AUDITING STANDARDS BOARD MEETING AGENDA
July 20-22, 2021
VideoConference (Zoom)
(Times are EST)

Tuesday, July 20 **11:00am –5:00pm**		Wednesday, July 21 **11:00am – 3:30pm**		Thursday, July 22 **11:00am – 3:45pm**	
11:00–11:30	**Chair/AICPA Update**	11:00–1:00 Agenda Item **3**	**Audits of LCEs** Discuss Issues	11:00–11:30 Agenda Item **5**	**Quality Management** Update
11:30–1:00 Agenda Item **1**	**IAASB Update**			11:30–12:30 Agenda Item **2**	**Risk Assessment** Draft Document
1:00–1:30	*Break*	*1:00–1:30*	*Break*	*12:30–1:00*	*Break*
1:30–3:00 Agenda Item **2**	**Risk Assessment** Draft Document	1:30–3:30 Agenda Item **4**	**Group Audits** Discuss Issues/Draft Document	1:00–2:15 Agenda Item **6**	**ASB Strategic Planning** Executive Session
3:00–3:30	*Break*			*2:15–2:30*	*Break*
3:30–5:00 Agenda Item **2**	**Risk Assessment** Draft Document			2:30–3:45 Agenda Item **6**	**ASB Strategic Planning** Executive Session

AUDITING STANDARDS BOARD (ASB)
Meeting Highlights
May 10-12, 2021
Videoconference

MEETING ATTENDANCE

ASB Members	AICPA Staff
Tracy Harding, *Chair*	Jennifer Burns, *Chief Auditor*
Brad Ames	Linda Delahanty, *Senior Technical Manager—A&A Standards*
Monique Booker	Mike Glynn, *Senior Technical Manager—A&A Standards*
Patricia Bottomly	Ahava Goldman, *Associate Director—A&A Standards*
Sherry Chesser	Hiram Hasty, *Associate Director—A&A Standards*
Harry Cohen	Judith Sherinsky, *Senior Technical Manager—A&A Standards*
Jeanne Dee	Teighlor March, *Asst. General Counsel—General Counsel & Trial Board*
Horace Emery	Andy Mrakovcic, *Technical Manager— A&A Standards*
Audrey Gramling	
Diane Hardesty	Note: The meeting was open to observers, whose names are not listed.
Robert Harris	
Kathy Healy	
Jon Heath	
Clay Huffman	
Kristen Kociolek	
Sara Lord	
Maria Manasses	
Chris Rogers	
Tania Sergott	

Tracy welcomed the new members who will be joining the ASB and thanked the outgoing members, Monique Booker, Audrey Gramling, Kristen Kociolek, and Sara Lord, for their years of service. He provided an update of recent activities.

Highlights of the January and March ASB meetings were approved unanimously.

1. **Specialists/Investments**

Ms. Bottomly led the ASB in a discussion of proposed SAS. The ASB voted unanimously to issue the SAS as a final standard after directing that the following substantive revisions be made, in addition to certain editorial changes:

AU-C section 501

- Paragraph A71, change "paragraph .07 of" to "the evaluation required by AU-C" and insert footnote referring to paragraph 7 of AU-C section 500.
- Par. A72 change "one or more of" to "matters such as"
- Par. A72 last bullet, change to separate subparagraph.

- Paragraphs A84-A86, content substantively unchanged but moved among the three paragraphs for better flow.
    - Par. A88, add "The management's specialist has a conflict of interest relevant to the specialist's work." as a separate bullet.

AU-C section 540

- No amendment to par. A126
- Appendix C, numbered par. 2, delete the second sentence and replace with "Quoted market prices for derivative instruments and securities listed on national exchanges or over-the-counter markets that are obtained from sources such as financial publications, the exchanges, NASDAQ, or pricing services based on sources such as these generally provide sufficient evidence of the fair value of the derivative instruments and securities."
- Appendix C, numbered paragraphs 3, 4, 12 and 13, delete the phrase "directly or indirectly control or significantly"
- Appendix C, numbered par. 4, change the first sentence to "The procedures performed under section 550, Related Parties, can assist the auditor in evaluating the reliability of the audit evidence obtained from the pricing service by taking into account the ability of management to influence the information obtained from the pricing service through relationships between the entity and the pricing service."
- Appendix C, numbered par. 13, delete the phrase "considering the entity's model and considering any contradictory evidence."
- Appendix C, numbered par. 14, revise to read as follows: " The procedures performed under section 550, Related Parties, can assist the auditor in evaluating the reliability of the audit evidence obtained from the broker or dealer by taking into account the ability of management to influence the information obtained from the broker or dealer through relationships between the entity and the broker or dealer."

AU-C section 630

- Par. A30, omit the phrase "including the need for the auditor's internal specialist to apply professional skepticism."
- Par. A31, delete "for example, testing the entity's process used to develop an accounting estimate, including when a management's specialist is involved in developing the estimate or developing an independent expectation of an estimate" from last subbullet of second bullet.
- Par. A35, insert "the risk of material misstatement in the matter to which the specialist's work relates"
- Par. A41, re-order the bullets.

2. **Risk Assessment**

Ms. Manasses led the ASB in a discussion of issues and proposed changes to proposed Statement on Auditing Standards (SAS) *Identifying and Assessing the Risks of Material Misstatement*

Through Understanding the Entity and its Environment (Proposed SAS), in response to issues raised in the comment letters received on the exposure draft of the proposed SAS.

Significant comments or observations by the ASB members related to the issues presented were as follows:

- *Spectrum of Inherent Risk*
    - The ASB agreed with the addition of a description of the spectrum of inherent risk within the definition of inherent risk factors but suggested adding a separate caption titled *spectrum of inherent risk* within the definition section referring to the definition of inherent risk factors in order to enhance the searchability of the phrase.
- *Evaluation of Internal Control Components (Excluding Control Activities)—*
    - ASB members made the following observations:
- ASB members expressed the view, and agreed with the Task Force, that controls that addressed the risks of material misstatement exist within the control activities component. However, such controls could exist in other components as well.
- An ASB member was still concerned that the work effort as articulated by the word "evaluate" is not clear.
- ASB members supported the Task Force's recommendation that in obtaining an understanding of the control environment, the entity's risk assessment process, the entity's process to monitor the system of internal control, and the information system and communication components, inquiry alone may be sufficient.
- ASB members expressed the view that the application material provides sufficient guidance with respect to obtaining an understanding of the entity's system of internal control, but the Task Force was directed to determine whether guidance can be further enhanced by improving its organization.
    - After discussion, the ASB agreed with the Task Force's recommendation to edit the requirements in paragraphs 21b, 22b, 24b, and 25c and to clarify the guidance that inquiry alone may be sufficient in obtaining an understanding of the control environment, the entity's risk assessment process, the entity's process to monitor the system of internal control, and the information system and communication components of internal control.
- *The Entity's Risk Assessment Process and Interplay with AU-C section 240*
    - The ASB agreed with the Task Force's recommendation to clarify the requirement in paragraph 22 to specifically refer to understanding the entity's process for identifying the potential for fraud. This change is intended to align paragraph 22 of the proposed SAS with paragraph 17 of AU-C section 240..
- *Evaluation of the Information System and Communication*
    - The ASB agreed with the Task Force's recommendations to
- Add application material to paragraph 25c referring to Appendix C, which further describes the information system and communication component.

- edit paragraph 25 to include a reference to considering the nature and complexity of the entity.
- *Separating the Requirements Related to Control Activities*
    - The ASB agreed with the Task Force's recommendation to restructure paragraph 26 into separate paragraphs to enhance clarity and readability, in response to comments related to complexity and understandability of the proposed SAS.
- *Controls over Journal Entries*
    - The ASB reviewed proposed revisions to paragraph .26(a)(ii) (temporarily renumbered as 26A*b*) and conforming amendments to paragraph 32(a)(i) in AU-C section 240. The ASB directed the Task Force to modify the requirement in the proposed SAS, rather than making conforming amendments to AU-C section 240.
- *Assessing Control Risk*
    - In response to specific comments about the clarity of paragraph 34, the ASB agreed to edit paragraph 34 so that it reads as follows:
        - 34. For identified risks of material misstatement at the assertion level, the auditor should assess control risk based on the auditor's understanding of controls and the auditor's plan to test the operating effectiveness of controls. If the auditor does not plan to test the operating effectiveness of controls, the auditor should assess control risk at maximum such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.
    - It was specifically noted that this change was made for purposes of clarifying the language to make the requirement more understandable and does not create a difference in what is required by ISA 315 (Revised 2019) and by the proposed SAS (that is, not ISA-plus, ISA-minus, or ISA-different).
    - The ASB also agreed with the addition of guidance that addresses how the auditor's evaluation of design and determination of implementation of identified controls may impact the nature or timing of the auditor's further audit procedures.
- *Clarifying the Concept of Reasonable Possibility*
    - The ASB agreed with the addition of application material that explains that a reasonable possibility that a risk of material misstatement exists when the likelihood of a material misstatement occurring is more than remote.
- *Documenting a Combined Assessment of Inherent Risk and Control Risk*
    - The ASB agreed to include guidance in the proposed SAS explaining that the auditor may, but is not required to, document a combined assessment of inherent risk and control risk.
- *New "Explanatory Memorandum" or "Wrap" Document*
    - The ASB directed the Task Force to prepare an executive summary to be issued simultaneously with the final SAS. This nonauthoritative document would be

reviewed by the ASB before issuance, similar to the explanatory memorandum that accompanies a proposed standard in an exposure draft.

3. IAASB Update

Wendy Stevens, AICPA-nominated IAASB member, presented an update on IAASB activities.

4. Direct review engagements

The Board continued its discussion of whether to revise the attestation standards to (a) provide for direct review engagements, and (b) eliminate the prohibitions on reviews of some or all of the following: prospective financial information, internal control, and compliance with requirements of specified laws, regulations, rules, contracts, or grants. After discussion of issues, including the perceived inflexibility of extant standards, the Board directed that the Attestation Standards Task Force focus on broad issues related to attestation review engagements such as relevance, reporting issues, and practice issues, and in doing so explore further the implications for removing the previously mentioned prohibitions. The Board charged the Task Force with developing a consultation paper intended to elicit input from practitioners and other stakeholders regarding the extent to which extant attestation standards limit a practitioners ability to perform engagements in response to needs in the marketplace. The Accounting and Review Services Committee will be asked for input given that committee's expertise with review engagements and the concept of limited assurance.

5. Group Audits

Ms. Burzenski, Chair of ASB's Group Audits Task Force and a member of the IAASB's ISA 600 Task Force, led the ASB in a discussion of proposed International Standard on Auditing (ISA) 600 (Revised), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors*) (ED). The ASB is monitoring the changes being made to the ED in anticipation of converging AU-C 600 with ISA 600 (Revised). Dora Burzenski presented the changes that the IAASB had directed be made to the ED at their March 2021 meeting. The topics that were discussed were the scope and applicability of the proposed ISA, definitions, communications with component auditors, materiality, and the risk-based approach.

Significant comments by ASB members were as follows:

- The proposed ISA is not always clear about what documentation needs to reside in the group auditor's file and what documentation needs to reside in the component auditor's file. Ms. Burzenski noted that it is unlikely that the proposed ISA will include more detailed guidance in this area because the ISA is intended to be principles-based; implementation guidance on this topic may need to be provided in a document outside the ISA

- The revision to the example in paragraph A5 is helpful because it clarifies that the three entities are being aggregated into a single component for the purpose of performing audit procedures because they are similar (e.g., they have a common system of internal control and are under common management), and not solely for the purpose of reducing the amount of testing.

- Paragraph 44*h* requires the group auditor to request that the component auditor communicate matters relevant to the group auditor's conclusion with regard to the group audit, such as the component auditor's overall findings, conclusions, or opinion. Paragraph A112B indicates that although an overall summary memorandum or report from the component auditor, including the component auditor's overall findings, conclusions, or opinion, may provide audit evidence about the work performed by the component auditor, such information typically is not sufficient on its own. This statement may create an expectation by the group auditor of a communication that is more detailed than what is required.

- Paragraph A52*b* indicates that a factor that contributes to two-way communication is "clarity of the instructions to the component auditor, particularly when the component auditor is from another firm and may not be familiar with the policies and procedures of the group auditor." An ASB member commented that it would not be practical to communicate the policies and procedures of the group auditor's firm to a component auditor from a non-network firm, and in some cases, even a network firm. The member believes that a component auditor need not follow the group auditor's policies and procedures in order for the group auditor to obtain sufficient appropriate audit evidence to express an opinion on the group financial statements.

- An ASB member requested a clarification of the difference between company performance materiality and tolerable misstatement for an equity method investment.

- In paragraph 25, the words "results of those procedures" at the end of the sentence refers to the component auditor's evaluation of the risks of material misstatement of the group financial statements. As worded, the paragraph would require the group auditor to "evaluate the component auditor's evaluation" of the risks of material misstatement of the group financial statements. To avoid the notion of evaluating an evaluation, it was suggested that the words "shall evaluate" be changed back to "shall consider."

- The application guidance regarding materiality (paragraphs A73-A74) linked to paragraph 29 may cause regulators to expect excessive documentation about how the auditor mitigated aggregation risk, for example in an audit of a large disaggregated group. Some of the guidance is these paragraphs relates to methodology and would be more appropriate in implementation guidance.

- Paragraphs A78-A79A indicate that in applying ISA 315, the group auditor develops an initial expectation about the potential risks of material misstatement and may, and often will, involve component auditors in risk assessment procedures. An ASB member believes that these application paragraphs may establish an expectation that the group auditor will communicate initial thoughts about the risk assessment, the component auditor will provide feedback, and a series of back and forth communications will follow. Because risk assessment is performed at the group level, the proposed standard should not establish such an expectation.

AUDITING STANDARDS BOARD (ASB)
Meeting Highlights
June 9, 2021
Videoconference

MEETING ATTENDANCE

ASB Members
Tracy Harding, *Chair*
Maxene Bardwell
Patricia Bottomly
Samantha Bowling
Sherry Chesser
Harry Cohen
Jeanne Dee
Horace Emery
Diane Hardesty
Robert Harris
Kathy Healy
Clay Huffman
Greg Jenkins
Maria Manasses
Andrew Prather
Chris Rogers
Tania Sergott

Absent
Brad Ames (absent)
Jon Heath (absent)

AICPA Staff
Jennifer Burns, *Chief Auditor*
Linda Delahanty, *Senior Technical Manager—A&A Standards*
Mike Glynn, *Senior Technical Manager—A&A Standards*
Ahava Goldman, *Associate Director—A&A Standards*
Hiram Hasty, *Associate Director—A&A Standards*
Judith Sherinsky, *Senior Technical Manager—A&A Standards*
Teighlor March, *Asst. General Counsel—General Counsel & Trial Board*
Andy Mrakovcic, *Technical Manager— A&A Standards*

IASTF Members and Guests
Andrew Alemian, *PwC*
Dora Burzenski, *Deloitte*
Susan Jones, *KPMG*
Len Jui, *KPMG*
Diane Larsen, *EY*
Wendy Stevens, *Mazars*

1. **Group Audits**

The ASB discussed the agenda materials for the IAASB's June 2021 discussion of proposed (ISA) 600 (Revised)*, Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors).* The following are some of the ASB's comments on the June 2021 draft of proposed ISA 600 (Revised):

- Paragraph A39-A39A discuss situations in which the fee quoted for an engagement is insufficient and may diminish the firm's ability to perform the engagement in accordance with professional standards and legal or regulatory requirements. Because threats to independence related to self-interest are addressed in the IESBA's International Code of Ethics for Professional Accountants and could be relevant to any audit, not just a group audit, the material related to fees should be deleted from proposed ISA 600 (Revised).

- The phrase in paragraph 21b "has otherwise been made available to the group engagement partner" is not all-encompassing of the ways in which the group engagement partner could become aware of the results of the monitoring and remediation process or

external inspections with respect to the component auditor's firm. The following is a suggested revision to the wording in paragraph 21b so that it encompasses all the ways in which such information could become known to the group engagement partner:

- When ***the group engagement partner is aware of*** information about the results of the monitoring and remediation process or external inspections with respect to the component auditor's firm ~~has been provided by the firm or has otherwise been made available to the group engagement partner~~, determine the relevance of such information to the group auditor's determination in paragraph 21(a)

- Subparagraph *b* of paragraph 22 indicates that if the group engagement partner has serious concerns about the matters in paragraphs 18–21, the group auditor is required to obtain sufficient appropriate audit evidence relating to the work to be performed at the component without involving that component auditor. The term "serious concerns" implies a range of concerns, e.g., serious, less serious, and not serious. It is unclear how the group engagement partner could have a range of concerns if the component auditor refuses to confirm that he or she will cooperate with the group auditor, including performing the work requested by the group auditor. If the component auditor doesn't confirm, it would be expected that the group auditor would not involve the component auditor.

