Notes-ISA-315 - Notes on PSA 315

BS Accountancy (University of Eastern Philippines)



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PSA Summary
PSA 315 (Revised 2019) – Identifying and Assessing the Risks of Material Misstatement

PSA 315

- Adopted as part of the Philippine auditing standards based on PRBOA Resolution NO. 32, series of 2020.
- Date of effectivity: December 6, 2020

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.

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 system of internal control.

Assertions

- Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework.

- Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement.

- Management's assertions are categorized as follows:

    a. Assertions about **classes of transactions and events, and related disclosures**, for the period under audit:

        (i) **Occurrence**—transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.

        (ii) **Completeness**—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

        (iii) **Accuracy**—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.

        (iv) **Cutoff**—transactions and events have been recorded in the correct accounting period.

        (v) **Classification**—transactions and events have been recorded in the proper accounts.

        (vi) **Presentation**—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

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b. Assertions about **account balances, and related disclosures**, at the period end:

(i) **Existence**—assets, liabilities and equity interests exist.

(ii) **Rights and obligations**—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) **Completeness**—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

(iv) **Accuracy, valuation and allocation**—assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

(v) **Classification**—assets, liabilities and equity interests have been recorded in the proper accounts.

(vi) **Presentation**—assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework

To compare and summarize:

Under the old PSA 315:		
Assertions about classes of transactions and events	***Assertions about account balances***	***Assertions about presentation and disclosure***
• *Occurrence* • *Completeness* • *Accuracy* • *Cutoff* • *Classification*	• *Existence* • *Rights and obligations* • *Completeness* • *Valuation and allocation*	• *Occurrence and rights and obligations* • *Completeness* • *Classification and understandability* • *Accuracy and valuation*

Under the new PSA 315 (revised 2019)	
Assertions about classes of transactions and events, and related disclosures	***Assertions about account balances, and related disclosure***
• *Occurrence* • *Completeness* • *Accuracy* • *Cutoff* • *Classification* • *Presentation*	• *Existence* • *Rights and obligations* • *Completeness* • *Accuracy, valuation and allocation* • *Classification* • *Presentation*

In identifying and assessing the risks of material misstatement, the auditor may use the categories of assertions as described above or may express them differently provided all these aspects have been covered. The auditor may choose to combine the assertions about classes of transactions and events, and related disclosures, with the assertions about account balances, and related disclosures.

Business risk

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- 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.

Controls
- Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance.
    - Policies
        - statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.
    - Procedures
        - are actions to implement policies.

- *(A2) Controls are embedded within the components of the entity's system of internal control.*
- *(A3) Policies are implemented through the actions of personnel within the entity, or through the restraint of personnel from taking actions that would conflict with such policies.*
- *(A4) Procedures may be mandated, through formal documentation or other communication by management or those charged with governance, or may result from behaviors that are not mandated but are rather conditioned by the entity's culture. Procedures may be enforced through the actions permitted by the IT applications used by the entity or other aspects of the entity's IT environment.*

- *Direct controls*
    - *controls that are precise enough to address risks of material misstatement at the assertion level.*
    - *controls that are sufficiently precise to prevent, detect or correct misstatements at the assertion level)*
- *Indirect controls*
    - *Indirect controls are controls that support direct controls.*
    - *are not sufficiently precise to prevent, detect or correct misstatements at the assertion level but which support other controls and may therefore have an indirect effect on the likelihood that a misstatement will be detected or prevented on a timely basis.*

General information technology (IT) controls
- Controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information (i.e., the completeness, accuracy and validity of information) in the entity's information system.

Information processing controls
- Controls relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information).

Inherent risk factors
- Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls.
- May be qualitative or quantative.

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- As regards preparation of financial information, inherent risk factors include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.
    - *The extent of susceptibility to misstatement arising from **complexity or subjectivity** is often closely related to the extent to which it is subject to **change or uncertainty**.*
    - *The greater the extent of susceptibility to misstatement due to complexity or subjectivity, the greater the need for the auditor's professional skepticism (because these create opportunity for management bias, intentional or unintentional)*
- Other inherent risk factors:
    - Quantitative or qualitative significance of the class of transactions, account balance or disclosure; or
    - Volume or lack of uniformity in the composition of the items to be processed through the class of transactions or account balance, or to be reflected in the disclosure.

IT environment

- The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies. For the purposes of this ISA
    a. An IT application is a program or a set of programs that is used in the initiation, processing, recording and reporting of transactions or information. IT applications include data warehouses and report writers.
    b. The IT infrastructure comprises the network, operating systems, and databases and their related hardware and software.
    c. The IT processes are the entity's processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations.

Relevant assertions

- An assertion about a class of transactions, account balance or disclosure is relevant when it has an identified risk of material misstatement. The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (i.e., the inherent risk).

- A risk of material misstatement may relate to more than one assertion, in which case all the assertions to which such a risk relates are relevant assertions. If an assertion does not have an identified risk of material misstatement, then it is not a relevant assertion.

Risks arising from the use of IT

- Susceptibility of information processing controls to ineffective design or operation, or risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information) in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes.

