UIF BVEJU XPSL QFSGPSNFE BOE UIF EBUF B t 3FTVMUT PG EJTDVTTJPOT PG TJHOJöDBOU NBUUFST XJUI N governance, and others, including the nature of the significant matters discussed, and when and with whom the discussions took place?	
Could an experienced auditor, who has had no previous connection with the audit, understand: t 5IF OBUVSF UJNJOH BOE FYUFOU PG UIF BVEJU QSPDFEVS applicable legal, regulatory, and professional requirements? t 5IF SFTVMUT PG UIF BVEJU QSPDFEVSFT BOE UIF BVEJU FW t 5IF OBUVSF PG TJHOJöDBOU NBUUFST BSJTJOH UIF DPODMV professional judgments made in reaching those conclusions?	
Does the file contain documentation that addresses: t 5IF QSFTFODF PG UIF BVEJU QSFDPOEJUJPOT BOE UIF EFDJ engagement? t 5IF PWFSBMM BVEJU TUSBUFHZ t %JTDVTTJPO BNPOH UIF FOHBHFNFOU UFBN t ,FZ FMFNFOUT PG UIF VOEFSTUBOEJOH PG UIF FOUJUZ PCU control components, including the sources of the information obtained? t 3FTVMUT PG QFSGPSNJOH SJTL BTTFTTNFOU QSPDFEVSFT t *EFOUJöFE BOE BTTFTTFE SJTLT PG NBUFSJBM NJTTUBUFNF at the assertion level? t 5IF EFUBJMFE BVEJU QMBO UIBU SFTQPOET UP UIF BTTFTTF t 3FTVMUT PG QFSGPSNJOH BVEJU QSPDFEVSFT JODMVEJOH obtained and the treatment of exceptions found, including any changes required in assessed risks? t *OGPSNBUJPO BOE QSPDFEVSFT QFSGPSNFE UP BEESFTT BC the audit? t $IBOHFT JO NBUFSJBMJUZ BT B SFTVMU PG OFX JOGPSNBUJ t &OPVHI JOGPSNBUJPO UP SF QFSGPSN FBDI QSPDFEVSF JG t 4JHOJöDBOU DIBOHFT NBEF EVSJOH UIF BVEJU FOHBHFNFOU audit plan, and the reasons for such changes? t %FUBJMT PG TJHOJöDBOU NBUUFST BOE UIFJS SFTPMVUJPO with management estimates, subsequent events, and other matters that could result in a modified audit opinion?	

Documentation Considerations	Yes/No
Have consultations within the firm and with experts hired by the auditor and management been documented? Where an expert was used, has the appropriateness of the expert's work as audit evidence been documented?	
Has compliance with the requirements of ISA 600 with regard to communications with component auditors been documented?	
Have all the documentation requirements of each relevant ISA been addressed? (See Volume 1, Chapter 16 for a list of ISAs with specific documentation requirements.)	

File Ownership

Unless otherwise specified by legislation or regulation, audit documentation is the property of the audit firm.

Copies of Entity's Records

Abstracts or copies of the entity's records (e.g., significant and specific contracts and agreements) may be included as part of audit documentation if considered appropriate. However, copies of the entity's accounting records are not a substitute for appropriate audit documentation.

$0 / 4 * % &03* /15

5 J N F M JPQGFSTHQ B S B U J P O

Preparing audit documentation on a timely basis helps to enhance the quality of the audit, and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

$BO UIF BVEJU öMF TUBOE CZ JUTFMG

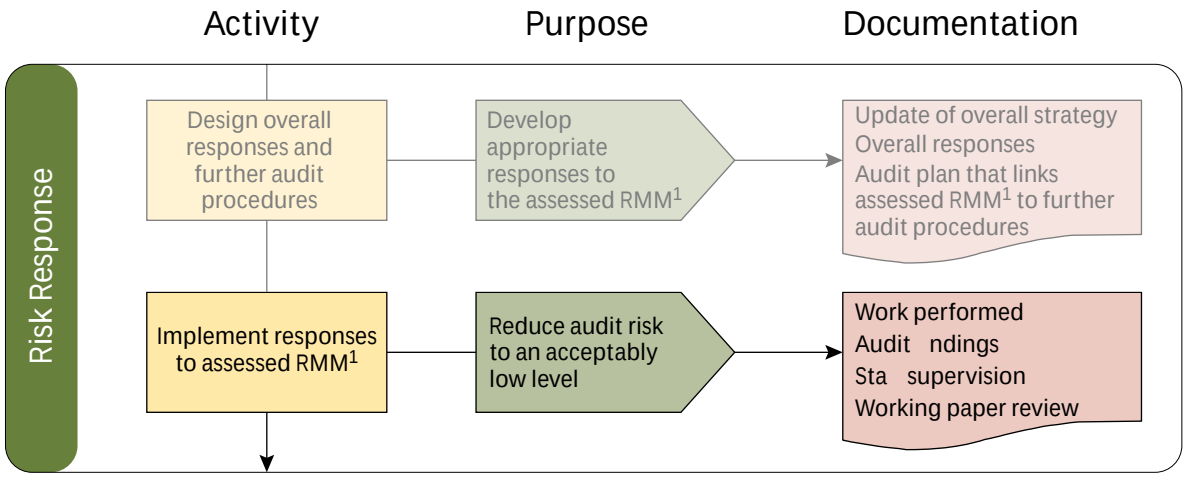
Where possible, audit documentation should be clear and understandable without the need for additional oral explanations. Oral explanations on their own do not represent adequate support for the work performed or conclusions reached. They may be used, though, to explain or clarify information contained in the audit documentation.