- For many of the examples in paragraph 9a, it is difficult to determine why the circumstance described represents a challenge to the exercise of professional skepticism in a group audit. For example, it is not clear how the fact that component auditors may be subject to varying cultural influences that affect the nature of the biases to which they are subject relates to professional skepticism. The IAASB may wish to reconsider what this list of items is intended to represent because many of the items do not appear to be examples of situations that would challenge the exercise of professional skepticism.

- Paragraph A29 discusses the ways in which the group auditor may be able to overcome restrictions on access to information or people, including when the component is an investment accounted for by the equity method. Paragraph A29A describes possible procedures to obtain sufficient appropriate audit evidence in this situation. The ISA doesn't really acknowledge that it may be unnecessary to "pierce through to the group audit" to obtain evidence about the component. It may be sufficient to obtain the audited financial statements of the investee and do some work on that. In addition, the draft needs to explain how the group auditor could comply with all the ISA 600 requirements for an equity method investment, if that is the IAASB's intention.

- The second sentence in paragraph A72D states, "The group auditor assesses the inherent risk by assessing the likelihood and magnitude of identified risks of material misstatement, taking into account the inherent risk factors." This sentence is inconsistent with the requirement in paragraph 26B of the proposed ISA which states, "In applying ISA 315 (Revised 2019), based on the understanding obtained in paragraph 24, the group auditor shall take responsibility for the identification and the assessment of the risks of material misstatement of the group financial statements"

- The third sentence of paragraph A72D states "After identifying the risks of material misstatement, including those communicated by component auditors, the group auditor determines the relevant assertions and related significant classes of transactions, account balances and disclosures of the group financial statements." This statement is inconsistent with ISA 315 which does not specify the order in which these activities occur.

2. Audits of Less Complex Entities (LCE)

The ASB discussed the agenda materials for the IAASB's June 2021 discussion of proposed ISA for Audits of Financial Statements of Less Complex Entities. The ASB agreed that for purposes of exposure of the proposed SAS, the Explanatory Memorandum was of higher priority than the wording of the proposed SAS itself, and identified the following issues as important for the Explanatory Memo to address:

Significant comments and observations were as follows:

<u>Reasonable assurance</u>

- The ASB expressed concern that the same level of assurance is proposed to be obtained in an audit performed in accordance with the proposed standard as that obtained in an audit in accordance with the full ISAs. The proposed standard omits procedures that are required in an audit performed in accordance with the full ISAs.

- The ASB believes that this is a potential fatal flaw in the proposed standard and requested that Ms. Stevens express to the IAASB that the explanatory memorandum that will be included in the exposure draft of the proposed standard include a summary as to how the IAASB believes that *reasonable assurance* is obtained in an audit performed in accordance with the proposed standard and ask respondents for their views.

- The IAASB Task Force's mapping documents illustrate which ISA requirements are not included in the proposed standard. While such documents should be available for consideration by respondents, the ASB requested that Ms. Stevens express to the IAASB a need for a summary of the major differences between an audit in accordance with the full ISAs vs. the proposed standard to be included in the explanatory memorandum of the exposure draft.

<u>Omission of group audits from the proposed standard</u>

- The ASB requested that Ms. Stevens request that the explanatory memorandum clearly state whether a component audit could be performed in accordance with the proposed standard.

<u>Proposed "stable platform"</u>

- The ASB requested that Ms. Stevens express to the IAASB the need to discuss the proposed "stable platform" in the explanatory memorandum. Respondents should be requested to comment as to whether they believe that consideration should be given to revising the

standard at the same time an ISA is being revised. The request for comment should not bias respondents with respect to concern with "standards overload."

Reporting

- If the intent is that the same level of assurance is obtained in an audit in accordance with the proposed standard as in an audit in accordance with the full ISAs, certain ASB members believe that the proposed report should mirror the report issued in accordance with the full ISAs.
- If the intent is that a different level of assurance is obtained from that which would have been obtained had the audit been performed in accordance with the full ISAs, the ASB stated that the report should disclose the procedures omitted and the evidence not obtained.
- The proposed standard is "light" with respect to certain reporting elements such as an audit on financial statements prepared in accordance with a special purpose framework. If the intent is that the proposed standard is to "stand-alone," such requirements should be included.

Ms. Stevens also asked that the ASB members e-mail her their individual thoughts as to whether the applicability and authority of the proposed standard is clear.

The ASB stated that it will discuss its preliminary intentions with respect to the development of a SAS addressing audits of LCEs SAS at its July 2021 meeting.

AICPA

Agenda Item 2B

The following table represents a comparison of the requirements in the proposed SAS, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* [marked from ISA 315 (Revised 2019)], extant AU-C section 315 of the same title, and selected paragraphs of PCAOB's AS 2110, *Identifying and Assessing Risks of Material Misstatements*. This comparison is not intended to be a full, comprehensive analysis of the differences between the proposed SAS, extant AU-Section 315, and AS 2110. In regard to AS 2210, this comparison only includes the relevant PCAOB paragraphs for purposes of this comparison.

Proposed SAS (marked for differences from ISA)	*Extant AU-C 315*	*AS 2110*
Introduction	**Introduction**	
Scope of this ~~ISA~~Proposed SAS	**Scope of This Section**	
1. This proposed Statement on Auditing Standards (SAS)~~International Standard on Auditing (ISA)~~ addresses~~deals with~~ the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements.	.01 This section addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control.	.01 This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement[1] of the financial statements.
		.02 Paragraphs .04-.58 of this standard discuss the auditor's responsibilities for performing risk

		assessment procedures.[2] Paragraphs .59-.73 of this standard discuss identifying and assessing the risks of material misstatement using information obtained from performing risk assessment procedures.
Key Concepts in ~~this ISA~~this proposed SAS		
2. ~~ISA~~AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance* With *Generally Accepted Auditing Standards*, addresses ~~deals with~~ the overall objectives of the auditor in conducting an audit of the financial statements, including to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.[1] Audit risk is a function of the risks of material misstatement and detection risk.[2] ~~ISA~~AU-C section 200 explains that the risks of material misstatement may exist at two levels:[3] the overall financial statement level; and the assertion level for classes of transactions, account balances and disclosures.		
3. ~~ISA~~AU-C section 200 requires the auditor to exercise professional judgment in planning and performing an audit, and to plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.[4]		
4. Risks at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level consist of two components,[5] inherent and control risk: • Inherent risk is described as the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or		

[1] ~~Paragraph .19 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.ISAAU-C section 200, paragraph 1719~~

[2] ~~Paragraph .14 of AU-C section 200.ISAAU-C section 200, paragraphs 13(c)14~~

[3] ~~Paragraph .A38 of AU-C section 200.ISAAU-C section 200, paragraph A36A38~~

[4] ~~Paragraphs .17–.18 of AU-C section 200.ISAAU-C section 200, paragraphs 1517–16 18~~

[5] Paragraph .14 of AU-C section 200.

when aggregated with other misstatements, before consideration of any related controls.		
• Control risk is described as the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's system of internal control.		
5. ~~ISA~~AU-C section 200 explains that risks of material misstatement are assessed at the assertion level in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. For purposes of generally accepted auditing standards (GAAS), a risk of material misstatement exists when (*a*) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (*b*) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).[6] For the identified risks of material misstatement at the assertion level, a separate assessment of inherent risk and control risk is required by ~~this ISA~~this proposed SAS. As explained in ~~ISA~~AU-C section 200, inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. The degree to which the level of inherent risk varies is referred to in ~~this ISA~~this proposed SAS as the 'spectrum of inherent risk.'		
6. Risks of material misstatement identified and assessed by the auditor include both those due to error and those due to fraud. Although both are addressed by ~~this ISA~~this proposed SAS, the significance of fraud is such that further requirements and guidance are included in ~~ISA~~AU-C section 240, *Consideration of Fraud in a Financial*		

[6] ~~ISA~~ paragraph ~~.A43a~~ of AU-C section 200, and paragraph ~~A43a and ISA~~.06 of AU-C section 330, ~~*The Auditor's Responses*~~*Performing Audit Procedures in Response to Assessed Risks*, paragraph 6 and *Evaluating the Audit Evidence Obtained*.

Statement Audit, in relation to risk assessment procedures and related activities to obtain information that is used to identify, assess and respond to the risks of material misstatement due to fraud.		
7. The auditor's risk identification and assessment process is iterative and dynamic. The auditor's understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control are interdependent with concepts within the requirements to identify and assess the risks of material misstatement. In obtaining the understanding required by this ~~ISA~~proposed SAS, initial expectations of risks may be developed, which may be further refined as the auditor progresses through the risk identification and assessment process. In addition, paragraph 40 of this ~~ISA~~proposed SAS and ~~ISA~~AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*,[7] require the auditor to revise the risk assessments~~,~~ and modify further overall responses and further audit procedures, based on audit evidence obtained from performing further audit procedures in accordance with ~~ISA~~AU-C section 330, or if new information is obtained.		
8. ~~ISA~~AU-C section 330 requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.[8] ~~ISA~~AU-C section 330 further explains that the auditor's assessment of the risks of material misstatement at the financial statement level, and the auditor's overall responses, is affected by the auditor's understanding of the control environment. ~~ISA~~AU-C section 330 also requires the auditor to design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at		

[7] Paragraph .27 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

[8] Paragraph .05 of AU-C section 330.

the assertion level.[9]		
Scalability		
9. ~~ISA~~AU-C section 200 states that some ~~ISAs~~AU-C sections include scalability considerations, which illustrate the application of the requirements to all entities regardless of whether their nature and circumstances are less complex or more complex.[10] This ~~ISA~~proposed SAS is intended for audits of all entities, regardless of size or complexity~~ and~~; therefore, the application material ~~therefore~~ incorporates ~~specific~~ considerations specific to both less and more complex entities, where appropriate. ~~While~~Although the size of an entity may be an indicator of its complexity, some smaller entities may be complex, and some larger entities may be less complex.		
Effective Date	**Effective Date**	
10. This ~~ISA~~proposed SAS is effective for audits of financial statements for periods ~~beginning~~ending on or after December 15, ~~2021~~2023.	.02 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.	
Objective	**Objective**	**Objective**
11. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.	.03 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 relevant 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	.03 The objective of the auditor is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement.

[9] Paragraph .06 of AU-C section 330.

[10] ~~ISA 200, paragraph~~ Paragraph .A65*a* of AU-C section 200.

	misstatement.	
Definitions	**Definitions**	
12. For purposes of ~~the ISA~~AU-C ~~sections~~GAAS, the following terms have the meanings attributed below:	.04 For purposes of generally accepted auditing standards (GAAS), the following terms have the meanings attributed as follows:	
a. Assertions – Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement. (Ref. Para: A1)	**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.	**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.	Business risks - Risks that result from significant conditions, events, circumstances, actions, or inactions that could adversely affect a company's ability to achieve its objectives and execute its strategies. Business risks also might result from setting inappropriate objectives and strategies or from changes or complexity in the company's operations or management.
c. Controls – Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context: (Ref: ~~Para.~~par. A2–A5)		

i. Policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.		
ii. Procedures are actions to implement policies.		
d. General information technology (IT) controls – Controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information processing controls and the integrity of information ~~(i.e., the completeness, accuracy and validity of information)~~ in the entity's information system. Also see the definition of IT environment. (Ref: par. A6)		
e. Information processing controls – Controls relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information). (Ref: ~~Para.~~par. A7-A8)		
f. Inherent risk factors – Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be		

qualitative or quantitative, and include complexity, subjectivity, change, uncertainty or susceptibility to misstatement due to management bias or other fraud risk factors[11] insofar as they affect inherent risk. ~~(Ref: Para.par. A7–A8)~~ Depending on the degree to which the inherent risk factors affect the susceptibility to misstatement of an assertion, the level of inherent risk varies on a scale that is referred to as the *spectrum of inherent risk*. (Ref: par. A9–A11)		
~~*f.*~~*g.* IT environment – The IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies. For the purposes of this ~~ISA~~ definition:		
i. An IT application is a program or a set of programs that is used in the initiation, processing, recording and reporting of transactions or information. IT applications include data warehouses and report writers.		
ii. The IT infrastructure comprises the network, operating systems, and databases and their related hardware and software.		
iii. The IT processes are the entity's processes to manage access to the IT environment, manage program changes or changes to the IT environment and manage IT operations.		
~~*g.*~~*h.* ~~Relevant asser~~tions – An assertion about a class of transactions, account balance or	**Relevant assertion.** A financial statement assertion that has a	

[11] ~~ISA~~AU-C section 240, paragraphs ~~A24–A28~~ A24–A27

disclosure is relevant when it has an identified risk of material misstatement. A risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).[12] The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (i.e., the inherent risk). (~~i.e.,~~that is, the determination is based on inherent risk). (Ref: ~~Para. A9)~~par. A12)	reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of internal controls. (Ref: par. .A131)	
~~h.~~i. Risks arising from the use of IT – Susceptibility of information processing controls to ineffective design or operation, or risks to the integrity of information (i.e., the completeness, accuracy and validity of transactions and other information) in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes (see IT environment).		
~~i.~~j. Risk assessment procedures – The audit procedures designed and performed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.	**Risk assessment procedures.** The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels.	.A4 Risk assessment procedures - The procedures performed by the auditor to obtain information for identifying and assessing the risks of material misstatement in the financial statements whether due to error or fraud. Note: Risk assessment procedures by themselves do not provide sufficient appropriate evidence on which to base an audit opinion.
~~j.~~k. Significant class of transactions, account balance or disclosure – A class of transactions, account balance or disclosure for which there is one or ~~more relevant asser~~tions. (Ref: par. A14).		

[12] Paragraph .A15 of AU-C section 200.

~~k.~~*l.* Significant *risk* – An identified risk of material misstatement: (Ref: ~~Para.~~par. A15)	**Significant risk.** An identified and assessed risk of material misstatement that, in the auditor's professional judgment, requires special audit consideration.	Significant risk - A risk of material misstatement that requires special audit consideration.
i. For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or		
ii. That is to be treated as a significant risk in accordance with the requirements of other ~~ISA~~AU-C sections.[13]		
Spectrum of Inherent Risk. See definition of inherent risk factors.		
~~l.~~*m.* *System of internal control* – The system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. For the purposes of the ~~ISA~~AU-C sections, the system of internal control consists of five inter-related components:	**Internal control.** A process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial	

[13] ~~ISA~~AU-C section 240, paragraph ~~27~~ 25 and ~~ISA~~AU-C section 550, *Related Parties*, paragraph 18.

fn 1 This section recognizes the definition and description of *internal control* contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission.

	reporting and operations objectives. fn 1	
i. Control environment;		
ii. The entity's risk assessment process;		
iii. The entity's process to monitor the system of internal control;		
iv. The information system and communication; and		
v. Control activities.		
		The PCAOB also defines the following terms in Appendix A: • Company's objectives and strategies • Executive officer
Requirements	**Requirements**	
Risk Assessment Procedures and Related Activities	**Risk Assessment Procedures and Related Activities**	**Performing Risk Assessment Procedures**
13. The auditor ~~shall~~should design and perform risk assessment procedures to obtain audit evidence that provides an appropriate basis for: (Ref: ~~Para.~~par. A17–~~A18~~A24)	.05 The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: par. .A1–.A5)	.04 The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud,[3] and designing further audit procedures.[4]

a. The identification and assessment of risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels; and		
b. The design of further audit procedures in accordance with ~~ISA~~AU-C section 330.		
The auditor ~~shall~~should design and perform risk assessment procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. (Ref: ~~Para.~~par. A14)		
14. The risk assessment procedures ~~shall~~should include the following: (Ref: ~~Para.~~par. A25–A27)	.06 The risk assessment procedures should 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). (Ref: ~~Para.~~par. A28–A32)	a. Inquiries of management, appropriate individuals within the internal audit function (if such function exists), others within the entity who, in the auditor's professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error (Ref: par. .A6–.A13)	.54 The auditor should inquire of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement. Note: The auditor's inquiries about risks of material misstatement should include inquiries regarding fraud risks.
		.55 The auditor should use his or her knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement.
b. Analytical procedures. (Ref: ~~Para.~~par. A33–	b. Analytical procedures (Ref:	.46 The auditor should perform analytical