Risk assessment procedures

- The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Significant class of transactions, account balance or disclosure

- A class of transactions, account balance or disclosure for which there is one or more relevant assertions.

Significant risk

- An identified risk of material misstatement:

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a. For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or
b. That is to be treated as a significant risk in accordance with the requirements of other ISAs.
    - PSA 240: The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks.

- "significance" – relative importance of the matter

System of internal control

- The system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
- The system of internal control consists of five interrelated components:
    a. Control environment;
    b. The entity's risk assessment process;
    c. The entity's process to monitor the s\stem of internal control;
    d. The information system and communication; and
    e. Control activities.

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Risk Assessment Procedures

Basis for:

1. Identifying and assessing of risks of material misstatement at the financial and assertion levels.
2. Designing further audit procedures

The auditor applies professional skepticism in critical assessment of audit evidence. This includes:

- Questioning contradictory information and the reliability of documents;
- Considering responses to inquiries and other information obtained from management and those charged with governance;
- Being alert to conditions that may indicate possible misstatement due to fraud or error;
- Considering whether audit evidence obtained supports the auditor's identification and assessment of the risks of material misstatement in light of the entity's nature and circumstances.

Sources of audit evidence

- May involve obtaining evidence from multiple sources within and outside the entity.
- However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence.
- May include:
    - Interactions with management, those charged with governance, and other key entity personnel, such as internal auditors.
    - Certain external parties such as regulators, whether obtained directly or indirectly.
    - Publicly available information about the entity, for example entity-issued press releases, materials for analysts or investor group meetings, analysts' reports or information about trading activity.

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- Regardless of the source of information, the auditor considers the relevance and reliability of the information to be used as audit evidence in accordance with ISA 500.

Scalability

- The nature and extent of risk assessment procedures will vary based on the nature and circumstances of the entity (e.g., the formality of the entity's policies and procedures, and processes and systems). The auditor uses professional judgment to determine the nature and extent of the risk assessment procedures to be performed to meet the requirements of this ISA.

- Although the extent to which an entity's policies and procedures, and processes and systems are formalized may vary, the auditor is still required to obtain the understanding in accordance with paragraphs 19, 21, 22, 24, 25 and 26.

- The nature and extent of risk assessment procedures to be performed the first time an engagement is undertaken may be more extensive than procedures for a recurring engagement. In subsequent periods, the auditor may focus on changes that have occurred since the preceding period.

Risk assessment procedures:

- *The nature, timing and extent of the audit procedures may be affected by the fact that some of the accounting data and other evidence may only be available in electronic form or only at certain points in time.*
- *The auditor may perform substantive procedures or tests of controls, in accordance with ISA 330, concurrently with risk assessment procedures, when it is efficient to do so.*
- *Audit evidence obtained that supports the identification and assessment of risks of material misstatement may also support the detection of misstatements at the assertion level or the evaluation of the operating effectiveness of controls.*

RAP shall include the following:

a. Inquiries of management and of other appropriate individuals within the entity, including individuals within the internal audit function (if the function exists)
    - Inquiries of management and those responsible for financial reporting and of other appropriate individuals within the entity and other employees with different levels of authority may offer the auditor varying perspectives when identifying and assessing risks of material misstatement, example:
        - Inquiries directed towards those charged with governance may help the auditor understand the extent of oversight by those charged with governance over the preparation of the financial statements by management. ISA 260 (Revised) identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
        - Inquiries of employees responsible for initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
        - Inquiries directed towards in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contractual terms.

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- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- Inquiries directed towards the risk management function (or inquiries of those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed towards IT personnel may provide information about system changes, system or control failures, or other IT-related risks

b. Analytical procedures
   - help identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that indicate matters that may have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
   - assist in identifying and assessing the risks of material misstatement by identifying aspects of the entity of which the auditor was unaware or understanding how inherent risk factors, such as change, affect susceptibility of assertions to misstatement.
   - Include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold (non-financial).
   - At risk assessment phase, analytical procedures use data aggregated at a high level. Accordingly, the results of those analytical procedures may provide a broad initial indication about the likelihood of a material misstatement.

c. Observation and inspection
   - Observation and inspection may support, corroborate or contradict inquiries of management and others, and may also provide information about the entity and its environment.
   - Scalability: Where policies or procedures are not documented, or the entity has less formalized controls, the auditor may still be able to obtain some audit evidence to support the identification and assessment of the risks of material misstatement through observation or inspection of the performance of the control. Examples:
     - The auditor may obtain an understanding of controls over an inventory count, even if they have not been documented by the entity, through direct observation.
     - The auditor may be able to observe segregation of duties.
     - The auditor may be able to observe passwords being entered.
   - Risk assessment procedures may include observation or inspection of the following:
     - The entity's operations.
     - Internal documents (such as business plans and strategies), records, and internal control manuals.
     - Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
     - The entity's premises and plant facilities.
     - Information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; regulatory or financial publications; or other external documents about the entity's financial performance (such as those referred to in paragraph A79).
     - The behaviors and actions of management or those charged with governance (such as the observation of an audit committee meeting).