Inconsistencies

If audit evidence is obtained that is inconsistent with the final conclusion regarding a significant matter, ensure that documentation is added to the file that explains how the auditor addressed the inconsistency. This does not imply that the auditor needs to retain documentation that is incorrect or superseded.

Chapter Content	Relevant ISA
Guidance on obtaining written confirmation of management representations.	580

Exhibit 19.0-1



Notes:
1. RMM = Risks of material misstatement.

Paragraph #	* 4 " 0 C K F D U J W F T
580.6	The objectives of the auditor are: (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the ö O B O D J B M T U B U F N F O U T B O E G P S U I F D P N Q M F U F O F T T P G U I F J C (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations if determined necessary by the auditor or S F R V J S F E C Z P U I F S * 4 " T B O E (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Paragraph #	3FMFWBOU &YUSBDUT GSPN *4"T
580.9	The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (Ref: Para. A2-A6)
580.10	The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement. (Ref: Para. A7-A9, A14, A22)
580.11	The auditor shall request management to provide a written representation that: (a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement, and (b) All transactions have been recorded and are reflected in the financial statements. (Ref: Para. A7-A9, A14, A22)
580.12	Management's responsibilities shall be described in the written representations required by paragraphs 10 and 11 in the manner in which these responsibilities are described in the terms of the audit engagement.
580.13	Other ISAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. (Ref: Para. A10-A13, A14, A22)
580.14	The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report. (Ref: Para. A15-A18)
580.15	The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required by paragraphs 10 or 11, the relevant matters covered by such statements need not be included in the representation letter. (Ref: Para. A19-A21)
580.16	If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A24-A25)
580.19	If management does not provide one or more of the requested written representations, the auditor shall: B %JTDVTT UIF NBUUFS XJUI NBOBHFNFOU (b) Reevaluate the integrity of management and evaluate the effect that this may have on the SFMJBCJMJUZ PG SFQSFTFOUBUJPOT PSBM PS XSJUUFO (c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with ISA 705, having regard to the requirement in paragraph 20 of this ISA.
580.20	The auditor shall disclaim an opinion on the financial statements in accordance with ISA 705 if: (a) The auditor concludes that there is sufficient doubt about the integrity of management TVDI UIBU UIF XSJUUFO SFQSFTFOUBUJPOT SFRVJSFE CZ (b) Management does not provide the written representations required by paragraphs 10 and 11. (Ref: Para. A26-A27)

19.1 Overview

Written representations are requested by the auditor from those responsible (usually management but, depending on the entity and any relevant law or regulation, may extend to those charged with governance) for the preparation of the financial statements. One of the responsibilities of management when they sign the engagement letter (see Volume 2, Chapter 4) is to confirm the auditor's expectation of receiving written confirmation concerning the representations made in connection with the audit.

During the course of the audit, management will make a number of verbal representations to the auditor, which can be used as audit evidence to complement other audit procedures. At the end of the engagement, these verbal representations are to be included in a written representation letter obtained from management and, where appropriate, those charged with governance.

Note: A number of ISAs contain specific requirements for the auditor to request written representations.

The written representation letter would include specific representations required, and management's belief that:

- *U IBT GVMöMMFE JUT SFTQPOTJCJMJUJFT GPS UIF QSFQBSB
- 5IF JOGPSNBUJPO QSPWJEFE UP UIF BVEJUPS XBT DPNQMFU

The written representation letter would be obtained as near as practicable to, but not after, the date of the auditor's report on the financial statements. Written representations would cover all financial statements and period(s) referred to in the auditor's report.

Written management representations are not to be used as:

- " TVCTUJUVUF GPS QFSGPSNJOH PUIFS BVEJU QSPDFEVSFT
- "T UIF TPMF TPVSDF PG FWJEFODF PO TJHOJöDBOU BVEJU N

$0 / 4 * % &03* /15

Who signs the letter?
For engagements deemed to be high risk, consider obtaining more than one signature on the representation letter. For example, the representation letter could be signed by the owner-manager and other key members of the management team.