A37)	par. .A14–.A17)	procedures that are designed to: a. Enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and b. Identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.
		.47 In applying analytical procedures as risk assessment procedures, the auditor should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. Also, when the auditor has performed a review of interim financial information in accordance with AS 4105, he or she should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures.
		.48 When performing an analytical procedure, the auditor should use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure. When comparison of those expectations with relationships derived from recorded amounts yields unusual or unexpected results, the auditor should take into account those results in identifying the risks of

		material misstatement. [footnote internationally omitted]
c. Observation and inspection. (Ref: ~~Para.~~par. A38–A42)	c. Observation and inspection (Ref: par. .A18)	
Information from Other Sources		**Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements**
15. In obtaining audit evidence in accordance with paragraph 13, the auditor ~~shall~~should consider information from: (Ref: ~~Para.~~par. A43–A44)		
a. The auditor's procedures regarding acceptance or continuance of the client relationship or the audit engagement; and	.07 The auditor should consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.	.41 *Client Acceptance and Retention and Audit Planning Activities*. The auditor should evaluate whether information obtained from the client acceptance and retention evaluation process or audit planning activities is relevant to identifying risks of material misstatement. Risks of material misstatement identified during those activities should be assessed as discussed beginning in paragraph .59 of this standard.
b. When applicable, other engagements performed by the engagement partner for the entity.	.08 If the engagement partner has performed other engagements for the entity, the engagement partner should consider whether information obtained is relevant to identifying risks of material misstatement.	.44 Other Engagements. When the auditor has performed a review of interim financial information in accordance with AS 4105, Reviews of Interim Financial Information, the auditor should evaluate whether information obtained during the review is relevant to identifying risks of material misstatement in the year-end audit.
		.45 The auditor should obtain an understanding of the nature of the services that have been

		performed for the company by the auditor or affiliates of the firm[25] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[26]
	.09 During planning, the auditor should consider the results of the assessment of the risk of material misstatement due to fraud [fn 2] along with other information gathered in the process of identifying the risks of material misstatements.	
16. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor ~~shall~~should evaluate whether such information remains relevant and reliable as audit evidence for the current audit. (Ref: ~~Para.~~par. ~~A43~~A45–~~A44~~A47)	.10 When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor should determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: par. .A19–.A20)	.42 *Past Audits.* In subsequent years, the auditor should incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement, including when identifying significant ongoing matters that affect the risks of material misstatement or determining how changes in the company or its environment affect the risks of material misstatement, as discussed in paragraph .08 of this standard.
		.43 If the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should evaluate whether the prior years' information remains relevant and reliable.
Engagement Team Discussion		**Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement**

17. The engagement partner and other key engagement team members ~~shall~~should discuss the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement. (Ref: ~~Para.~~par. ~~A42~~A48~~–A47~~A54)	11 The engagement partner and other key engagement team members should 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 should determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: par. .A21–.A23)	.49 The key engagement team members should discuss (1) the company's selection and application of accounting principles, including related disclosure requirements, and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud. Note: The key engagement team members should discuss the potential for material misstatement due to fraud either as part of the discussion regarding risks of material misstatement or in a separate discussion.28 Note: As discussed in paragraph .67, the financial statements might be susceptible to misstatement through omission of required disclosures or presentation of inaccurate or incomplete disclosures. .50 Key engagement team members include all engagement team members who have significant engagement responsibilities, including the engagement partner. The manner in which the discussion is conducted depends on the individuals involved and the circumstances of the engagement. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. The engagement partner or other key engagement team members should communicate the important matters from the discussion to engagement team members who are not involved in the discussion. Note: If the audit is performed entirely by the engagement partner, that engagement

		partner, having personally conducted the planning of the audit, is responsible for evaluating the susceptibility of the company's financial statements to material misstatement. .51 Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change. [footnote internationally omitted].
18. When there are engagement team members not involved in the engagement team discussion, the engagement partner ~~shall~~should determine which matters are to be communicated to those members.	See paragraph 11	
Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework and the Entity's System of Internal Control (Ref: ~~Para.~~par. ~~A48~~A57)	**Understanding the Entity and Its Environment, Including the Entity's Internal Control**	
Understanding the Entity and Its Environment, and the Applicable Financial Reporting Framework (Ref: ~~Para.~~par. ~~A50~~A58–~~A55~~A63)		
	The Entity and Its Environment (Ref: par. .A24)	**Obtaining an Understanding of the Company and Its Environment**
19. The auditor ~~shall~~should perform risk assessment procedures to obtain an understanding of:	.12 The auditor should obtain an understanding of the following:	.07 The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of

		the company includes understanding:
a. a) The following aspects of the entity and its environment:		
i. The entity's organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT; (Ref: ~~Para.~~par. ~~A56~~A64–~~A67~~A77)	b. The nature of the entity, including i. its operations; ii. its ownership and governance structures; iii. the types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives; and iv. the way that the entity is structured and how it is financed, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: par. .A30–.A34)	[.07] b. The nature of the company;
ii. Industry, regulatory and other external factors; (Ref: ~~Para.~~par. ~~A68~~A78–~~A73~~A83) and	a. Relevant industry, regulatory, and other external factors, including the applicable financial re-porting framework. (Ref: par. .A25–.A29)	[.07] a. Relevant industry, regulatory, and other external factors;
iii. The measures used, internally and externally, to assess the entity's financial performance; (Ref: ~~Para.~~par. ~~A74~~A84–~~A84~~A91)	e. The measurement and review of the entity's financial performance. (Ref: par. .A43–.A48)	[.07] e. The company's measurement and analysis of its financial performance.
b. The applicable financial reporting framework, and the entity's accounting policies and the reasons for any changes thereto; (Ref: ~~Para.~~par.		

~~A82~~A92–~~A84~~A94) and		
	d. The entity's objectives and strategies and those related business risks that may result in risks of material misstatement. (Ref: par. .A36–.A42)	[7] d. The **company's objectives and strategies** and those related **business risks** that might reasonably be expected to result in risks of material misstatement
c. How inherent risk factors affect susceptibility of assertions to misstatement and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework, based on the understanding obtained in (a) and (b). (Ref: ~~Para.~~par. ~~A85~~A95–~~A88~~A100)		
20. The auditor ~~shall~~should evaluate whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework.	c. The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should 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: par. .A35)	[.07] c. The company's selection and application of accounting principles, including related disclosures; .12 As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, the auditor should evaluate whether the company's selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted, incomplete, or inaccurate disclosures, the auditor should develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting

		framework.
		.08 In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.
Understanding the Components of the Entity's System of Internal Control (Ref: ~~Para.~~par. ~~A89~~A101–~~A94~~A112)		
	The Entity's Internal Control	***Obtaining an Understanding of Internal Control Over Financial Reporting***
	.13 The auditor should 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 re-porting 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: par. .A49–.A74)	
	Nature and Extent of the Understanding of Relevant Controls	
	.14 When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by	.18 The auditor should obtain a sufficient understanding of each component of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of

	performing procedures in addition to inquiry of the entity's personnel. (Ref: par. .A75–.A77)	material misstatement, and (c) design further audit procedures. [footnote intentionally omitted]
		.19 The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company;9 the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting. Note: The auditor also might obtain an understanding of certain controls that are not part of internal control over financial reporting, e.g., controls over the completeness and accuracy of operating or other nonfinancial information used as audit evidence.[10]
	Components of Internal Control	
Control Environment, the Entity's Risk Assessment Process and the Entity's Process to Monitor the System of Internal Control (Ref: ~~Para.~~par. ~~A95~~A113–~~A97~~A115)		
Control Environment		Control Environment
21. The auditor ~~shall~~should, through performing risk assessment procedures, obtain an understanding of the control environment relevant to the preparation of the financial statements, by: (Ref: ~~Para.~~par. ~~A98~~A116–~~A99~~A117)	.15 Control environment. The auditor should obtain an understanding of the control environment. As part of obtaining this understanding, the auditor should	.23 The auditor should obtain an understanding of the company's control environment, including the policies and actions of management, the board, and the audit committee concerning the company's control

	evaluate whether	environment.
a. Understanding the set of controls, processes and structures that address: (Ref: ~~Para.~~par. ~~A100–A101~~A118)		.24 Obtaining an understanding of the control environment includes assessing…
i. How management's oversight responsibilities are carried out, such as the entity's culture and management's commitment to integrity and ethical values;		[24] Whether management's philosophy and operating style promote effective internal control over financial reporting;
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;		[24] Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control. Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph .23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, AS 220114 describes the auditor's responsibility for evaluating the control environment.
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;		

and		
b. Evaluating, based on the auditor's understanding obtained in paragraph 21*a*, whether: (Ref: ~~Para.~~par. ~~A103~~A119–~~A107~~A124)		
i. Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior;	a. management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior and	[24] Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
ii. The control environment provides an appropriate foundation for the other components of the entity's system of internal control considering the nature and complexity of the entity; and	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 under-mined by deficiencies in the control environment. (Ref: par. .A78–.A88)	
iii. Control deficiencies identified in the control environment undermine the other components of the entity's system of internal control.		.25 If the auditor identifies a control deficiency[15] in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor, as discussed in paragraphs .65-.66 of this standard.
The Entity's Risk Assessment Process		**The Company's Risk Assessment Process**
22. The auditor ~~shall~~should, through performing risk assessment procedures, obtain an understanding of the entity's risk assessment process relevant to the preparation of the financial statements, by:	.16 The entity's risk assessment process. The auditor should obtain an understanding of whether the entity has a process for	.26 The auditor should obtain an understanding of management's process for: a. Identifying risks relevant to financial reporting objectives, including risks of material

		misstatement due to fraud ("fraud risks"); b. Assessing the likelihood and significance of misstatements resulting from those risks; and c. Deciding about actions to address those risks.
a. Understanding the entity's process for: (Ref: ~~Para.~~par. ~~A108~~A125–~~A109~~A127)		.27 Obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.
i. Identifying business risks, including the potential for fraud, relevant to financial reporting objectives; (Ref: ~~Para.~~par. ~~A62~~A71)	a. identifying business risks relevant to financial reporting objectives,	
ii. Assessing the significance of those risks, including the likelihood of their occurrence; ~~and~~	b. estimating the significance of the risks, c. assessing the likelihood of their occurrence, and	
iii. Addressing those risks; and	d. deciding about actions to address those risks. (Ref: par. .A89–.A90)	
b. (b) Evaluating, based on the auditor's understanding obtained in paragraph 22*a*, whether the entity's risk assessment process is appropriate to the entity's circumstances considering the nature and complexity of the entity. (Ref: ~~Para.~~par. ~~A111~~A128–~~A120~~A130)		

	.17 If the entity has established a risk assessment process (referred to hereafter as the entity's risk assessment process), the auditor should obtain an understanding of it and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor should evaluate whether an underlying risk existed that the auditor expects would have been identified by the entity's risk assessment process. If such a risk exists, the auditor should obtain an understanding of why that process failed to identify it and evaluate whether the process is appropriate to its circumstances or determine if a significant deficiency or material weakness exists in internal control regarding the entity's risk assessment process.	
	18 If the entity has not established such a process or has an ad hoc process, the auditor should discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor should evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances or determine whether it represents a significant deficiency or material	

	weakness in the entity's internal control. (Ref: par. .A91)	
23. If the auditor identifies risks of material misstatement that management failed to identify, the auditor ~~shall~~should:		
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	See paragraph 17	
b. ~~(b)~~ Consider the implications for the auditor's evaluation in paragraph 22(b).		
The Entity's Process for Monitoring the System Of Internal Control		**Monitoring of Controls**
24. 24.The auditor ~~shall~~should, through performing risk assessment procedures, obtain an understanding of the entity's process for monitoring the system of internal control relevant to the preparation of the financial statements, ~~through performing risk assessment procedures,~~ by: (Ref: ~~Para.~~par. A131~~A113–A133~~A132)	.23 *Monitoring of controls.* The auditor should 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: par. .A110–.A111)	.35 The auditor should obtain an understanding of the major types of activities that the company uses to monitor the effectiveness of its internal control over financial reporting and how the company initiates corrective actions related to its controls.[19]
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; (Ref: ~~Para.~~par.		

A133–A134~~A116~~) and		
ii. The entity's internal audit function, if any, including its nature, responsibilities and activities; (Ref: ~~Para.~~par. A135-A136~~-A117~~)	.24 If the entity has an internal audit function, [fn 3] the auditor should obtain an understanding of the nature of the internal audit function's responsibilities how the internal audit function fits in the entity's organizational structure, and the activities performed or to be performed. (Ref: par. .A113–.A120) [As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]	
b. Understanding the sources of the information used in the entity's process to monitor the system of internal control, and the basis upon which management considers the information to be sufficiently reliable for the purpose.~~;~~ (Ref: ~~Para.~~par. A137~~-A119~~–A138~~A120~~) ~~and~~	25 The auditor should obtain an understanding of the sources of the information used in the entity's monitoring activities and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: par. .A121)	
c. (c) Evaluating, based on the auditor's understanding obtained in paragraph 24*a*-24*b*, whether the entity's process for monitoring the system of internal control is appropriate to the entity's circumstances considering the nature and complexity of the entity. (Ref: ~~Para.~~par. A139 - A140~~A121~~)		
Information System and Communication, and Control Activities (Ref: ~~Para.~~par. A141~~A123~~–A148~~A129~~)		**Information and Communication**
The Information System and Communication		

25. The auditor ~~shall~~should, through performing risk assessment procedures, obtain an understanding of the entity's information system and communication relevant to the preparation of the financial statements, ~~through performing risk assessment procedures,~~ by: (Ref: ~~Para.~~par. A149-A150~~A130~~)	19 *The information system, including the related business processes relevant to financial reporting and communication.* The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas:	.28 Information System Relevant to Financial Reporting. The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including: Note: Appendix B discusses additional considerations regarding manual and automated systems and controls.
a. Understanding the entity's information processing activities, including its data and information, the resources to be used in such activities and the policies that define, for significant classes of transactions, account balances and disclosures: (Ref: ~~Para.~~par. A151~~A131~~–A164~~A142~~)	a. The classes of transactions in the entity's operations that are significant to the financial statements.	[28.] a. The classes of transactions in the company's operations that are significant to the financial statements;
i. How information flows through the entity's information system, including how:		
a. Transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated in the general ledger and reported in the financial statements; and	b. The procedures within both IT and manual systems by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and re-ported in the financial statements.	[28.] b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;
b. Information about events and conditions, other than transactions, is captured, processed and disclosed in the financial statements;	d. How the information system captures events and conditions, other than transactions, that are significant to the financial statements.	[28.] d. How the information system captures events and conditions, other than transactions,[16] that are significant to the financial statements; and
ii. The accounting records, specific accounts in the financial statements and other supporting	c. The related accounting records supporting information and	[28.] c. The related accounting records, supporting information, and specific accounts

records relating to the flows of information in the information system;	specific accounts in the financial statements that are used to initiate, authorize, record, process, and report transactions. This includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form.	in the financial statements that are used to initiate, authorize, process, and record transactions;
iii. The financial reporting process used to prepare the entity's financial statements, including disclosures; and	e. The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.	[28.] f. The period-end financial reporting process.
		Paragraph 28e. was intentionally omitted because it is addressed in AU-C 540.
iv. The entity's resources, including the IT environment, relevant to (a)(i) to (a)(iii) above;		.29 The auditor also should obtain an understanding of how IT affects the company's flow of transactions. (See Appendix B.) Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort.
		.B1 While obtaining an understanding of the company's information system related to financial reporting, the auditor should obtain an understanding of how the company uses information technology ("IT") and how IT affects the financial statements.1 The auditor

		also should obtain an understanding of the extent of manual controls and automated controls used by the company, including the IT general controls that are important to the effective operations of the automated controls. That information should be taken into account in assessing the risks of material misstatement.2
	f. Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments. (Ref: par. .A92–.A96)	
	This understanding of the information system relevant to financial reporting should include relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers. (Ref: par. A93-.A99) [As amended, effective for audits of financial statements for periods ending on or after December 15, 2020, by SAS No. 134]	
b. Understanding how the entity communicates significant matters that support the preparation of the financial statements and related reporting responsibilities in the information system and other components of the system of internal control: (Ref: ~~Para.~~par. A165~~A143~~–A166~~A144~~)	.20 The auditor should obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including	.33 *Communication.* The auditor should obtain an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting to relevant company personnel and others, including: ▪ Communications between management,

		the audit committee, and the board of directors; and ▪ Communications to external parties, including regulatory authorities and shareholders.
i. Between people within the entity, including how financial reporting roles and responsibilities are communicated;		
ii. Between management and those charged with governance; and	a. communications between management and those charged with governance and	
iii. With external parties, such as those with regulatory authorities; and	b. external communications, such as those with regulatory authorities. (Ref: par. .A97–.A98)	
c. Evaluating, based on the auditor's understanding obtained in paragraph 25*a*-25*b*, 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 considering the nature and complexity of the entity. (Ref: ~~Para.~~par. A167~~A144(a)~~)		
Control activities		
26. The auditor ~~shall~~should, through performing risk assessment procedures, obtain an understanding of the control activities component, ~~through performing risk assessment procedures,~~ by applying the requirements in paragraphs 27-29: (Ref: ~~Para.~~par. A168~~A146~~–A179~~A156~~)	.21 *Control activities relevant to the audit.* The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level	.34 The auditor should obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures, as described in paragraph .18 of this standard.18 As the auditor obtains an understanding of the other components of internal control over financial reporting, he or

	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. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances. (Ref: par. .A99–.A105)	she is also likely to obtain knowledge about some control activities. The auditor should use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures. Note: A broader understanding of control activities is needed for relevant assertions for which the auditor plans to rely on controls. Also, in the audit of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.
27. The auditor should ~~Identifying~~identify the following controls that address risks of material misstatement at the assertion level~~ in the control activities component as follows~~:		
a. Controls that address a risk that is determined to be a significant risk; (Ref: ~~Para.~~par. A180~~A157~~–A181~~A158~~)		.72 When the auditor has determined that a significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs .18-.40 of

		this standard. [Footnote intentionally omitted] .73A The auditor should obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs .18-.40 and .72-.73 of this standard.
b. Controls over journal entries and other adjustments, including controls over nonstandard journal entries used to record nonrecurring, unusual transactions, as required by AU-C section 240[14]~~, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments~~ ; (Ref: ~~Para.~~par. A182~~A159~~–A183~~A160~~)		
c. Controls for which the auditor plans to test operating effectiveness in determining the nature, timing and extent of substantive ~~testing~~procedures, which ~~shall~~should include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; and (Ref: ~~Para.~~par. A184~~A161~~–A186~~A163~~)		.B6 When a company uses manual elements in internal control systems and the auditor plans to rely on, and therefore test, those manual controls, the auditor should design procedures to test the consistency in the application of those manual controls.
d. Other controls that, based on the auditor's professional judgment, 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~~		

[14] Paragraph 32(a)(i) of AU-C section 240.