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- *Although the auditor is required to perform all the risk assessment procedures described above (a, b, c) in the course of obtaining the required understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control, the auditor is not required to perform all of them for each aspect of that understanding.*
- *Other procedures may be performed when the information to be obtained may be helpful in identifying risks of material misstatement. Examples of such procedures may include making inquiries of the entity's external legal counsel or external supervisors, or of valuation experts that the entity has used.*

Engagement Team Discussion

The engagement partner and other key engagement team members shall discuss the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement.

When there are engagement team members not involved in the engagement team discussion, the engagement partner shall determine which matters are to be communicated to those members.

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework and the Entity's System of Internal Control

Understanding the Entity and Its Environment, and the Applicable Financial Reporting Framework

The auditor shall perform risk assessment procedures to obtain an understanding of:

(a) The following aspects of the entity and its environment:

a. The entity's **organizational structure**, **ownership** and **governance**, and its **business model**, including the extent to which the business model integrates the use of IT;

Understanding the entity's organizational structure and ownership may enable the auditor to understand:

- *Complexity of the entity's structure (e.g. subsidiaries, divisions, other components, legal structure different from operating structure, accounting for and disclosure of goodwill, joint ventures, investments, SPEs)*
- *The ownership, and relationships between owners and other people or entities, including related parties. This understanding may assist in determining whether related party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial statements.*
- *Distinction between the owners, those charged with governance and management.*
- *The structure and complexity of the entity's IT environment, example:*
  - *Have multiple legacy IT systems in diverse businesses that are not well integrated resulting in a complex IT environment*
  - *Be using external or internal service providers for aspects of its IT environment (e.g., outsourcing the hosting of its IT environment to a third party or using a shared service center for central management of IT processes in a group).*

Understanding of the entity's governance enables the auditor to understand the entity's ability to provide appropriate oversight of its system of internal control. This may also provide evidence of deficiencies, which may indicate an increase in the susceptibility of the entity's FS to risks of material misstatements. Consider whether:

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- *Whether any or all of those charged with governance are involved in managing the entity.*
- *The existence (and separation) of a non-executive Board, if any, from executive management.*
- *Whether those charged with governance hold positions that are an integral part of the entity's legal structure, for example as directors.*
- *The existence of sub-groups of those charged with governance, such as an audit committee, and the responsibilities of such a group.*
- *The responsibilities of those charged with governance for oversight of financial reporting, including approval of the financial statements*

Understanding the entity's business model (this includes understanding of the entity's objectives, strategies and business risk):

Understanding the entity's objectives, strategy and business model helps the auditor to understand the entity at a strategic level, and to understand the business risks the entity takes and faces. An understanding of the business risks that have an effect on the financial statements assists the auditor in identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements.

Business risks increasing the susceptibility to risks of material misstatement may arise from:

- *Inappropriate objectives or strategies, ineffective execution of strategies, or change or complexity.*
- *A failure to recognize the need for change may also give rise to business risk, for example, from:*
    - *The development of new products or services that may fail;*
    - *A market which, even if successfully developed, is inadequate to support a product or service; or*
    - *Flaws in a product or service that may result in legal liability and reputational risk.*
- *Incentives and pressures on management, which may result in intentional or unintentional management bias, and therefore affect the reasonableness of significant assumptions and the expectations of management or those charged with governance.*

b. **Industry**, **regulatory** and other **external** factors; and

Industry factors include:

- *industry conditions such as the competitive environment, supplier and customer relationships*
- *technological developments.*
- *The market and competition, including demand, capacity, and price competition.*
- *Cyclical or seasonal activity.*
- *Product technology relating to the entity's products.*
- *Energy supply and cost.*
- *Nature of the business or the degree of regulation.*

Regulatory factors include:

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- *Regulatory framework for a regulated industry, for example, prudential requirements, including related disclosures.*
- *Legislation and regulation that significantly affect the entity's operations, for example, labor laws and regulations.*
- *Taxation legislation and regulations.*
- *Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restriction policies.*
- *Environmental requirements affecting the industry and the entity's business*

c. The **measures** used, internally and externally, **to assess the entity's financial performance**;

- *assists the auditor in considering whether such measures, whether used externally or internally, create pressures on the entity to achieve performance targets. These pressures may motivate management to take actions that increase the susceptibility to misstatement due to management bias or fraud (e.g., to improve the business performance or to intentionally misstate the financial statements)*

- *these may also indicate to the auditor the likelihood of risks of material misstatement of related financial statement information. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry.*

- *Example:*

  - *Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.*
  - *Period-on-period financial performance analyses.*
  - *Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.*
  - *Employee performance measures and incentive compensation policies.*
  - *Comparisons of an entity's performance with that of competitors*
  - *Publicly available information from external parties who review and analyze the entity's performance, like:*
    - *Analysts or credit agencies*
    - *News and other media, including social media*
    - *Taxation authorities*
    - *Regulators*
    - *Trade unions*
    - *Providers of finance.*