Representations as evidence
Written representations do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Nor does the fact that management has provided reliable written representation affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

19.2 Subject Matter

Management representations may be:

t 7FSCBM XIFUIFS TPMJDJUFE PS VOTPMJDJUFE
Such representations are typically obtained during the audit engagement.

t 8SJUUFO
At the end of the engagement, the auditor is required to request a written statement from management confirming certain matters such as:

- The verbal representations referred to above,
- Management has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework,
- All transactions have been recorded and are reflected in the financial statements, and
- Other representations as necessary to support the audit evidence obtained.

Exhibit 19.2-1

'PSNT PG .BOBHFNFOU Representations	Matters communicated in discussions.
	Matters communicated electronically, such as emails, recorded telephone messages, or text messages.
	Schedules, analyses, and reports prepared by the entity, and management's notations and comments therein.
	Internal and external memoranda or correspondence.
	Minutes of meetings of those charged with governance and compensation committees.
	Signed copy of the financial statements.
	Representation letter from management.

19.3 Considerations in Performing the Audit

The following matters should be considered when evaluating management representations.

Exhibit 19.3-1

& W B M V. BB U0 J BO HH F N3 FF CQ US F T F O U B U J P O T	
. B U U F S T U P Consider	Can the person making the representation be expected to be objective and knowledgeable on the subject matter?
	Is the representation reasonable in light of: t 5 I F B V E J U P S T V O E F S T U B O E J O H P G U I F F O U J U Z t 0 U I F S F W J E F O D F P C U B J O F E J O D M V E J O H P U I F S management? t 0 U I F S F W J E F O D F P C U B J O F E U I S P V H I U I F Q F S G P achieve other audit objectives?
	What further audit procedures are required to corroborate the representations? For corroborating management intent, consider sources of evidence such as board minutes, minutes of investment committees, legal documents, or internal correspondence and emails. For example, as part of the auditor's consideration of going concern, "substantiating" evidence would include inspection of board minutes, legal documents, and availability of funding information, etc. Where corroborating evidence is not available, is there a scope limitation?
	Where management representations have been contradicted by other audit evidence obtained: t * U I F S F B T U P E P V N C B O B H F N I P O U F B O E O U F H & F W J E B V E J U P S would discuss the matter with those charged with governance, and consider the impact on the risk assessment and the need for further audit procedures. t * T D P O U J O V F E S F M J B O D F P O B O Z P U I F S P G N B O appropriate and justified?
	Consider the most appropriate means of documenting the representation. For example: t " N F N P S B O E V N D S F B U F E C Z U I F B V E J U P S t " X S J U U F O N F N P S B O E V N D S F B U F E C Z U I F F O U J U t * O D M V S J P O J O U I F N B O B H F N F O U S F Q S F T F O U B U J

19.4 Written Representations

Written representations are an important source of audit evidence, for reasons such as the following:

t * G N B O B H F N F O U N P E J öF T P S E P F T O P U Q S P W J E F U I F S F R V F T B V E J U P S U P U I F Q P T T J C J M J U Z U I B U P O F P S N P S F T J H O J öD B O

t " S F R V F T U G P S X S J U U F O S B U I F S U I B O P S B M S F Q S F T F O U B U matters more rigorously, thereby enhancing the quality of the representations.

Written representations are requested from those responsible for the preparation and presentation of the financial statements and knowledge of the matters concerned. Often, this will be the entity's chief executive officer and the chief financial officer, or other equivalent persons such as the owner-manager.

The auditor is required to request management to provide a written representation that:

- *U IBT GVMöMMFE JUT SFTQPOTJCJMJUZ GPS UIF QSFQBSBUJ BQQMJDBCMF öOBODJBM SFQPSUJOH GSBNFXPSL
- *U IBT QSPWJEFE UIF BVEJUPS XJUI BMM SFMFWBOU JOGPSN FOHBHFand NFOU
- "MM USBOTBDUJPOT IBWF CFFO SFDPSEFE BOE BSF SFøFDUF

If management does not provide these required representations, or if the auditor concludes there is sufficient doubt about the integrity of management such that these representations are not reliable, then the auditor must disclaim an opinion on the financial statements.

Written representations also support other evidence relevant to the financial statements (such as required by other ISAs) or one or more specific assertions in the financial statements.

Other particular ISAs that require written representations are outlined below.

Exhibit 19.4-1

ISA	5 J U M F	Paragraph
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	39
250	Consideration of Laws and Regulations in an Audit of Financial Statements	16
450	Evaluation of Misstatements Identi ed during the Audit	14
501	Audit Evidence—Speci c Considerations for Selected Items	12
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	22
550	Related Parties	26
560	4 V C T F R&W FF OU T	9
570	Going Concern	16(e)
710	Comparative Information—Corresponding Figures and Comparative Financial Statements	9

Written representations address matters such as those set out below.

Exhibit 19.4-2

	.BOBHFNFOU IBT
.BOBHFNFOUt T Responsibilities	Fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework (including, where relevant, its fair presentation, as set out in the terms of the audit engagement), BOE GPS UIF DPNQMFUFOFTT PG UIF JOGPSNBUJ
	t In some cases (such as where the terms of engagement were agreed by other