~~auditor's professional judgment;~~. (Ref: ~~Para.~~par. ~~A164~~A187-A188)		
~~28.~~ Based on controls identified in 27~~(a)~~, the auditor should identify~~ing~~ the IT applications and the other aspects of the entity's IT environment that are subject to risks arising from the use of IT.~~; (Ref: Para.par. A165–A171)~~ ~~29.~~28. ~~28.~~ For the identified ~~For such~~ IT applications ~~IT applications~~ and other aspects of the IT environment, the auditor should identify the following: ~~and other aspects of the IT environment identified in (b), identifying:~~ (Ref: ~~Para.~~par. A189~~A167~~–A200~~A189~~) *a.* The related risks arising from the use of IT; and *b.* The entity's general IT controls that address such risks; and	.22 In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. (Ref: par. .A106–.A109)	.B4 The auditor should obtain an understanding of specific risks to a company's internal control over financial reporting resulting from IT. Examples of such risks include: B5 In obtaining an understanding of the company's control activities, the auditor should obtain an understanding of how the company has responded to risks arising from IT. B6 When a company uses manual elements in internal control systems and the auditor plans to rely on, and therefore test, those manual controls, the auditor should design procedures to test the consistency in the application of those manual controls.
~~30.~~29. ~~29(d)~~ For each control identified in paragraph 27~~(a)~~ or 28*b*~~(c)(ii)~~, the auditor should: (Ref: ~~Para.~~par. A201~~A174~~–A210~~A180~~)		
a. ~~Evaluating~~ Evaluate 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~~		.20 Obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented. Note: Procedures the auditor performs to obtain

		evidence about design effectiveness include inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs, as described in paragraphs .37-.38, that include these procedures ordinarily are sufficient to evaluate design effectiveness. Note: Determining whether a control has been implemented means determining whether the control exists and whether the company is using it. The procedures to determine whether a control has been implemented may be performed in connection with the evaluation of its design. Procedures performed to determine whether a control has been implemented include inquiry of appropriate personnel, in combination with observation of the application of controls or inspection of documentation. Walkthroughs, as described in paragraphs .37-.38, that include these procedures ordinarily are sufficient to determine whether a control has been implemented.
		.B5 In obtaining an understanding of the company's control activities, the auditor should obtain an understanding of how the company has responded to risks arising from IT.
b. ~~Determining~~ Determine whether the control has been implemented by performing procedures in addition to inquiry of the entity's personnel.		
Control Deficiencies Within the Entity's System of Internal Control		

31.30. ~~30.~~ Based on the auditor's evaluation of each of the components of the entity's system of internal control, the auditor ~~shall~~should determine whether one or more control deficiencies have been identified. (Ref: ~~Para.~~par. A211~~A181~~–A212~~A182~~)		
Identifying and Assessing the Risks of Material Misstatement (Ref: par. A213-A214)	**Identifying and Assessing the Risks of Material Misstatement**	**Identifying and Assessing the Risks of Material Misstatement**
Identifying Risks of Material Misstatement		
32.31. ~~31.~~ The auditor ~~shall~~should identify the risks of material misstatement and determine whether they exist at: (Ref: ~~Para.~~par. A215~~A183~~–A221~~A191~~)	.26 To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at	.59 The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should: Note: Factors relevant to identifying fraud risks are discussed in paragraphs .65-.69 of this standard.
a. The financial statement level; (Ref: ~~Para.~~par. A222~~A192~~–A229~~A199~~) or	a. the financial statement level and (Ref: par. .A122–.A125)	
b. The assertion level for classes of transactions, account balances and disclosures. (Ref: ~~Para.~~par. A230-A231~~A200~~)	b. the relevant assertion level for classes of transactions, account balances, and disclosures. (Ref: par. .A126–.A133)	
	.27 For this purpose, the auditor should a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant	a. Identify risks of misstatement using information obtained from performing risk assessment procedures (as discussed in paragraphs .04-.58) and considering the characteristics of the accounts and disclosures in the financial statements.

	controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: par. .A134–.A135) b. assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions; c. relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: par. .A136–.A138) 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.	Note: Factors relevant to identifying fraud risks are discussed in paragraphs .65-.69 of this standard.
~~33.~~32. 32. The auditor ~~shall~~should determine the relevant assertions and the related significant classes of transactions, account balances and disclosures. (Ref: ~~Para.~~par. A232 ~~A201~~–A234~~A203~~)		[51.] e. Identify significant accounts and disclosures[33] and their relevant assertions[34] (paragraphs .60-.64 of this standard). Note: The determination of whether an account or disclosure is significant or whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.
		Identifying Significant Accounts and Disclosures and Their Relevant Assertions

		.60 To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph .59e, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include: • Size and composition of the account; • Susceptibility to misstatement due to error or fraud; • Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure; • Nature of the account or disclosure; • Accounting and reporting complexities associated with the account or disclosure; • Exposure to losses in the account; • Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure; • Existence of related party transactions in the account; and • Changes from the prior period in account and disclosure characteristics. .60A Additional risk factors relevant to the identification of significant accounts and disclosures involving accounting estimates include the following: a. The degree of uncertainty associated with the future occurrence or outcome

		of events and conditions underlying the significant assumptions; b. The complexity of the process for developing the accounting estimate; c. The number and complexity of significant assumptions associated with the process; d. The degree of subjectivity associated with significant assumptions (for example, because of significant changes in the related events and conditions or a lack of available observable inputs); and e. If forecasts are important to the estimate, the length of the forecast period and degree of uncertainty regarding trends affecting the forecast.
		.61 As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.
		.62 The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits. Note: In the financial statement audit, the

		auditor might perform substantive auditing procedures on financial statement accounts, disclosures, and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[35]
		.63 The components of a potential significant account or disclosure might be subject to significantly differing risks.
		.64 When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements.
Assessing Risks of Material Misstatement at the Financial Statement Level		
33. For identified risks of material misstatement at the financial statement level, the auditor ~~shall~~should assess the risks and~~:~~ (Ref: ~~Para.~~par. A222~~A192~~–A229~~A199~~)	See paragraph 27*b*	
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.		[59.] b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.
Assessing Risks of Material Misstatement at the Assertion Level		
Assessing Inherent Risk (Ref: par. A235-A244)		
34. For identified risks of material misstatement at the assertion level, the auditor ~~shall~~should assess inherent risk	See paragraph 27*d*	[59] c. Evaluate the types of potential misstatements that could result from the

by assessing the likelihood and magnitude of misstatement. In doing so, the auditor ~~shall~~should take into account how, and the degree to which~~: (Ref: Para. A204–A216)~~		identified risks and the accounts, disclosures, and assertions that could be affected. Note:In identifying and assessing risks at the assertion level, the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level. [59.] d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements. Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test.32
a. Inherent risk factors affect the susceptibility of relevant assertions to misstatement; and		
b. The risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level. (Ref: par. A245-A246)		
	Risks That Require Special Audit Consideration	
35. The auditor ~~shall~~should determine whether any of the assessed risks of material misstatement are significant risks. (Ref: ~~Para.~~par. A247~~A217–~~A251~~A220~~)	.28 As part of the risk assessment described in paragraph .26, the auditor should determine whether any of the risks identified are, in the auditor's professional judgment, a significant risk. In exercising this	[51.] f. Determine whether any of the identified and assessed risks of material misstatement are significant risks (paragraphs .70-.71 of this standard).

	judgment, the auditor should exclude the effects of identified controls related to the risk.	
		.70 To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk. Note: The determination of whether a risk of material misstatement is a significant risk is based on inherent risk, without regard to the effect of controls.
	29 In exercising professional judgment about which risks are significant risks, the auditor should con-sider at least a. whether the risk is a risk of fraud; b. whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention; c. the complexity of transactions; d. whether the risk involves significant transactions with related parties; e. the degree of subjectivity in the measurement of financial information related to the risk,	.71 Factors that should be evaluated in determining which risks are significant risks include: a. The effect of the quantitative and qualitative risk factors discussed in paragraph .60 on the likelihood and potential magnitude of misstatements; b. Whether the risk is a fraud risk; Note: A fraud risk is a significant risk. c. Whether the risk is related to recent significant economic, accounting, or other developments; d. The complexity of transactions; e. Whether the risk involves significant transactions with related parties; f. The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those

	especially those measurements involving a wide range of measurement uncertainty; and f. whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual. (Ref: par. .A139–.A143)	measurements involving a wide range of measurement uncertainty; and g. Whether the risk involves significant unusual transactions.
	.30 If the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks. (Ref: par. .A144–.A146)	.72 When the auditor has determined that a significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs .18-.40 of this standard.[36]
		.73 Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of intentional misstatement of specific accounts and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.37 Such controls also include those that address the risk of management override of other controls.
		.73A The auditor should obtain an understanding of the controls that management has established to identify, authorize and approve, and account for and disclose

		significant unusual transactions in the financial statements, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs .18-.40 and .72-.73 of this standard.
	Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence	
36. The auditor ~~shall~~should determine whether substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatement at the assertion level. (Ref: ~~Para.~~par. A252~~-A221~~–A255~~A224~~)	.31 In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient ap-propriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit, and the auditor should obtain an understanding of them. (Ref: par. .A147–.A150)	
Assessing Control Risk		
37. For identified risks of material misstatement at the assertion level~~If the auditor plans to test the operating effectiveness of controls~~, the auditor ~~shall~~should assess control risk based on the auditor's understanding of controls and the auditor's plan to test the operating effectiveness of controls. If the auditor does not plan to test the operating		.39 The objective of obtaining an understanding of internal control, as discussed in paragraph .18 of this standard, is different from testing controls for the purpose of assessing control risk or for the purpose of expressing an opinion on internal control over financial reporting in

effectiveness of controls, the auditor~~'s~~ should ~~assessment of~~assess control risk at the maximum level ~~shall be~~ such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk. (Ref: ~~Para.~~par. A256~~A225~~–A260~~A228~~)		the audit of internal control over financial reporting. The auditor may obtain an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures. Also, the auditor should take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control over financial reporting, forming an opinion about the effectiveness of internal control over financial reporting. [footnotes intentionally omitted]
Evaluating the Audit Evidence Obtained from the Risk Assessment Procedures		
38. The auditor ~~shall~~should 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~~should 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~~should take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management. (Ref: ~~Para.~~par. A261~~A229~~–A263~~A231~~)		
Classes of Transactions, Account Balances and Disclosures that Are Not Significant, but Which Are Material		
39. 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~~should evaluate whether the auditor's determination remains appropriate. (Ref: ~~Para.~~par. A265~~A232~~–A266~~A234~~)		
Revision of Risk Assessment	**Revision of Risk Assessment**	**Revision of Risk Assessment**
40. 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~~should revise the identification or assessment. (Ref: ~~Para.~~par. A266~~A235~~)	.32 The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances in which the auditor obtains audit evidence from performing further audit procedures or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and modify the further planned audit procedures accordingly. (Ref: par. .A151)	.74 The auditor's assessment of the risks of material misstatement, including fraud risks, should continue throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.38
Documentation	**Documentation**	
41. The auditor ~~shall~~should include in the audit documentation:[15] (Ref: ~~Para.~~par. A267~~A239~~–A273~~A241~~)	.33 The auditor should include in the audit documentation [fn 4] the	
a. The discussion among the engagement team and the significant decisions reached; in accordance with paragraphs 17 and 18;	a. discussion among the engagement team required by paragraph .11, the significant decisions reached, how and when the discussion occurred, and the audit team members who participated;	

[15] ~~ISA~~AU-C section 230, *Audit Documentation*, paragraphs 8–~~11~~12, and ~~A6~~A8–~~A7~~A9

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;	b. key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph .12 and each of the internal control components specified in paragraphs .15–.25, the sources of information from which the understanding was obtained, and the risk assessment procedures performed;	
c. The evaluation of the design of identified controls, and determination whether such controls have been implemented, in accordance with ~~the requirements in~~ paragraph 26; and		
d. The identified and assessed risks of material misstatement at the financial statement level and at the assertion level, including significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for the significant judgments made.	c. identified and assessed risks of material misstatement at the financial statement level and at the relevant assertion level, as required by paragraph .26; and	
	d. risks identified and related controls about which the auditor has obtained an understanding as a result of the requirements in paragraphs .28–.31. (Ref: par. .A152–.A155)	

AICPA

Agenda Item 2

Proposed SAS, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment

Objective of Agenda Item

To discuss the proposed SAS, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment,* which has been revised to take into consideration the issues identified in the comment letters received in response to the exposure draft and the feedback provided by the Auditing Standards Board (ASB or the Board) at the January, March, and May meetings. The revised draft of the proposed SAS is being discussed with the goal of voting to issue a final standard in August 2021.

Task Force

The Task Force members are as follows:

- Maria Manasses–GT, Chair (succeeded Tracy Harding)
- Diane Hardesty–EY
- Kathy Healy–PwC
- Susan Jones–KPMG
- April King–RSM
- Tania Sergott–Deloitte
- Dan Wernke–Clark Schaefer Hackett

Agenda Materials

Agenda Item 2: Cover Memo

Agenda Item 2A: Proposed SAS, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*, marked from the Exposure Draft

Agenda item 2B: Comparison Matrix of Requirement Paragraphs, which includes the proposed SAS marked from ISA 315 (Revised 219), extant AU-C section 315, and AS 2110, *Identifying and Assessing the Risks of Material Misstatement*

Agenda item 2C: Draft of Executive Summary

Ms. Manasses will use Item 2A in leading the discussion.

May ASB Meeting

The ASB continued to discuss several issues and changes at the March ASB meeting. The ASB's discussion was primarily focused on the requirements and application material of the proposed SAS related to the issues presented. The Task Force had not completed its review of the appendices of the proposed SAS and conforming amendments. Thus, those sections were not presented for discussion at the May ASB meeting.

The following provides a summarized version of the May ASB meeting highlights with a focus on the Board's recommendations or conclusions:

A. **Spectrum of Inherent Risk**—The ASB agreed with the Task Force's recommendation to add a description of the spectrum of inherent risk within the definition of inherent risk factors but suggested adding a separate caption titled *spectrum of inherent risk* within the definition section with a reference to the definition of inherent risk factors in order to enhance its searchability.

B. **Evaluation of Internal Control Components (Excluding Control Activities)**—The ASB agreed with the Task Force's recommendation to edit the requirements in paragraphs 21b, 22b, 24b, and 25c and to clarify the guidance that inquiry alone may be sufficient in obtaining an understanding of the control environment, the entity's risk assessment process, the entity's process to monitor the system of internal control, and the information system and communication components of internal control. The Task Force Was directed to determine whether guidance can be further enhanced by improving its organization.