(b) The applicable **financial reporting framework**, and the entity's **accounting policies** and the reasons for and changes thereto; and

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Matters that the auditor may consider when obtaining an understanding of the entity's applicable financial reporting framework, and how it applies in the context of the nature and circumstances of the entity and its environment include:

- *The entity's **financial reporting practices** in terms of the applicable financial reporting framework, such as:*
  - *Accounting principles and industry-specific practices, including for industry-specific significant classes of transactions, account balances and related disclosures in the financial statements (for example, loans and investments for banks, or research and development for pharmaceuticals).*
  - *Revenue recognition.*
  - *Accounting for financial instruments, including related credit losses.*
  - *Foreign currency assets, liabilities and transactions. o Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for cryptocurrency).*
- *An understanding of the entity's selection and application of accounting policies, including and changes thereto as well as the reasons therefore, may encompass such matters as:*
  - *The methods the entity uses to recognize, measure, present and disclose significant and unusual transactions.*
  - *The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.*
  - *Changes in the environment, such as changes in the applicable financial reporting framework or tax reforms that may necessitate a change in the entity's accounting policies.*
  - *Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt, or comply with, such requirements.*

- *Obtaining an understanding of the entity and its environment may assist the auditor in considering where changes in the entity's financial reporting (e.g., from prior periods) may be expected (e.g. business combinations).*

(c) How inherent risk factors affect susceptibility of assertions to misstatement and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework, based on the understanding obtained in (a) and (b).

- *Assist the auditor with a preliminary understanding of the likelihood or magnitude of misstatements, which assists the auditor in **identifying risks of material misstatement** at the assertion level. (Ref. par. 28(b) – whether RMM exist)*

- *Assists the auditor in **assessing the likelihood and magnitude of a possible misstatement** when assessing inherent risk. (Ref. par. 31(a) - Assessing inherent risk at the assertion level)*

- *assist the auditor in **designing and performing further audit procedures** in accordance with ISA 330*

The auditor shall evaluate whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework.

<u>Understanding the Components of the Entity's System of Internal Control</u>

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Control environment**, **risk assessment process**, and **monitoring of controls

- *more likely to affect the identification and assessment of risks of material misstatement at the **financial statement level**.*
- *These are primarily indirect controls. However, some controls within these components may also be direct controls.*
- *Control environment provides an overall foundation for the operation of the other components of the system of internal control. It does not directly prevent, or detect and correct, misstatements. It may, however, influence the effectiveness of controls in the other components of the system of internal control.*
- *Similarly, the entity's risk assessment process and its process for monitoring the system of internal control are designed to operate in a manner that also supports the entire system of internal control.*
- *Because these components are foundational to the system of internal control, any deficiencies in their operation could have pervasive effects on the preparation of the financial statements. Therefore, the auditor's understanding and evaluations of these components affect the auditor's identification and assessment of risks of material misstatement at the financial statement level, and may also affect the identification and assessment of risks of material misstatement at the assertion level.*

Information system and communication**, and **control activities

- *more likely to affect the identification and assessment of risks of material misstatement at the **assertion level**.*

The auditor obtains an understanding of the components of the entity's system of internal control relevant to the preparation of financial statements through performing RAP by:

1. Control environment
    a. Understanding the set of controls, processes and structures that address:
        i. How management's oversight responsibilities are carried out, such as the entity's culture and management's commitment to integrity and ethical values;
        ii. When those charged with governance are separate from management, the independence of, and oversight over the entity's system of internal control by, those charged with governance;
        iii. The entity's assignment of authority and responsibility;
        iv. How the entity attracts, develops, and retains competent individuals; and
        v. How the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control;

    b. Evaluating whether:
        i. Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior;
        ii. The control environment provides an appropriate foundation for other components of the entity's system of internal control considering the nature and complexity of the entity; and
        iii. Control deficiencies identified in the control environment undermine the other components of the entity's system of internal control.

    - *In less complex entities:*
        - *Organizational structure will likely be simpler and may include a small number of employees involved in roles related to financial reporting.*

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        - *If the role of governance is undertaken directly by the owner-manager, the independence of those charged with governance may not be relevant.*
        - *They may not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of control environment in these entities.*

    - *Some entities may be dominated by a single individual who may exercise a great deal of discretion. The actions and attitudes of that individual may have a pervasive effect on the culture of the entity, which in turn may have a pervasive effect on the control environment. Such an effect may be positive or negative.*
        - *Example: Direct involvement by a single individual may be key to enabling the entity to meet its growth and other objectives, and can also contribute significantly to an effective system of internal control. On the other hand, such concentration of knowledge and authority can also lead to an increased susceptibility to misstatement through* ***management override of controls****.*

    - *The auditor may consider how the different elements of the control environment may be influenced by the philosophy and operating style of senior management taking into account the involvement of independent members of those charged with governance.*

    - *Although the control environment may provide an appropriate foundation for the system of internal control and may help reduce the risk of fraud, an appropriate control environment is not necessarily an effective deterrent to fraud.*

2. Risk assessment process
    a. Understanding the entity's process for:
        i. Identifying business risks relevant to financial reporting objectives;
        ii. Assessing the significance of those risks, including the likelihood of their occurrence; and
        iii. Addressing those risks; and
    b. Evaluating whether the entity's risk assessment process is appropriate to the entity's circumstances considering the nature and complexity of the entity.

    If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall:
    a. Determine whether any such risks are of a kind that the auditor expects would have been identified by the entity's risk assessment process and, if so, obtain an understanding of why the entity's risk assessment process failed to identify such risks of material misstatement; and
    b. Consider the implications for the auditor's evaluation of the appropriateness of the entity's risk assessment process.

    - *For less complex entities (particularly owner-managed entities)*
        - *risk assessment may be performed through the direct involvement of management or the owner-manager (e.g., the manager or owner-manager may routinely devote time to monitoring the activities of competitors and other developments in the market place to identify emerging business risks).*
        - *evidence of this risk assessment occurring in these types of entities is often not formally documented, but may be evident from the discussions the auditor*

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has with management that management are in fact performing risk assessment procedures.

3. Monitoring

    a. Understanding those aspects of the entity's process that address:
        i. Ongoing and separate evaluations for monitoring the effectiveness of controls, and the identification and remediation of control deficiencies identified; and
        ii. The entity's internal audit function, if any, including its nature, responsibilities and activities;
            - *If the internal audit's responsibilities are related to financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit by reviewing the internal audit's plan for the period, if any, and discussing that plan with the appropriate individuals within the function.*
    b. Understanding the sources of the information used in the entity's process to monitor the system of internal control, and the basis upon which management considers the information to be sufficiently reliable for the purpose; and
    c. Evaluating whether the entity's process for monitoring the system of internal control is appropriate to the entity's circumstances considering the nature and complexity of the entity.

    - *For less complex entities (particularly owner-managed entities)*
        - *Auditor's understanding of monitoring of controls is often focused on how management or the owner-manager is directly involved in operations, as there may not be any other monitoring activities.*

    - *Matters that may be relevant to the auditor's understanding:*
        - *Design of the monitoring activities, (e.g. whether it is periodic or ongoing)*
        - *Performance and frequency*
        - *Evaluation of the results of the monitoring activities, on a timely basis, to determine whether the controls have been effective;*
        - *How identified deficiencies have been addressed through appropriate remedial actions, including timely communication of such deficiencies to those responsible for taking remedial action.*

    - *The auditor may also consider how the entity's process to monitor the system of internal control addresses monitoring information processing controls that involve the use of IT, for example:*
        - *Controls to monitor complex IT environments that evaluate the continuing design effectiveness and operating effectiveness of information processing controls*
        - *Controls that monitor the permissions applied in automated information processing controls that enforce the segregation of duties*
        - *Controls that monitor how errors or control deficiencies related to the automation of financial reporting are identified and addressed.*

4. Information System and Communication

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a. Understanding the entity's information processing activities, including its data and information, the resources to be used in such activities and the policies that define, for significant classes of transactions, account balances and disclosures:
    i. How information flows through the entity's information system, including how:
        1. Transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated in the general ledger and reported in the financial statements; and
        2. Information about events and conditions, other than transactions, is captured, processed and disclosed in the financial statements;
    ii. The accounting records, specific accounts in the financial statements and other supporting records relating to the flows of information in the information system;
        - *Examples of information outside of the general and subsidiary ledgers:*
            - *Information from lease agreements*
            - *Fair value information produced by management's experts*
            - *Information obtained from models, or from other calculations used to develop accounting estimates, including underlying data and assumptions used in those models (e.g. those affecting useful lives, interest rates)*
            - *Information about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.*
            - *Information from an tax returns and records.*
            - *Information from analyses prepared to support management's assessment of the entity's ability to continue as a going concern*

    iii. The financial reporting process used to prepare the entity's financial statements, including disclosures; and
    iv. The entity's resources, including the IT environment, relevant to (a)(i) to (a)(iii) above;
        - *Including human resources:*
            - *Competence, adequacy, adequate segregation of duties*

b. Understanding how the entity communicates significant matters that support the preparation of the financial statements and related reporting responsibilities in the information system and other components of the system of internal control:
    i. Between people within the entity, including how financial reporting roles and responsibilities are communicated;
    ii. Between management and those charged with governance; and
    iii. With external parties, such as those with regulatory authorities; and
c. Evaluating whether the entity's information system and communication appropriately support the preparation of the entity's financial statements in accordance with the applicable financial reporting framework.

Matters that may be considered when understanding the policies that define the flows of information relating to significant classes of transactions, account balances, and disclosures include:

i. The data or information relating to transactions, other events and conditions to be processed;

ii. The information processing to maintain the integrity of that data or information;

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iii. The information processes, personnel and other resources used in the information processing process.