C. **The Entity's Risk Assessment Process and Interplay with AU-C section 240**—The Task Force suggested clarifying the requirement in paragraph 22 to specifically refer to understanding the entity's process for identifying the potential for fraud. This change is intended to align paragraph 22 of the proposed SAS with paragraph 17 of AU-C section 240. The ASB agreed with the Task Force's recommendation.

D. **Evaluation of the Information System and Communication**—The ASB agreed with the the Task Force's recommendations to (a) edit paragraph 25 of the proposed SAS to include the reference to considering the nature and complexity of the entity, and (b) add application material that refers to Appendix C, which further describes the information system and communication component.

E. **Separating the Requirements Related to Control Activities**— To enhance clarity and readability, the Task Force suggested restructuring paragraph 26 into separate paragraphs. Such restructuring is responsive to comments related to complexity and understandability of the proposed SAS. The ASB agreed with the Task Force's recommendation.

F. **Controls over Journal Entries**—At its prior meeting, the ASB agreed that paragraph .26(a)(ii) (renumbered as 27*b*) is intended to cover the requirement in paragraph 32(a)(i) in AU-C section 240, which is incremental to ISA 240. The ASB directed the Task Force to the

to modify the requirement in the proposed SAS, rather than make the conforming amendments to AU-C section 240 proposed by the Task Force.

G. **Assessing Control Risk**—The ASB agreed to edit paragraph 34 such as follows to clarify the language in the requirement to make the requirement more understandable based on comments received from responders:

> 34. For identified risks of material misstatement at the assertion level, the auditor should assess control risk based on the auditor's understanding of controls and the auditor's plan to test the operating effectiveness of controls. If the auditor does not plan to test the operating effectiveness of controls, the auditor should assess control risk at maximum such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.

This is a difference in wording only, not a difference between the requirement in ISA 315 (Revised 2019) and the proposed SAS (that is, not ISA-plus, ISA-minus, or ISA-different).

The ASB also agreed with the additional guidance that was added to the proposed SAS that addresses how the auditor's evaluation of design and determination of implementation of identified controls may impact the nature or timing of the auditor's further audit procedures.

H. **Clarifying the Concept of Reasonable Possibility**—Based on the ASB's instructions, the Task Force suggested adding application material that explains that a reasonable possibility that a risk of material misstatement exists when the likelihood of a material misstatement occurring is more than remote. The ASB agreed with the Task Force's recommendation.

I. **Documenting a Combined Assessment of Inherent Risk and Control Risk**—The Task Force's view is that the auditor may, but is not required to, document a combined assessment of inherent risk and control risk. The ASB agreed with the Task Force's recommendation to include such guidance in the proposed SAS.

J. **New "Explanatory Memorandum" or "Wrap" Document**—The ASB directed the Task Force to prepare an executive summary to be issued simultaneously with the final SAS. Such document, albeit non authoritative would be reviewed by the ASB before issuance, similar to the explanatory memorandum that accompanies a proposed standard.

Matters for the Attention of the ASB

The following areas represent the most significant edits made by the Task Force to the proposed SAS since the draft was presented at the May 2021 ASB meeting and other matters that the Task Force is highlighting for the ASB.

Internal Control Application Guidance	As indicated above, at its May 2021 meeting, the ASB directed the Task Force to review the application material dealing with obtaining an understanding the components of internal control and determine whether any changes were necessary to enhance the organization and readability of that section of the proposed SAS. The Task Force

	reviewed that guidance and is suggesting some reorganization of that section of the proposed SAS (see paragraphs A102 – A110).
Appendices E and F	Appendix E, *Considerations for Understanding Information Technology*, and Appendix F, *Considerations for Understanding General IT Controls*, provide guidance that the auditor might consider in obtaining an understanding of the entity's information technology (IT) and general IT controls, respectively. Included in those appendixes are tables that are intended to provide examples of typical characteristics of the IT environment based on specific types of IT applications (Appendix E) and examples of general IT controls that may address examples of risks arising from the use of IT (Appendix F). A responder (EY) commented that the information in those tables is not clear and is confusing. In reviewing EY's comments, the Task Force agreed that the tables are confusing and too prescriptive for the proposed SAS and decided that a better location for these tables would be in the revised audit guide where more information could be provided to put the information of the table in better context.
COSO and Green Book Analysis	The Task Force analyzed the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) 2013 *Internal Control—Integrated Framework* and the U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government* (the "Green Book"), by assessing whether the COSO and Green Book principles are covered in the proposed SAS (see detailed analysis in the Appendix to this Cover Memo). Based on this analysis, the Task Force made the following changes: 1. Added "including the potential for fraud" to paragraph 22*a* I, which deals with the requirement of the auditor to obtain an understanding of the entity's risk assessment process. This addition was previously discussed with the ASB at its May 2021 meeting and the ASB agreed with the change. 2. Added application material in paragraph A126 related to the entity's risk assessment process to deal with changes that could significantly impact of internal control.
Considerations Specific to Governmental Entities	The application material of the proposed SAS includes various paragraphs that are intended to provide guidance specific to audits of governmental entities. Responders to the Exposure Draft (such as

	TIC and Eide Bailly) observed that those paragraphs could also provide guidance related to other regulated entities. The Task Force reviewed these paragraphs to assess whether the guidance is specific to audits of governmental entities. Based on this review, the Task Force concluded that the guidance in some of these paragraphs is broader and could be applicable to audits other than those of governmental entities and, therefore, modified and moved that guidance to the main application material (paragraphs A32, A51, A54, A82, and A225). In one instance, the Task Force concluded that the guidance is duplicative of the requirements and guidance in AU-C section 250 and, thus, suggests deleting this paragraph (see previous paragraph A246).
ESG Guidance Related to Climate Change	In October 2020, IFAC issued an audit staff alert on climate change. The ASB chair and the Chief Auditor discussed how to leverage this guidance in developing an AICPA publication. The AICPA will endeavor in developing a separate publication, but since climate change is pertinent to an entity's business risks, an idea discussed was to acknowledge climate change as part of risk assessment in the proposed SAS. To that end, considering the guidance in the IFAC audit staff alert, a principles-based paragraph was included in the application material (see paragraph A74) and other guidance was added related to climate change risks (see paragraph 9 of Appendix C).
AU-C section 935, *Compliance Audits*	The Task Force considered whether additional conforming amendments to AU-C section 935 were necessary. However, the Task Force believes that changes to AU-C section 935 would be beyond making conforming amendments because a detailed assessment might be necessary to determine the applicability of various requirements in the proposed SAS to a compliance audit engagement. In consultation with the chair of the ASB, it was concluded to treat the applicability of this proposed SAS to a compliance audit as a separate project to be conducted following the issuance of this standard much like the ASB did in revising AU-C section 935 (and other AU-C sections) when AU-C section 700 was revised. This avoids delaying the issuance of this proposed SAS and allows for the necessary time to consult with other stakeholders, such as the AICPA's State and Local Governments Expert Panel.

The Task Force also reviewed the Audit Guide, *Assessing and Responding the Risk of Material Misstatement*, for the purpose of assessing whether the Audit Guide contains guidance that

would be useful in the proposed SAS. The Task Force concluded that no guidance exists in the Audit Guide that should be added to the proposed SAS.

Questions for the Board

What are the Board's comments on the proposed SAS, and what are the Board views on the following matters:

a) Reorganization of internal control paragraphs dealing with obtaining an understanding of the components of internal control

b) Deletion of the tables in Appendixes E and F

c) Disposition of the COSO principles

d) Modifications related to considerations specific to governmental entities

e) Inclusion of ESG guidance in the Application Material and Appendix C, and

f) Compliance Audits?

Appendix

The following includes a comparative analysis between COSO, the Green Book, and the proposed SAS. It also includes the Task Force's proposed disposition.

COSO	Green Book	Proposed SAS - Requirements	Proposed Task Force Disposition
Control Environment			
The organization demonstrates a commitment to integrity and ethical values.	The oversight body and management should demonstrate a commitment to integrity and ethical values.	21*a* i. how management's oversight responsibilities are carried out, such as the entity's culture and management's commitment to integrity and ethical values;	No changes
The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.	The oversight body should oversee the entity's internal control system.	21*a* 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;	No changes
Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.	Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives.	21*a* iii. the entity's assignment of authority and responsibility;	No changes
The organization demonstrates a commitment to attract, develop, and retain competent	Management should demonstrate a commitment to	21*a* iv. how the entity attracts, develops, and retains competent individuals;	No changes

COSO	Green Book	Proposed SAS - Requirements	Proposed Task Force Disposition
individuals in alignment with objectives.	recruit, develop, and retain competent individuals.		
The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.	Management should evaluate performance and hold individuals accountable for their internal control responsibilities.	21*a* v. how the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control; and	No changes
Risk Assessment			
The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.	Management should define objectives clearly to enable the identification of risks and define risk tolerances.	A126. …may consider…has done the following: • Specified the entity's objectives with sufficient precision and clarity to enable the identification and assessment of the risks relating to the objectives	No changes; while not a requirement, this is appropriately addressed
The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.	Management should identify, analyze, and respond to risks related to achieving the defined objectives.	22*a* i. identifying business risks, including the potential for fraud, relevant to financial reporting objectives; 22*a* ii. assessing the significance of those risks, including the likelihood of their occurrence; and 22*a* iii addressing those risks	See disposition below

COSO	Green Book	Proposed SAS - Requirements	Proposed Task Force Disposition
The organization considers the potential for fraud in assessing risks to the achievement of objectives.	Management should consider the potential for fraud when identifying, analyzing, and responding to risks.	See paragraph 22*a* i above	Added "including the potential for fraud" to the requirement
The organization identifies and assesses changes that could significantly impact the system of internal control.	Management should identify, analyze, and respond to significant changes that could impact the internal control system.	See paragraph A126	Added "assesses changes that could significantly impact the system of internal control" to the application guidance
Information and Communication			
The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.	Management should use quality information to achieve the entity's objectives	Paragraph 25 addresses the understanding of the information system relevant to financial reporting. This understanding includes, among other things, the entity's information-processing activities	No changes
The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.	Management should internally communicate the necessary quality information to achieve the entity's objectives.	25*b* understanding how the entity communicates significant matters that support the preparation of the financial statements and related reporting responsibilities in the information system and other components of the system of internal control (Ref: par. A159–A160)	No changes

COSO	Green Book	Proposed SAS - Requirements	Proposed Task Force Disposition
		i. between people within the entity, including how financial reporting roles and responsibilities are communicated, ii. between management and those charged with governance,	
The organization communicates with external parties regarding matters affecting the functioning of internal control.	Management should externally communicate the necessary quality information to achieve the entity's objectives.	25*b* iii. with external parties, such as those with regulatory authorities.	No changes
Control Activities			
The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.	Management should design control activities to achieve objectives and respond to risks.	Paragraphs 26-29 address the auditor's responsibilities related to understanding and evaluating controls within the control activities component in the context of a financial statement audit; there is no separate evaluation of this particular component	No changes
The organization selects and develops general control activities over technology to support the achievement of objectives.	Management should design the entity's information system and related control activities to achieve objectives and respond to risks.	See comment on paragraphs 26-29 above	No changes; specific requirements exist with respect to IT general controls

COSO	Green Book	Proposed SAS - Requirements	Proposed Task Force Disposition
The organization deploys control activities through policies that establish what is expected and in procedures that put policies into action.	Management should implement control activities through policies.	See comment on paragraphs 26-29 above	No changes
Monitoring Activities			
The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.	Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.	24*a* i. ongoing and separate evaluations for monitoring the effectiveness of controls and the identification and remediation of control deficiencies identified	No changes
The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and those charged with governance, as appropriate.	Management should remediate identified internal control deficiencies on a timely basis.	See paragraph 24*a* i above	No changes

AICPA

Agenda Item 2A

Agenda Item Proposed Statement on Auditing Standards, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

Introduction

Scope of This Proposed SAS

1. This proposed Statement on Auditing Standards (SAS) addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements.

Key Concepts in This Proposed SAS

2. AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, addresses the overall objectives of the auditor in conducting an audit of the financial statements, including to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.[1] Audit risk is a function of the risks of material misstatement and detection risk.[2] AU-C section 200 explains that the risks of material misstatement may exist at two levels:[3] the overall financial statement level and the assertion level for classes of transactions, account balances, and disclosures.

3. AU-C section 200 requires the auditor to exercise professional judgment in planning and performing an audit and to plan and perform an audit with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated.[4]

4. Risks at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level consist of two components:[5] inherent risk and control risk:

[1] Paragraph .19 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

[2] Paragraph .14 of AU-C section 200.

[3] Paragraph .A38 of AU-C section 200.

[4] Paragraphs .17–.18 of AU-C section 200.

[5] Paragraph .14 of AU-C section 200.

- *Inherent risk* is described as the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
- *Control risk* is described as the risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's system of internal control.

5. AU-C section 200 explains that risks of material misstatement are assessed at the assertion level in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. For purposes of generally accepted auditing standards (GAAS), a risk of material misstatement exists when (*a*) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (*b*) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).[6] For the identified risks of material misstatement at the assertion level, a separate assessment of inherent risk and control risk is required by this proposed SAS. As explained in AU-C section 200, inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. The degree to which the level of inherent risk varies is referred to in this proposed SAS as the *spectrum of inherent risk*.

Commented [RMM1]: Change made to align with conforming amendments that were proposed to paragraph .A43 of AU-C section 200 in the Exposure Draft

6. Risks of material misstatement identified and assessed by the auditor include both those due to error and those due to fraud. Although both are addressed by this proposed SAS, the significance of fraud is such that further requirements and guidance are included in AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*, in relation to risk assessment procedures and related activities to obtain information that is used to identify, assess, and respond to the risks of material misstatement due to fraud.

7. The auditor's risk identification and assessment process is iterative and dynamic. The auditor's understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control are interdependent with concepts within the requirements to identify and assess the risks of material misstatement. In obtaining the understanding required by this proposed SAS, initial expectations of risks may be developed, which may be further refined as the auditor progresses through the risk identification and assessment process. In addition, paragraph 40 of this proposed SAS and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*,[7] require the auditor to revise the risk assessments and modify further overall responses and further audit procedures, based on audit evidence obtained from performing further audit procedures in accordance with AU-C section 330, or if new information is obtained.

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[6] Paragraph .A43*a* of AU-C section 200 and paragraph .06 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

[7] Paragraph .27 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

8. AU-C section 330 requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.[8] AU-C section 330 further explains that the auditor's assessment of the risks of material misstatement at the financial statement level, and the auditor's overall responses, is affected by the auditor's understanding of the control environment. AU-C section 330 also requires the auditor to design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.[9]

Scalability

9. AU-C section 200 states that some AU-C sections include scalability considerations, which illustrate the application of the requirements to all entities regardless of whether their nature and circumstances are less complex or more complex.[10] This proposed SAS is intended for audits of all entities, regardless of size or complexity; therefore, the application material incorporates considerations specific to both less and more complex entities, where appropriate. Although the size of an entity may be an indicator of its complexity, some smaller entities may be complex, and some larger entities may be less complex.

Effective Date

10. This proposed SAS is effective for audits of financial statements for periods ending on or after December 15, 2023.

Objective

11. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

Definitions

12. For purposes of GAAS, the following terms have the meanings attributed:

> **Assertions.** Representations, explicit or otherwise, with respect to the recognition, measurement, presentation, and disclosure of information in the financial statements, which are inherent in management, representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing, and responding to the risks of material misstatement. (Ref: par. A1)

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[8] Paragraph .05 of AU-C section 330.

[9] Paragraph .06 of AU-C section 330.

[10] Paragraph .~~A65*a*~~ A68 of AU-C section 200.

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.

Controls. Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context (Ref: par. A2–A5)

i. policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.

ii. procedures are actions to implement policies.

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 in the entity's information system. Also see **IT environment**. (Ref: par. A6)

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. (Ref: par. A7~~A6–A7~~A8)

Commented [RMM2]: Word missing; change is consistent with the ISA

Inherent risk factors. Characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, before consideration of controls. Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other fraud risk factors[11] insofar as they affect inherent risk.

Depending on the degree to which the inherent risk factors affect the susceptibility to misstatement of an assertion, the level of inherent risk varies on a scale that is referred to as the *spectrum of inherent risk*. (Ref: par. A9–A11)

Commented [RMM3]: **See Issue A (May 2021)**

Aligns with conforming amendment to paragraph A43 of AU-C section 200. Included in response to comments requesting a "definition" of the spectrum of inherent risk.