Auditor's procedures to obtain an understanding may include:

i. Inquiries of relevant personnel about the procedures used to initiate, record, process and report transactions or about the entity's financial reporting process
ii. Inspection of policy or process manuals or other documentation of the entity's information system;
iii. Observation of the performance of the policies or procedures by entity's personnel; or
*iv. Selecting transactions and tracing them through the applicable process in the information system (i.e., performing a **walk-through**).*
v. Automated techniques such as digital download from database that store accounting records (i.e., extract of all journal entries posted during the period)

5. Control Activities

a. Identifying controls that address risks of material misstatement at the assertion level in the control activities component as follows:
    i. Controls that address a risk that is determined to be a **significant risk**;
    ii. Controls over journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments;
    iii. Controls for which the auditor plans to test operating effectiveness in determining the nature, timing and extent of substantive testing, which shall include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; and
    iv. Other controls that the auditor considers are appropriate to enable the auditor to meet the objectives of paragraph 13 with respect to risks at the assertion level, based on the auditor's professional judgment;
b. Based on controls identified in (a), identifying the IT applications and the other aspects of the entity's IT environment that are subject to risks arising from the use of IT;
c. For such IT applications and other aspects of the IT environment identified in (b), identifying:
    i. The related risks arising from the use of IT; and
    ii. The entity's general IT controls that address such risks; and
d. For each control identified in (a) or (c)(ii):
    i. Evaluating whether the control is **designed effectively** to address the risk of material misstatement at the assertion level, or effectively designed to support the operation of other controls; and
    ii. Determining whether the control has been **implemented** by performing procedures in addition to inquiry of the entity's personnel.

The auditor focuses on information processing controls, which are controls applied during the processing of information in the entity's information system that directly address risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information). However, the auditor is not required to identify and evaluate all information processing controls related to the entity's policies that define the flows of transactions and other aspects of the entity's information processing activities for the significant classes of transactions, account balances and disclosures.

In less complex entities:

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- *Control activities are likely similar with those of larger entities, but formality with which the operate may vary.*
- *In less complex entities more controls may be applied directly by management*
- *It may be **less practicable to establish segregation of duties** because of fewer employees. However, in an owner-managed entity, the owner-manager may be able to exercise more effective **oversight through direct involvement** than in a larger entity, which may compensate for the generally more limited opportunities for segregation of duties. Although domination of management by a single individual can be a potential control deficiency since there is an opportunity for **management override of controls**.*

The auditor's plans to test the operating effectiveness of controls may also be influenced by the identified risks of material misstatement at the financial statement level. For example, if deficiencies are identified related to the control environment, this may affect the auditor's overall expectations about the operating effectiveness of direct controls.

Other controls that the auditor may consider are appropriate to identify, and evaluate the design and determine the implementation:

- *Controls that address risks assessed as higher on the spectrum of inherent risk but have not been determined to be a significant risk;*
- *Controls related to reconciling detailed records to the general ledger; or*
- *Complementary user entity controls, if using a service organization.*

*Evaluating whether controls are **designed effectively***

- *whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements (i.e., the control objective).*

Evaluating whether the controls are implemented

- *establish whether the controls exists and that the entity is using it.*

RAP to obtain evidence about design and implementation of controls in the control activities component may include:

1. *Inquiry of entity personnel*
2. *Observing the application of specific controls*
3. *Inspecting documents and records*

- *Inquiry alone is not sufficient for this purpose.*

Control Deficiencies Within the Entity's System of Internal Control

- Based on the auditor's evaluation of each of the components of the entity's system of internal control, the auditor shall determine whether one or more control deficiencies have been identified.

Control deficiency

-

Significant deficiency

-

Circumstances that may indicate a significant control deficiency exists include matters such as:

- *The identification of fraud of any magnitude that involves senior management;*
- *Identified internal processes that are inadequate relating to the reporting and communication of deficiencies noted by internal audit;*

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- *Previously communicated deficiencies that are not corrected by management in a timely manner;*
- *Failure by management to respond to significant risks, for example, by not implementing controls over significant risks; and*
- *The restatement of previously issued financial statements.*

Identifying and Assessing the Risks of Material Misstatement

Identifying and assessing risks of material misstatement

The auditor shall identify the risks of material misstatement and determine whether they exist at:

4. At the financial statements level

   For identified risks of material misstatement at the financial statement level, the auditor shall assess the risks and:

   a. Determine whether such risks affect the assessment of risks at the assertion level; and
   b. Evaluate the nature and extent of their pervasive effect on the financial statements.

   - *Risks of material misstatement at the FS level refer to risks that relate pervasively to the FS as a whole, and potentially affect many assertions.*
   - *These not necessarily identifiable with specific assertions at the class of transactions, account balance or disclosure level (e.g., risk of management override of controls). Rather, these may pervasively increase the RMM at the assertion level.*
   - *The auditor's evaluation of whether risks identified relate pervasively to the FS supports the auditor's assessment of the RMM at the FS level. In other cases, a number of assertions may also be identified as susceptible to the risk, and may therefore affect the auditor's risk identification and assessment of RMM at the assertion level.*
   - *Example: The entity faces operating losses and liquidity issues and is reliant on funding that has not yet been secured. In such a circumstance, the auditor may determine that the going concern basis of accounting gives rise to a RMM at the FS level. In this situation, the accounting framework may need to be applied using a liquidation basis, which would likely affect all assertions pervasively.*

   - *The auditor's understanding, including the related evaluations, of the control environment and other components of the system of internal control may raise doubts about the auditor's ability to obtain audit evidence on which to base the audit opinion or be cause for withdrawal from the engagement where withdrawal is possible under applicable law or regulation.*

     - *Example: As a result of evaluating the entity's control environment, the auditor has concerns about the integrity of the entity's management, which may be so serious as to cause the auditor to conclude that the risk of intentional misrepresentation by management in the financial statements is such that an audit cannot be conducted. As a result of evaluating the entity's information system and communication, the auditor determines that significant changes in the IT environment have been poorly managed, with little oversight from management and those charged with governance. The auditor concludes that there are significant concerns about the condition and reliability of the entity's accounting records. In such circumstances, the auditor may determine that it is*

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unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the FS.

5. At the assertion level for classes of transactions, account balances and disclosures

These are RMM that do not relate pervasively to the FS as a whole.

The auditor shall determine the relevant assertions and the related significant classes of transactions, account balances and disclosures.

Disclosures that may be significant
These include both quantitative and qualitative disclosures for which there is one or more relevant assertions. Examples of disclosures that have qualitative aspects and that may have relevant assertions and may therefore be considered significant include disclosures about

- *Liquidity and debt covenants of an entity in financial distress.*
- *Events or circumstances that have led to the recognition of an impairment loss.*
- *Key sources of estimation uncertainty, including assumptions about the future.*
- *The nature of a change in accounting policy, and other relevant disclosures required by the applicable financial reporting framework, where, for example, new financial reporting requirements are expected to have a significant impact on the financial position and financial performance of the entity.*
- *Share-based payment arrangements, including information about how any amounts recognized were determined, and other relevant disclosures.*
- *Related parties, and related party transactions.*
- *Sensitivity analysis, including the effects of changes in assumptions used in the entity's valuation techniques intended to enable users to understand the underlying measurement uncertainty of a recorded or disclosed amount*

Inherent risk

For identified risks of material misstatement at the assertion level, the auditor shall assess inherent risk by assessing the **likelihood** and **magnitude of misstatement**.

In doing so, the auditor shall take into account how, and the degree to which:
a. Inherent risk factors affect the susceptibility of relevant assertions to misstatement; and

- *The significance of the **combination** of the **likelihood of a misstatement occurring** and the **magnitude of the potential misstatement** were the misstatement to occur determines where on the **spectrum of inherent risk** the identified risk is assessed, which informs the auditor's design of further audit procedures to address the risk.*

SPECTRUM OF INHERENT RISK		
Likelihood of misstatement	*Higher risk*	*Significant risk*
	Lower risk	*Higher risk*
	Magnitude of misstatement	

Likelihood of misstatement – consider the possibility that a misstatement may occur, based on consideration of inherent risk factors.

Magnitude of misstatement – consider the qualitative and quantitative aspects of possible misstatement (i.e., misstatements in assertions about classes of transactions,

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account balances or disclosures may be judged to be material due to size, nature or circumstances)

b. The risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level.

The auditor shall determine whether any of the assessed risks of material misstatement are **significant risks**.

- *This allows the auditor to focus more attention on those risks that are on the upper end of the spectrum of inherent risk, through the performance of certain required responses, including:*
  - *PSA 315 – If significant risk exists, the auditor is required to identify controls that address them and evaluate whether designed effectively and has been implemented.*
  - *PSA 330 – Controls that address significant risk are required to be tested in the current period (when the auditor intends to rely on the operating effectiveness of such controls). Substantive procedures are to be planned and performed that are specifically responsive to the identified significant risk.*
  - *PSA 330 – The auditor should obtain more persuasive audit evidence the higher the auditor's assessment of risk.*
  - *PSA 260 – The auditor should communicate significant risks to those charged with governance.*
  - *PSA 701 – The auditor should take into account significant risks when determining those matters that required significant audit attention, which are matters that may be KAM.*
  - *PSA 220 - Timely review of audit documentation by the engagement partner at the appropriate stages during the audit allows significant matters, including significant risks, to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report.*
  - *PSA 600 - requires more involvement by the group engagement partner if the significant risk relates to a component in a group audit and for the group engagement team to direct the work required at the component by the component auditor.*

- *Examples:*
  - *Cash at a supermarket retailer would ordinarily be determined to be a high likelihood of possible misstatement (due to the risk of cash being misappropriated), however the magnitude would typically be very low (due to the low levels of physical cash handled in the stores). The combination of these two factors on the spectrum of inherent risk would be unlikely to result in the existence of cash being determined to be a significant risk.*
  - *An entity is in negotiations to sell a business segment. The auditor considers the effect on goodwill impairment, and may determine there is a higher likelihood of possible misstatement and a higher magnitude due to the impact of inherent risk factors of subjectivity, uncertainty and susceptibility to management bias or other fraud risk factors. This may result in goodwill impairment being determined to be a significant risk.*

- *The auditor also takes into the account the relative effects of inherent risk factors when assessing inherent risk. The lower the effect of inherent risk factors, the lower the assessed risk is likely to be. Risks of material misstatement that may be assessed as*

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having higher inherent risk and may therefore be determined to be a significant risk, may arise from matters such as the following:

- *Transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved.*
- *Accounting estimates that have high estimation uncertainty or complex models.*
- *Complexity in data collection and processing to support account balances.*
- *Account balances or quantitative disclosures that involve complex calculations.*
- *Accounting principles that may be subject to differing interpretation.*
- *Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions.*

The auditor shall determine whether **substantive procedures alone cannot provide sufficient appropriate audit evidence** for any of the risks of material misstatement at the assertion level.