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 definition

i. an *IT application* is a program or a set of programs that is used in the initiation, processing, recording, and reporting of transactions or information. IT

[11] Paragraphs .A28–.A32 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.

applications include data warehouses and report writers.

ii. the IT infrastructure comprises the network, operating systems, and databases and their related hardware and software.

iii. the IT processes are the entity's processes to manage access to the IT environment, manage program changes or changes to the IT environment, and manage IT operations.

Relevant assertions. An assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement. A risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).[12] The determination of whether an assertion is a relevant assertion is made before consideration of any related controls (that is, the determination is based on inherent risk). (Ref: par. A12)

Commented [RMM4]: Change agreed to by the Board during the March ASB meeting. Elevates language from A12

Risks arising from the use of IT. Susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes. See **IT environment**. (Ref: par. A6 and A13)

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. (Ref: par. A14)

Commented [RMM5]: Added application guidance, in lieu of modifying the definition, as agreed to by the Board at the March ASB meeting

Significant risk. An identified risk of material misstatement (Ref: par. A15)

i. for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur, or

ii. that is to be treated as a significant risk in accordance with the requirements of other AU-C sections.[13]

Spectrum of Inherent Risk. See definition of inherent risk factors.

Commented [MM6]: See comment on the definition of inherent risk factors. Change requested by the Board to refer to that definition

System of internal control. The system designed, implemented, and maintained by those charged with governance, management, and other personnel, to provide reasonable

[12] Paragraph .A15 of AU-C section 200.
[13] Paragraph .25 of AU-C section 240 and paragraph .18 of AU-C section 550, *Related Parties*.

assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. For purposes of GAAS, the system of internal control consists of five interrelated components:

i. Control environment

ii. The entity's risk assessment process

iii. The entity's process to monitor the system of internal control

iv. The information system and communication

v. Control activities

(Ref: par. A16)

Requirements

Risk Assessment Procedures and Related Activities

13. The auditor should design and perform risk assessment procedures to obtain audit evidence that provides an appropriate basis for (Ref: par. A17–A24)

a. the identification and assessment of risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, and

b. the design of further audit procedures in accordance with AU-C section 330.

The auditor should design and perform risk assessment procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

14. The risk assessment procedures should include the following: (Ref: par. A25–A27)

a. Inquiries of management and of other appropriate individuals within the entity, including individuals within the internal audit function (if the function exists) (Ref: par. A28–A32)

b. Analytical procedures (Ref: par. A33–A37)

c. Observation and inspection (Ref: par. A38–A42)

Information From Other Sources

15. In obtaining audit evidence in accordance with paragraph 13, the auditor should consider information from (Ref: par. A43–A44)

a. the auditor's procedures regarding acceptance or continuance of the client relationship or the audit engagement, and

b. when applicable, other engagements performed by the engagement partner for the entity.

16. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor should evaluate whether such information remains relevant and reliable as audit evidence for the current audit. (Ref: par. A45–A47)

Engagement Team Discussion

17. The engagement partner and other key engagement team members should discuss the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement. (Ref: par. A48–~~A52~~A54)

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

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control (Ref: par. A55–A57)

Understanding the Entity and Its Environment, and the Applicable Financial Reporting Framework (Ref: par. A58–A63)

19. The auditor should perform risk assessment procedures to obtain an understanding of

a. the following aspects of the entity and its environment:

i. The entity's organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT (Ref: par. A64–A77)

ii. Industry, regulatory, and other external factors (Ref: par. A78–A83)

iii. The measures used, internally and externally, to assess the entity's financial performance (Ref: par. A84–A91)

b. the applicable financial reporting framework and the entity's accounting policies and the reasons for any changes thereto. (Ref: par. A92–A94)

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 subparagraphs *a* and *b*. (Ref: par. A95–A100)

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

Understanding the Components of the Entity's System of Internal Control (Ref: par. A101–A112)

Control Environment, the Entity's Risk Assessment Process, and the Entity's Process to Monitor the System of Internal Control (Ref: par. A113–A115)

Control Environment

21. The auditor should, through performing risk assessment procedures, obtain an understanding of the control environment relevant to the preparation of the financial statements by (Ref: par. A116–A117)

a. understanding the set of controls, processes, and structures that address (Ref: par. A118)

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;

v. how the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of the system of internal control; and

b. evaluating, based on the auditor's understanding obtained in paragraph 21*a*, whether (Ref: par. A119–A124)

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 the 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.

The Entity's Risk Assessment Process

22. The auditor should, through performing risk assessment procedures, obtain an understanding of the entity's risk assessment process relevant to the preparation of the financial statements by

a. understanding the entity's process for (Ref: par. A125–A127)

i. identifying business risks, including the potential for fraud, relevant to financial

Commented [RMM7]: See Issue B (May 2021)

Modifications align with the intent of ISA 315 (Revised 2019) along with its application material. Changes are intended to also respond to comments requesting additional guidance related to the required "evaluation".

Commented [RMM8]: See Issue C (May 2021)

The language aligns with the COSO principles and also links the requirements in AU-C section 240. Guidance linking this requirement to AU-C Section 240 was initially added to the Exposure Draft.

reporting objectives; (Ref: par. A71)

ii. assessing the significance of those risks, including the likelihood of their occurrence;

iii. addressing those risks; and

b. evaluating, based on the auditor's understanding obtained in paragraph 22*a*, whether the entity's risk assessment process is appropriate to the entity's circumstances considering the nature and complexity of the entity. (Ref: par. A128–A130)

Commented [RMM9]: See Issue B (May 2021)

23. If the auditor identifies risks of material misstatement that management failed to identify, the auditor should

a. determine whether any such risks are of a kind that the auditor expects would have been identified by the entity's risk assessment process and, if so, obtain an understanding of why the entity's risk assessment process failed to identify such risks of material misstatement; and

b. consider the implications for the auditor's evaluation in paragraph 22*b.*

The Entity's Process for Monitoring the System of Internal Control

24. The auditor should, through performing risk assessment procedures, obtain an understanding of the entity's process for monitoring the system of internal control relevant to the preparation of the financial statements by (Ref: par. A131–A132)

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 (Ref: par. A133–A134) and

ii. the entity's internal audit function, if any, including its nature, responsibilities, and activities (Ref: par. A135–A136).

b. understanding the sources of the information used in the entity's process to monitor the system of internal control, and the basis upon which management considers the information to be sufficiently reliable for the purpose (Ref: par. A137–A138).

c. Evaluating, based on the auditor's understanding obtained in paragraph 24*a*-24*b*, whether the entity's process for monitoring the system of internal control is appropriate to the entity's circumstances considering the nature and complexity of the entity (Ref: par. A139–A140).

Commented [RMM10]: See Issue B (May 2021)

Information System and Communication, and Control Activities (Ref: par. A141–A148)

The Information System and Communication

25. The auditor should, through performing risk assessment procedures, obtain an

understanding of the entity's information system and communication relevant to the preparation of the financial statements by (Ref: par. A149–A150)

a. understanding the entity's information-processing activities, including its data and information, the resources to be used in such activities and the policies that define, for significant classes of transactions, account balances, and disclosures (Ref: par. A151–A164)

i. how information flows through the entity's information system, including how

(a) transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated in the general ledger, and reported in the financial statements and

(b) 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,

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 preceding *a*(i) to *a*(iii).

b. understanding how the entity communicates significant matters that support the preparation of the financial statements and related reporting responsibilities in the information system and other components of the system of internal control (Ref: par. A165–A166)

i. between people within the entity, including how financial reporting roles and responsibilities are communicated,

ii. between management and those charged with governance,

iii. with external parties, such as those with regulatory authorities.

c. Evaluating, based on the auditor's understanding obtained in paragraph 25*a*-25*b*, 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 considering the nature and complexity of the entity. (Ref: par. A167).

Control Activities

26. The auditor should, through performing risk assessment procedures, obtain an understanding of the control activities component, by applying the requirements in paragraphs 27–29 ~~by~~. (Ref: par. A168–A179)

Commented [RMM11]: See Issue B (May 2021)

Commented [RMM12]: See Issue D (May 2021)

Language aligns with requirements in paragraphs 21, 22, 24

Commented [RMM13]: See Issue E (May 2021)

Paragraph 26 was separated into more than one paragraph to improve readability and understandability. Paragraphs were renumbered.

27. The auditor should identify~~ing~~ the following controls that address risks of material misstatement at the assertion level ~~in the control activities component~~ ~~as follows~~:

a. Controls that address a risk that is determined to be a significant risk (Ref: par. A180–A181)

b. Controls over journal entries and other adjustments, including controls over nonstandard journal entries used to record nonrecurring, unusual transactions, ~~or adjustments~~ as required by AU-C section 240[14] (Ref: par. A182–A183)

c. Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive ~~testing~~procedures, which should include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (Ref: par. A184–A186)

d. Other controls that, based on the auditor's professional judgment, the auditor considers are appropriate to enable the auditor to meet the objectives of paragraph 13 with respect to risks at the assertion level~~, based on the auditor's professional judgment~~. (Ref: par. A187–A188~~A182~~)

~~28. B~~ ~~b~~Based on controls identified in paragraph 27~~(a)~~, the auditor should identify~~ing~~ the IT applications and the other aspects of the entity's IT environment that are subject to risks arising from the use of IT ~~(Ref: par. A183–A190)~~.

~~29.~~28. ~~f~~For the ~~such~~ identified IT applications and other aspects of the IT environment ~~identified in (b)~~, the auditor should identify~~ing~~ the following: (Ref: par. A189~~A183~~~~A191~~–A200)

a. the related risks arising from the use of IT, and

b. the entity's general IT controls that address such risks.

~~30.~~29. ~~C~~ ~~f~~For each control identified in paragraph 27~~a~~ or ~~c(ii)~~28*b*, the auditor should: (Ref: par. A201–A210~~A202~~)

a. evaluate~~ing~~ 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

b. determine~~ing~~ whether the control has been implemented by performing procedures in addition to inquiry of the entity's personnel.

Control Deficiencies Within the Entity's System of Internal Control

~~31.~~30. Based on the auditor's evaluation of each of the components of the entity's system of internal control, the auditor should determine whether one or more control deficiencies have been identified. (Ref: par. A211–A212)

[14] Paragraph 32(a)(i) of AU-C section 240.

Commented [RMM14]: See Issue E (May 2021)

Eliminated "in the control activities component" as it is addressed in paragraph 26 and improves readability. In addition, "controls" in other components may address risks of material misstatement.

Commented [RMM15]: See Issue E (May 2021)

Changed "as follows" to "the following" so as not to infer that all controls related to assertion level risks need to be identified. This was a comment provided in response to the Exposure Draft.

Commented [MM16]: See Issue F (May 2021)

As requested by the Board at the May 2021 ASB meeting, retained the requirement in the proposed SAS. The language, however, has been aligned with AU-C 240, which refers to "journal entries and other adjustments."

Commented [RMM17]: The defined term is AU-C section 330 is "substantive procedures"

Commented [MM18]: Modified for readability

Identifying and Assessing the Risks of Material Misstatement (Ref: par. A213–A214)

Identifying Risks of Material Misstatement

~~32.~~31. The auditor should identify the risks of material misstatement and determine whether they exist at (Ref: par. A215–A221)

a. the financial statement level (Ref: par. A222–A229~~A221~~) or

b. the assertion level for classes of transactions, account balances, and disclosures (Ref: par. A230–A231).

~~33.~~32. The auditor should determine the relevant assertions and the related significant classes of transactions, account balances, and disclosures. (Ref: par. A232–A234)

Assessing Risks of Material Misstatement at the Financial Statement Level

~~34.~~33. For identified risks of material misstatement at the financial statement level, the auditor should assess the risks and (Ref: par. A222–A229~~A221~~)

a. determine whether such risks affect the assessment of risks at the assertion level, and

b. evaluate the nature and extent of their pervasive effect on the financial statements.

Assessing Risks of Material Misstatement at the Assertion Level

Assessing Inherent Risk (Ref: par. A235–A244~~A239~~)

Commented [MR19]: A236-A245?

Commented [MM20R20]: Hiram – Can you check these references against the IAASB as well. I think they might need to be revised.

~~35.~~34. For identified risks of material misstatement at the assertion level, the auditor should assess inherent risk by assessing the likelihood and magnitude of misstatement. In doing so, the auditor should take into account how, and the degree to which

a. inherent risk factors affect the susceptibility of relevant assertions to misstatement, and

b. the risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level. (Ref: par. A245–A246)

~~36.~~35. The auditor should determine whether any of the assessed risks of material misstatement are significant risks. (Ref: par. A247–A251)

~~37.~~36. The auditor should determine whether substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatement at the assertion level. (Ref: par. A252–A255)

Assessing Control Risk

~~38.~~37. For identified risks of material misstatement at the assertion level~~If the auditor plans to test the operating effectiveness of controls~~, the auditor should assess control risk based on the auditor's understanding of controls and the auditor's plan to test the operating effectiveness of controls. If

the auditor does not plan to test the operating effectiveness of controls, the auditor's should assessment ofassess control risk at the maximum level should be such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk. (Ref: par. A256–A260)

Commented [RMM21]: See Issue G (May 2021)

Modified to clarify the requirement based on comments received and the Board's feedback. Requirement aligns closer with PCAOB standard but is not intended to be ISA-minus or ISA-plus.

Refer to additional guidance in paragraph A258

Evaluating the Audit Evidence Obtained From the Risk Assessment Procedures

39.38. The auditor should 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 should 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 should take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management. (Ref: par. A261–A263)

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

40.39. 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 should evaluate whether the auditor's determination remains appropriate. (Ref: par. A264–A265)

Revision of Risk Assessment

41.40. If the auditor obtains new information that is inconsistent with the audit evidence on which the auditor originally based the identification or assessments of the risks of material misstatement, the auditor should revise the identification or assessment. (Ref: par. A266)

Audit Documentation

42.41. The auditor should include in the audit documentation[15] (Ref: par. A267–A273A263)

Commented [MR22]: A268-A273

Commented [MM23R23]: Hiram – I didn't check all of these

Commented [RMM24]: Added in response to comments and for consistency throughout paragraph 41

a. the discussion among the engagement team and the significant decisions reached in accordance with paragraphs 17 and 18;

b. key elements of the auditor's understanding in accordance with paragraphs 19, 21, 22, 24, and 2625; the sources of information from which the auditor's understanding was obtained; and the risk assessment procedures performed

c. the evaluation of the design of identified controls, and determination whether such controls have been implemented, in accordance with the requirements in paragraph 26; and

Commented [RMM25]: Removed for consistency throughout paragraph 41

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

[15] Paragraphs .08–.12 and .A8–.A9 of AU-C section 230, *Audit Documentation*.

the rationale for the significant judgments made.

***

Application and Other Explanatory Material

Definitions (Ref: par. 12)

Assertions

A1. Categories of assertions are used by auditors to consider the different types of potential misstatements that may occur when identifying, assessing, and responding to the risks of material misstatement. Examples of these categories of assertions are described in paragraph A219. The assertions differ from the written representations required by AU-C section 580, *Written Representations*, to confirm certain matters or support other audit evidence.

Controls

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, rather, are conditioned by the entity's culture. Procedures may be enforced through the actions permitted by the IT applications used by the entity or other aspects of the entity's IT environment.

A5. Controls may be direct or indirect (see paragraph A113 ~~A107~~ and A141). *Direct controls* are controls that are precise enough to address risks of material misstatement at the assertion level. *Indirect controls* are controls that support direct controls. Although indirect controls are not sufficiently precise to prevent, or detect and correct, misstatements at the assertion level, they are foundational and may have an indirect effect on the likelihood that a misstatement will be prevented or detected on a timely basis.

General IT Controls

A6. The integrity of information may include the completeness, accuracy, and validity of transactions and other information. Although this proposed SAS does not prescribe the use of a particular internal control framework, the auditor may find the following guidance regarding the concepts encompassed by the term *validity*, from COSO's 2013 *Internal Control—Integrated Framework* (COSO framework), helpful: "Recorded transactions represent economic events that actually occurred and were executed according to prescribed procedures. Validity is generally achieved through control activities that include the authorization of transactions as specified by an organization's established policies and procedures (that is, approval by a person having the

authority to do so)."[16] The U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government* (the "Green Book") provides similar guidance on validity.[17]

Commented [RMM26]: Added in response to comments. This is also consistent with AU-C section 940, which refers to both COSO and the Green Book

Information-Processing Controls

A7. Risks to the integrity of information arise from susceptibility to ineffective implementation of the entity's information policies, which are policies that define the information flows, records, and reporting processes in the entity's information system. Information-processing controls are procedures that support effective implementation of the entity's information policies. Information-processing controls may be automated (that is, embedded in IT applications) or manual (for example, input or output controls) and may rely on other controls, including other information-processing controls or general IT controls.

A8. Business processes result in the transactions that are recorded, processed, and reported by the information system. Information-processing controls are also known as transaction controls. Such controls directly support the actions to mitigate information-processing risks in an entity's business processes.

Commented [RMM27]: Paragraph added to help bridge "information-processing controls" as defined in the proposed SAS and "transaction controls" as defined in COSO. The Green Book refers to "transaction control activities"

Commented [RMM28]: This comes from paragraph .15 of Appendix C

Commented [RMM29]: This language was adapted from the COSO definition of transaction controls, which include automated or manual controls

Inherent Risk Factors

~~**A8.**~~**A9.** Appendix B sets out further considerations relating to understanding inherent risk factors.

~~**A9.**~~**A10.** Inherent risk factors may be qualitative or quantitative and affect the susceptibility of assertions to misstatement. Qualitative inherent risk factors relating to the preparation of information required by the applicable financial reporting framework include the following:

- Complexity
- Subjectivity
- Change
- Uncertainty
- Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk

~~**A10.**~~**A11.** Other inherent risk factors that affect susceptibility to misstatement of an assertion about a class of transactions, account balance, or disclosure may include one or both of the following:

- The quantitative or qualitative significance of the class of transactions, account balance, or disclosure
- The volume or a lack of uniformity in the composition of the items to be processed through the class of transactions or account balance, or to be reflected in the disclosure

[16] Section 7, "Control Activities" of COSO's 2013 *Internal Control—Integrated Framework.*
[17] See paragraph 11.05 of *Standards for Internal Control in the Federal Government.*

Relevant Assertions

~~A11.~~A12. 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. For the purposes of the AU-C sections, a risk of material misstatement exists when (*a*) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (*b*) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).[18] A reasonable possibility that a risk of material misstatement exists when the likelihood of a material misstatement occurring is more than remote. 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

~~A12.~~A13. Appendix E sets out further considerations relating to understanding IT.

~~Significant~~ class of transactions, account balance, or disclosure

A14. A class of transactions, account balance, or disclosure is considered significant when it has an identified risk of material misstatement at the assertion level (that is, there is one or more relevant assertions). The determination of whether a class of transactions, account balance, or disclosure is significant is made before consideration of any related controls (that is, the determination is based on inherent risk).

Significant Risk

~~A13.~~A15. Significance can be described as the relative importance of a matter and is judged by the auditor in the context in which the matter is being considered. For inherent risk, significance may be considered in the context of how, and the degree to which, inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur.

System of Internal Control

~~A14.~~A16. Internal control frameworks may use different terms that are similar to the concept of *system of internal control*. For example, the 2013 COSO framework and the Green Book ~~uses~~define *internal control* similarly to the *system of internal control* in this proposed SAS. ~~the term *internal control*.~~

Risk Assessment Procedures and Related Activities (Ref: par. 13–18)

~~A15.~~A17. The risks of material misstatement to be identified and assessed include both those due to fraud and those due to error, and both are covered by this proposed SAS. However, the significance of fraud is such that further requirements and guidance are included in AU-C section 240 in relation to risk assessment procedures and related activities to obtain information that is

Commented [RMM30]: **See Issue H (May 2021)**

Added to provide guidance related "reasonable possibility," which is consistent with the concept of "more than remote" in other AU-C sections (such as AU-C 265).

Also discussed by the Board at the March meeting

Commented [RMM31]: Additional guidance discussed by the Board at the March meeting

Commented [RMM32]: Modified to add the Green Book. Also modified based on comments received with respect to the terms "system of internal control" and "internal control" being synonymous (and common terminology in current practice).

[18] Paragraph .~~A43a~~14 of AU-C section 200 and paragraph .06 of AU-C section 330.

used to identify and assess the risks of material misstatement due to fraud.[19] In addition, the following AU-C sections provide further requirements and guidance on identifying and assessing risks of material misstatement regarding specific matters or circumstances:

- AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, with regard to accounting estimates
- AU-C section 550, *Related Parties*, with regard to related party relationships and transaction
- AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, with regard to going concern
- AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*, with regard to group financial statements

Professional skepticism is necessary for the critical assessment of audit evidence gathered when performing the risk assessment procedures and assists the auditor in remaining alert to audit evidence that is not biased towards corroborating the existence of risks or that may be contradictory to the existence of risks. Professional skepticism is an attitude that is applied by the auditor when making professional judgments that then provides the basis for the auditor's actions. The auditor applies professional judgment in determining when the auditor has audit evidence that provides an appropriate basis for risk assessment.

Commented [RMM33]: Added for parallel construction

~~A16.~~A18.

~~A17.~~A19. The application of professional skepticism by the auditor may include the following:

- Taking into account the reliability of information to be used as audit evidence
- ~~Questioning~~ Taking into account contradictory information ~~and the reliability of documents~~that comes to the auditor's attention
- 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

Commented [RMM34]: Modified based on comments received to separate the reliability of information from contradictory information.

Why Obtaining Audit Evidence in an Unbiased Manner Is Important (Ref: par. 13)

~~A18.~~A20. Designing and performing risk assessment procedures to obtain audit evidence to support the identification and assessment of the risks of material misstatement in an unbiased manner may assist the auditor in identifying potentially contradictory information. This~~, which~~

Commented [RMM35]: Modified to shorten the sentence structure and to eliminate the duplication of the phrase "may assist"

[19] Paragraphs .12–.27 of AU-C section 240.

may also assist the auditor in exercising professional skepticism in identifying and assessing the risks of material misstatement.

Sources of Audit Evidence (Ref: par. 13)

~~A19.~~A21. Designing and performing risk assessment procedures to obtain audit evidence in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence. In addition to information from other sources,[20] sources of information for risk assessment procedures may include the following:

- Interactions with management, those charged with governance, and other key entity personnel, such as internal auditors
- Certain external parties such as regulators, whether obtained directly or indirectly
- Publicly available information about the entity, for example, entity-issued press releases, materials for analysts or investor group meetings, analysts' reports, or information about trading activity

Regardless of the source of information, the auditor considers the relevance and reliability of the information to be used as audit evidence in accordance with AU-C section 500, *Audit Evidence*.[21]

Scalability (Ref: par. 13)

~~A20.~~A22. The nature and extent of risk assessment procedures, including obtaining an understanding pursuant to the following requirements, will vary based on the nature and circumstances of the entity (for example, the formality of the entity's policies and procedures, and processes and systems):

a. Performing risk assessment procedures (paragraph 19)

b. Understanding the components of internal control

i. Control environment (paragraph 21)

ii. The entity's risk assessment process (paragraph 22)

iii. The entity's process to monitor the system of internal control (paragraph 24)

iv. The information system and communication (paragraph 25)

v. Control activities (paragraph 26)

[20] See paragraph A43 and A44 of this proposed SAS.
[21] Paragraph .07 of AU-C section 500, *Audit Evidence*.

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 proposed SAS.

~~A21.~~A23. Some entities, including less complex entities, and particularly owner-managed entities, may not have established structured processes and systems (for example, a risk assessment process or a process to monitor the system of internal control) or may have established processes or systems with limited documentation or a lack of consistency in how they are undertaken. When such systems and processes lack formality, the auditor may still be able to perform risk assessment procedures through observation and inquiry. Other entities, typically more complex entities, are expected to have more formalized and documented policies and procedures. The auditor may use such documentation in performing risk assessment procedures.

~~A22.~~A24. The nature and extent of risk assessment procedures to be performed in an initial audit may be more extensive than procedures for a recurring engagement. In subsequent periods, the auditor may focus on changes that have occurred since the preceding period.

Types of Risk Assessment Procedures (Ref: par. 14)

~~A23.~~A25. AU-C section 500[22] explains the types of audit procedures that may be performed in obtaining audit evidence from risk assessment procedures and further audit procedures. The nature, timing, and extent of the audit procedures may be affected by the fact that some of the accounting data and other evidence may be available only in electronic form or only at certain points in time.[23] The auditor may perform substantive procedures or tests of controls, in accordance with AU-C section 330, concurrently with risk assessment procedures, such as 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.

~~A24.~~A26. Although the auditor is required to perform all the risk assessment procedures described in paragraph 14 in the course of obtaining the required understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control (see paragraphs 19–26), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed when the information to be obtained may be helpful in identifying risks of material misstatement. Examples of such procedures may include making inquiries of the entity's external legal counsel, or of valuation specialists that the entity has used.

Automated Tools and Techniques (Ref: par. 14)

~~A25.~~A27. Using automated tools and techniques, the auditor may perform risk assessment procedures on large volumes of data (from the general ledger, sub-ledgers, or other operational data), including for analysis, recalculations, reperformance, or reconciliations.

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22 Paragraphs .A14–.A17 and .A21–.A26 of AU-C section 500.

23 Paragraph .A12 of AU-C section 500.

Inquiries of Management and Others Within the Entity (Ref: par. 14a)

Why Inquiries Are Made of Management and Others Within the Entity

~~A26.~~A28. Information obtained by the auditor to support an appropriate basis for the identification and assessment of risks, and the design of further audit procedures, may be obtained through inquiries of management and those responsible for financial reporting. As described in AU-C section 500, responses to inquiries may provide the auditor with information not previously possessed, with corroborative audit evidence, or with information that differs significantly from other information that the auditor has obtained.[24]

Commented [MM36]: Modified based on comments received during the May 2021 Board meeting to clarify the importance of inquiries in risk assessment. Leveraged language in AU-C 500.

~~A27.~~A29. 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. Examples follow:

- Inquiries directed toward 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. AU-C section 260, *The Auditor's Communication With Those Charged With Governance*,[25] 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 toward in-house legal counsel[26] may provide information about such matters as litigation; compliance with laws and regulations; knowledge of fraud or suspected fraud affecting the entity; warranties; post-sales obligations; arrangements (such as joint ventures) with business partners; and the meaning of contractual terms.
- Inquiries directed toward 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 toward 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 toward IT personnel may provide information about IT processes as well as system changes, system or control failures, or other IT-related risks.

[24] Paragraphs .A~~23~~62-.~~A26~~A63 of AU-C section 500.

[25] Paragraph .A1 of AU-C section 260, *The Auditor's Communication With Those Charged With Governance*.

[26] See paragraph .16 of AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items*

Considerations Specific to Governmental Entities

~~A28.~~A30. When making inquiries of those who may have information that is likely to assist in identifying risks of material misstatement, auditors of governmental entities may obtain information from additional sources such as from the auditors that are involved in performance or other audits related to the entity.

Inquiries of the Internal Audit Function (Ref: par. 14a)

Why Inquiries Are Made of the Internal Audit Function (If the Function Exists)

~~A29.~~A31. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may assist the auditor in understanding the entity and its environment, and the entity's system of internal control, in the identification and assessment of risks. Appendix D sets out considerations for understanding an entity's internal audit function.

~~Considerations Specific to Governmental Entities~~

Commented [MM37]: See July 2021 Issues Paper

~~A30.~~A32. ~~Auditors of governmental~~Some entities, for example governmental entities, ~~often~~ may have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function may assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of control deficiencies related to financial reporting.

Analytical Procedures (Ref: par. 14b)

Why Analytical Procedures Are Performed as a Risk Assessment Procedure

~~A31.~~A33. 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.

~~A32.~~A34. Analytical procedures performed as risk assessment procedures may, therefore, assist in identifying and assessing the risks of material misstatement by identifying aspects of the entity of which the auditor was unaware or understanding how inherent risk factors, such as change, affect susceptibility of assertions to misstatement.

Types of Analytical Procedures

~~A33.~~A35. Analytical procedures performed as risk assessment procedures may be as follows:

- Include both financial and nonfinancial information, for example, the relationship between sales and square footage of selling space or volume of goods sold (nonfinancial).
- Use data aggregated at a high level. Accordingly, the results of those analytical procedures may provide a broad initial indication about the likelihood and potential magnitude of a material misstatement. For example, in the audit of many entities, including those with

less complex business models and processes, and a less complex information system, the auditor may perform a comparison of information, such as the change in interim or monthly account balances from balances in prior periods, to obtain an indication of potentially higher risk areas.

~~A34.~~A36. This proposed SAS addresses the auditor's use of analytical procedures as risk assessment procedures. AU-C section 520, *Analytical Procedures*, addresses the auditor's use of analytical procedures as substantive procedures (substantive analytical procedures) and the auditor's responsibility to perform analytical procedures near the end of the audit. Accordingly, analytical procedures performed as risk assessment procedures are not required to be performed in accordance with the requirements of AU-C section 520. However, the requirements and application material in AU-C section 520 may provide useful guidance to the auditor when performing analytical procedures as part of the risk assessment procedures.

Automated Tools and Techniques

~~A35.~~A37. Analytical procedures can be performed using a number of tools or techniques, which may be automated. Applying automated analytical procedures to the data may be referred to as *data analytics*. For example, the auditor may use a spreadsheet to perform a comparison of actual recorded amounts to budgeted amounts or may perform a more advanced procedure by extracting data from the entity's information system, and further analyzing this data using visualization techniques to identify classes of transactions, account balances, or disclosures for which further specific risk assessment procedures may be warranted.

Observation and Inspection (Ref: par. 14c)

Why Observation and Inspection Are Performed as Risk Assessment Procedures

~~A36.~~A38. 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

~~A37.~~A39. When 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 are as follows:

- The auditor may obtain an understanding of controls over an inventory count, even if they have not been documented by the entity, through a combination of inquiry and direct observation.
- The auditor may be able to observe segregation of duties.
- The auditor may be able to observe passwords being entered.

Observation and Inspection as Risk Assessment Procedures

~~A38.~~A40. 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 A89)
- The behaviors and actions of management or those charged with governance (such as the observation of an audit committee meeting)

Automated Tools or Techniques

~~A39.~~A41. Automated tools or techniques may also be used to observe or inspect ~~, in~~ particular assets. ~~,~~ For~~for~~ example, such tools and techniques may include ~~through~~ the use of remote observation tools, such as ~~(for example,~~ a video camera or drone~~)~~.

Commented [RMM38]: Modified to add an additional example based on comments received.

Considerations Specific to Governmental Entities

~~A40.~~A42. Risk assessment procedures performed by auditors of governmental entities may also include observation and inspection of documents prepared by management for the governing body, for example, documents related to performance reporting.

Information From Other Sources (Ref: par. 15)

Why the Auditor Considers Information From Other Sources

~~A41.~~A43. Information obtained from other sources may be relevant to the identification and assessment of the risks of material misstatement by providing information and insights about the following:

- The nature of the entity and its business risks, and what may have changed from previous periods
- The integrity and ethical values of management and those charged with governance, which may also be relevant to the auditor's understanding of the control environment

The Applicable Financial Reporting Framework and Its Application to the Nature and

Circumstances of the Entity

Other Relevant Sources

~~A42.~~A44. Other relevant sources of information are as follows:

- The auditor's procedures regarding acceptance or continuance of the client relationship or the audit engagement in accordance with AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, including the conclusions reached thereon.[27]
- Other engagements performed for the entity by the engagement partner. The engagement partner may have obtained knowledge relevant to the audit, including about the entity and its environment, when performing other engagements for the entity. Such engagements may include agreed-upon procedures engagements or other audit or assurance engagements, including engagements to address incremental reporting requirements in the jurisdiction.

Information From the Auditor's Previous Experience With the Entity and Previous Audits (Ref: par. 16)

Why Information From Previous Audits Is Important to the Current Audit

~~A43.~~A45. The auditor's previous experience with the entity and from audit procedures performed in previous audits may provide the auditor with information that is relevant to the auditor's determination of the nature and extent of risk assessment procedures, and the identification and assessment of risks of material misstatement.

Nature of the Information From Previous Audits

~~A44.~~A46. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about the following matters:

- Past misstatements and whether they were corrected on a timely basis
- The nature of the entity and its environment, and the entity's system of internal control (including control deficiencies)
- Significant changes that the entity or its operations may have undergone since the prior financial period
- Those particular types of transactions and other events or account balances (and related disclosures) in which the auditor experienced difficulty in performing the necessary audit procedures, for example, due to their complexity

[27] Paragraph .14 of AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.

~~A45.~~A47. The auditor is required to determine whether information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits remains relevant and reliable, if the auditor intends to use that information for the purposes of the current audit. If the nature or circumstances of the entity have changed, or new information has been obtained, the information from prior periods may no longer be relevant or reliable for the current audit. To determine whether changes have occurred that may affect the relevance or reliability of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of the applicable information-processing activities in the information~~relevant~~ system~~s~~. ~~If the information is not reliable, the auditor may consider performing additional procedures that are appropriate in the circumstances.~~

Commented [RMM39]: Modified to assist with clarifying the concept of a walk-through

Commented [RMM40]: Modified as there is a requirement related to using prior period audit evidence. The "may consider performing" might be misinterpreted.