- *Due to the nature of the risk, the only way to obtain sufficient appropriate evidence is to test the operating effectiveness of controls*
- *This applies to **routine business transactions subject to highly automated processing with little or no manual intervention**, such as in circumstances where a **significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form** such as in an information system that involves a high degree of integration across its IT applications. In such cases:*
  - *Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.*
  - *The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.*
  - *Example:*
    - *It is typically not possible to obtain sufficient appropriate audit evidence relating to revenue for a telecommunications entity based on substantive procedures alone. This is because the evidence of call or data activity does not exist in a form that is observable. Instead, substantial controls testing is typically performed to determine that the origination and completion of calls, and data activity is correctly captured (e.g., minutes of a call or volume of a download) and recorded correctly in the entity's billing system.*

<u>Control risk</u>

- If the auditor plans to test the operating effectiveness of controls, the auditor shall assess control risk.
- **If the auditor does not plan to test the operating effectiveness of controls, the auditor's assessment of control risk shall be such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk**.

- *The initial expectation of the operating effectiveness of controls is based on the auditor's evaluation of the design, and the determination of implementation, of the identified controls in the control activities component. Once the auditor has tested the operating effectiveness of the controls in accordance with ISA 330, the auditor will be*

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able to confirm the initial expectation about the operating effectiveness of controls. If the controls are not operating effectively as expected, then the auditor will need to revise the control risk assessment.

- *If the auditor plans to test the operating effectiveness of controls, it may be necessary to test a combination of controls to confirm the auditor's expectation that the controls are operating effectively. The auditor may plan to test both direct and indirect controls, including general IT controls, and, if so, take into account the combined expected effect of the controls when assessing control risk. To the extent that the control to be tested does not fully address the assessed inherent risk , the auditor determines the implications on the design of further audit procedures to reduce audit risk to an acceptably low level.*

- *When the auditor plans to test the operating effectiveness of an automated control, the auditor may also plan to test the operating effectiveness of the relevant general IT controls that support the continued functioning of that automated control to address the risks arising from the use of IT, and to provide a basis for the auditor's expectation that the automated control operated effectively throughout the period. When the auditor expects related general IT controls to be ineffective, this determination may affect the auditor's assessment of control risk at the assertion level and the auditor's further audit procedures may need to include substantive procedures to address the applicable risks arising from the use of IT. Further guidance about the procedures that the auditor may perform in these circumstances is provided in ISA 330.*

Evaluating the Audit Evidence Obtained from the Risk Assessment Procedures

The auditor shall evaluate whether the audit evidence obtained from the risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement. If not, the auditor shall perform additional risk assessment procedures until audit evidence has been obtained to provide such a basis. In identifying and assessing the risks of material misstatement, the auditor shall take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management.

Classes of Transactions, Account Balances and Disclosures that Are Not Significant, but Which Are Material

For material classes of transactions, account balances or disclosures that have not been determined to be significant classes of transactions, account balances or disclosures, the auditor shall evaluate whether the auditor's determination remains appropriate. (Ref: Para. A233±A235)

- *When considered significant?*
  - *A class of transactions, account balance or disclosure for which **there is one or more relevant assertions**.*

- *When considered material?*
  - *Classes of transactions, account balances or disclosures are material if omitting, misstating or obscuring information about them could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole.*

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- *When a class of transactions, account balance or disclosure is determined to be **significant**, the class of transactions, account balance or disclosure is **also a material** class of transactions, account balance or disclosure for the purposes of paragraph 18 of ISA 330. (ISA 330 par. 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.)*

Revision of risk assessment

If the auditor obtains new information which is inconsistent with the audit evidence on which the auditor originally based the identification or assessments of the risks of material misstatement, the auditor shall revise the identification or assessment. (Ref: Para. A236)

Documentation

The auditor shall include in the audit documentation: (Ref: Para. A237±A241)

a. The discussion among the engagement team and the significant decisions reached;
b. Key elements of the auditor's understanding in accordance with paragraphs 19, 21, 22, 24 and 25; the sources of information from which the auditor's understanding was obtained; and the risk assessment procedures performed;
c. The evaluation of the design of identified controls, and determination whether such controls have been implemented, in accordance with the requirements in paragraph 26;
d. The identified and assessed risks of material misstatement at the financial statement level and at the assertion level, including significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for the significant judgments made.

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