Engagement Team Discussion (Ref: par. 17–18)

Why the Engagement Team Is Required to Discuss the Application of the Applicable Financial Reporting Framework and the Susceptibility of the Entity's Financial Statements to Material Misstatement

~~A46.~~A48. Key engagement team members include those members who have significant engagement responsibilities, including the engagement partner. The manner in which the discussion is conducted depends on the individuals involved and the circumstances of the engagement. For example, if the audit involves more than one location, there could be multiple discussions with team members in different locations.

~~A47.~~A49. The discussion among the engagement team about the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement accomplishes the following:

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity. Sharing information contributes to an enhanced understanding by all engagement team members.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject, how inherent risk factors may affect the susceptibility to misstatement of classes of transactions, account balances, and disclosures, and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them and to understand how the results of the audit procedures that they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures. In particular, the discussion assists engagement team members in further considering contradictory information based on each member's own understanding of the nature and circumstances of the entity.

- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

AU-C section 240 requires the engagement team discussion to place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud may occur.[28]

A50. Professional skepticism is necessary for the critical assessment of audit evidence, and a robust and open engagement team discussion, including for recurring audits, may lead to improved identification and assessment of the risks of material misstatement. Another outcome from the discussion may be that the auditor identifies specific areas of the audit for which exercising professional skepticism may be particularly important and may lead to the involvement of more experienced members of the engagement team who are appropriately skilled to be involved in the performance of audit procedures related to those areas.

~~A48.~~A51. As part of the discussion among the engagement team, consideration may also be given to additional broader objectives, and related risks, arising from specific audit requirements, for example those related to governmental entities.

Commented [HH41]: See July 2021 Issues Paper

Previously a consideration specific to governmental entities. Made it broader and moved it here from below.

Scalability

~~A49.~~A52. When the engagement is carried out by a single individual, such as a sole practitioner (that is, when an engagement team discussion would not be possible), consideration of the matters referred to in paragraphs A49 and A54, nonetheless, may assist the auditor in identifying where there may be risks of material misstatement.

~~A50.~~A53. When an engagement is carried out by a large engagement team, such as for an audit of group financial statements, it is not always necessary or practical for the discussion to include all members in a single discussion (for example, in a multi-location audit), nor is it necessary for all the members of the engagement team to be informed of all the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team, including, if considered appropriate, those with specific skills or knowledge and those responsible for the audits of components, while delegating discussion with others, taking into account the extent of communication considered necessary throughout the engagement team. A communications plan, agreed to by the engagement partner, may be useful.

Discussion of Disclosures in the Applicable Financial Reporting Framework

~~A51.~~A54. As part of the discussion among the engagement team, consideration of the disclosure requirements of the applicable financial reporting framework assists in identifying early in the audit where there may be risks of material misstatement in relation to disclosures, even in circumstances in which the applicable financial reporting framework requires only simplified disclosures. Matters the engagement team may discuss include the following:

[28] Paragraph .15 of AU-C section 240.

- Changes in financial reporting requirements that may result in significant, new, or revised disclosures
- Changes in the entity's environment, financial condition, or activities that may result in significant, new, or revised disclosures, for example, a significant business combination in the period under audit
- Disclosures for which obtaining sufficient appropriate audit evidence may have been difficult in the past
- Disclosures about complex matters, including those involving significant management judgment about what information to disclose

~~• *Considerations Specific to Governmental Entities*~~

~~As part of the discussion among the engagement team by auditors of governmental entities, consideration may also be given to any additional broader objectives, and related risks, arising from audit requirements of governmental entities.~~

Commented [MM42]: See July 2021 Issues Paper

Made this broader and moved above

Commented [MM43]: Hiram we lost the paragraph reference here

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control (Ref: par. 19–30)

~~A52.~~A55. Appendixes A–F set out further considerations relating to obtaining an understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control.

Obtaining the Required Understanding (Ref: par. 19–30)

~~A53.~~A56. Obtaining an understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control is a dynamic and iterative process of gathering, updating, and analyzing information and continues throughout the audit. Therefore, the auditor's expectations may change as new information is obtained.

~~A54.~~A57. The auditor's understanding of the entity and its environment and the applicable financial reporting framework may also assist the auditor in developing initial expectations about the classes of transactions, account balances, and disclosures that may be significant classes of transactions, account balances, and disclosures. These expected significant classes of transactions, account balances, and disclosures form the basis for the scope of the auditor's understanding of the entity's information system.

Why an Understanding of the Entity and Its Environment, and the Applicable Financial Reporting Framework, Is Required (Ref: par. 19–20)

~~A55.~~A58. The auditor's understanding of the entity and its environment and the applicable financial reporting framework assist the auditor

a. in understanding the events and conditions that are relevant to the entity, and

b. in identifying how inherent risk factors affect the susceptibility of assertions to misstatement in the preparation of the financial statements, in accordance with the applicable financial reporting framework, and the degree to which they do so.

Such information establishes a frame of reference within which the auditor identifies and assesses risks of material misstatement. This frame of reference also assists the auditor in planning the audit and exercising professional judgment and professional skepticism throughout the audit, for example, when

- identifying and assessing risks of material misstatement of the financial statements in accordance with this proposed SAS or other relevant AU-C sections (for example, relating to risks of fraud in accordance with AU-C section 240 or when identifying or assessing risks related to accounting estimates in accordance with AU-C section 540);
- performing procedures to help identify instances of noncompliance with laws and regulations that may have a material effect on the financial statements in accordance with AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*;[29]
- evaluating whether the financial statements provide adequate disclosures in accordance with AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*;[30]
- determining materiality or performance materiality in accordance with AU-C section 320, *Materiality in Planning and Performing an Audit*;[31] or
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures.

~~A56.~~A59. The auditor's understanding of the entity and its environment, and the applicable financial reporting framework, also informs how the auditor plans and performs further audit procedures, for example, when

- developing expectations for use when performing substantive analytical procedures in accordance with AU-C section 520;[32]
- designing and performing further audit procedures to obtain sufficient appropriate audit evidence in accordance with AU-C section 330; and
- evaluating the sufficiency and appropriateness of audit evidence obtained (for example, relating to assumptions or management's oral and written representations).

Commented [RMM44]: AU-C Section 520 addresses "substantive" analytical procedures as further audit procedures

Scalability (Ref: par. 19–20)

[22] Paragraph .13 of AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.

[30] Paragraph .~~15*f*~~15*e* of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*.

[31] Paragraphs .10–.11 of AU-C section 320, *Materiality in Planning and Performing an Audit*.

[32] Paragraph .05 of AU-C section 520, *Analytical Procedures*.

~~A57.~~A60. The nature and extent of the required understanding is a matter of the auditor's professional judgment and varies from entity to entity based on the nature and circumstances of the entity, including the following:

- The size and complexity of the entity, including its IT environment
- The auditor's previous experience with the entity
- The nature of the entity's systems and processes, including whether they are formalized or not
- The nature and form of the entity's documentation

~~A58.~~A61. The auditor's risk assessment procedures to obtain the required understanding may be less extensive in audits of less complex entities and more extensive for entities that are more complex. The depth of the understanding that is required by the auditor is expected to be less than that possessed by management in managing the entity.

~~A59.~~A62. Some financial reporting frameworks allow smaller entities to provide simpler and less detailed disclosures in the financial statements. However, this does not relieve the auditor of the responsibility to obtain an understanding of the entity and its environment and the applicable financial reporting framework as it applies to the entity.

~~A60.~~A63. The entity's use of IT and the nature and extent of changes in the IT environment, including the risks arising from the use of IT identified in accordance with paragraph 28*a*, may also affect the specialized skills that are needed to assist with obtaining the required understanding, including the entity's general IT controls to be identified in accordance with paragraph 28*b*.

Commented [RMM45]: Added to clarify that specialized skills may assist with understanding the entity's use of IT but also with identifying the risks arising from IT and evaluating design and determining implementation.

The Entity and Its Environment (Ref: par. 19)

The Entity's Organizational Structure, Ownership and Governance, and Business Model (Ref: par. 19*a*(i))

The Entity's Organizational Structure and Ownership (Ref: par. 19*a*(i))

~~A61.~~A64. An understanding of the entity's organizational structure and ownership may enable the auditor to understand the following matters:

- The complexity of the entity's structure. For example, the entity may be a single entity or the entity's structure may include subsidiaries, divisions, or other components in multiple locations. Further, the legal structure may be different from the operating structure. Complex structures often introduce factors that may give rise to increased susceptibility to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or variable interest entities are accounted for appropriately and whether adequate disclosure of such issues in the financial statements has been made.
- The ownership, and relationships between owners and other people or entities, including related parties. This understanding may assist in determining whether related

party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial statements.[33]

- The distinction between the owners, those charged with governance and management. For example, in some less complex entities, owners of the entity may be involved in managing the entity, therefore, there is little or no distinction. In contrast, such as in some larger entities with diverse ownership, there may be a clear distinction between management, the owners of the entity, and those charged with governance. Even in some larger entities, owners of the entity may be involved in managing the entity. AU-C section 260 provides guidance on the identification of those charged with governance and explains that, in some cases, some or all of those charged with governance may be involved in managing the entity.[34]

Commented [RMM46]: Added to address comments received with respect to owners managing the entity. In addition, elevated the footnote to the application material due to clarity drafting conventions.

- The structure and complexity of the entity's IT environment. For example, an entity may
  - have multiple legacy IT systems in diverse businesses that are not well integrated, resulting in a complex IT environment.
  - be using external or internal service providers for aspects of its IT environment (for example, 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).

Automated Tools and Techniques

~~A62.~~A65. The auditor may use automated tools and techniques to understand flows of transactions and processing as part of the auditor's procedures to understand the information system. An outcome of these procedures may be that the auditor obtains information about the entity's organizational structure or those with whom the entity conducts business (for example, vendors, customers, or related parties).

Considerations Specific to Governmental Entities

~~A63.~~A66. Ownership of a governmental entity may not have the same relevance as in the private sector because many governmental entities do not have owners or because decisions related to the entity may be made outside of the entity as a result of political processes. Therefore, management may not have control over certain decisions that are made. Matters that may be relevant include understanding the ability of the entity to make unilateral decisions and the ability of other governmental entities to control or influence the entity's mandate and strategic direction. For example, a governmental entity may be subject to laws or other directives from authorities that require it to obtain approval from parties external to the entity of its strategy and objectives prior to it implementing them. Therefore, matters related to understanding the legal structure of the

[33] AU-C section 550 addresses the auditor's considerations relevant to related parties.

[34] Paragraphs .A6–.A7 of AU-C section 260 ~~provide guidance on the identification of those charged with governance and explain that in some cases, some or all of those charged with governance may be involved in managing the entity~~.

entity may include applicable laws and regulations, and the classification of the entity (that is, whether the entity is a department, agency, or other type of entity).

Governance (Ref: par. 19*a*(i))

Why the Auditor Obtains an Understanding of Governance

~~A64.~~A67. Understanding the entity's governance may assist the auditor with understanding the entity's ability to provide appropriate oversight of its system of internal control. However, this understanding, in connection with the auditor's understanding of the control environment, may also provide evidence of control deficiencies, which may indicate an increase in the susceptibility of the entity's financial statements to risks of material misstatement.

Understanding the Entity's Governance

~~A65.~~A68. The following matters may be relevant for the auditor to consider in obtaining an understanding of the governance of the entity:

- Whether any or all of those charged with governance are involved in managing the entity and, if applicable, how those charged with governance demonstrate independence from management
- 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 subgroups 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~~approving the financial statements or monitoring the entity's internal control related to financial reporting

The Entity's Business Model (Ref: par. 19*a*(i))

~~A66.~~A69. Appendixes A–B set out additional considerations for obtaining an understanding of the entity and its business model as well as additional considerations for auditing variable interest entities.

Why the Auditor Obtains an Understanding of the Entity's Business Model

~~A67.~~A70. 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 because most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. For example, an entity's business model may rely on the use of IT in different ways:

Commented [RMM47]: Modified to clarify that control deficiencies may be identified in connection with the auditor's understanding of the control environment, not simply understanding the governance structure.

Commented [RMM48]: Modified to use the same term consistently throughout.

Commented [RMM49]: Added the notion of independence based on comments received. The language is consistent with COSO. The Green Book references the "possible independence" needed.

Commented [RMM50]: Modified to align with paragraph A10 of AU-C section 260

- An entity sells shoes from a physical store and uses an advanced stock and point of sale system to record the selling of shoes.
- An entity sells shoes online so that all sales transactions are processed in an IT environment, including initiation of the transactions through a website.

The business risks arising from a significantly different business model would be substantially different, notwithstanding both entities sell shoes.

Understanding the Entity's Business Model

~~A68.~~A71. Not all aspects of the business model are relevant to the auditor's understanding. Business risks are broader than the risks of material misstatement of the financial statements, although business risks include the latter. The auditor does not have a responsibility to understand or identify all business risks because not all business risks give rise to risks of material misstatement.

~~A69.~~A72. Business risks could affect risks of material misstatement at the financial statement level or assertion level. For example, an entity's loss of financing or declining conditions affecting the entity's industry could affect its ability to settle its obligations when due and, thus, could affect the risks of material misstatement related to the classification of long-term liabilities or the valuation of long-term assets, or it could result in substantial doubt about the entity's ability to continue as a going concern. An unsuccessful new product or service or failed business expansion might affect the risks of material misstatement related to the valuation of inventory and other related assets.

Commented [RMM51]: Added as part of the evaluation of PCAOB AS 2110. The paragraph was adapted from paragraph 15 of PCAOB AS 2110 to provide additional guidance with respect to the connection between business risks and the risks of material misstatement in response to comments received.

~~A70.~~A73. Business risks increasing the susceptibility to risks of material misstatement may arise from the following:

- 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

~~A71.~~A74. Examples of matters that the auditor may consider when obtaining an understanding of the entity's business model, objectives, strategies, and related business risks that may result in a risk of material misstatement of the financial statements may include the following:

- Industry developments, such as the lack of personnel or expertise to deal with the changes in the industry
- New products and services that may lead to increased product liability
- Expansion of the entity's business, and demand has not been accurately estimated
- New accounting requirements in which there has been incomplete or improper implementation
- Regulatory requirements resulting in increased legal exposure
- Current and prospective financing requirements, such as loss of financing due to the entity's inability to meet requirements
- Use of IT, such as the implementation of a new IT system that will affect both operations and financial reporting
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements
- Climate related events or conditions that may impact the entity in terms of its business model, its operations and processes, or its ability to raise finance or attract investment and customers

Commented [MM52]: See July 2021 Issues Paper

~~A72.~~A75. Ordinarily, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of the entity's system of internal control and is discussed in paragraph 22 and paragraphs A125~~A119~~–A130~~A124~~.

Commented [MR53]: A125-A131

Considerations Specific to Governmental Entities

~~A73.~~A76. Entities operating in the governmental sector may create and deliver value in different ways from those creating wealth for owners but will still have an operating "model" with specific objectives. Matters that governmental sector auditors may obtain an understanding of that are relevant to the model of the entity include the following:

- Knowledge of relevant government activities, including related programs
- Program objectives and strategies, including public policy elements

~~A74.~~A77. For the audits of governmental entities, "management objectives" may be influenced by requirements to demonstrate public accountability and may include objectives that have their source in law, regulation, or other authority.

Industry, Regulatory, and Other External Factors (Ref: par. 19a(ii))

Industry Factors

~~A75.~~A78. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. The following are matters the auditor may consider:

- 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

~~A76.~~A79. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, in the construction industry, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with ~~sufficient relevant knowledge and experience~~the appropriate competence and capabilities.[35]

Commented [RMM54]: Modified to align with paragraph .A16 of AU-C section 220.

Regulatory Factors (Ref: par. 19*a*(ii))

~~A77.~~A80. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment and any changes thereto. The following are matters the auditor may consider:

- Regulatory framework for a regulated industry, 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 policies, including foreign exchange controls, fiscal policies, financial incentives (for example, government aid programs), and tariffs or trade restriction policies
- Environmental requirements affecting the industry and the entity's business

~~A78. Environmental requirements affecting the industry and the entity's business~~

Commented [MM55]: Hiram – there is nothing here. I wonder if this might be throwing off the paragraph references? I think A81 needs to be deleted.

[35] Paragraph .16 of AU-C section 220.

~~A79.~~A81. AU-C section 250 includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.[36]

~~Considerations Specific to Governmental Entities~~

Commented [MM56]: See July 2021 Issues Paper

~~A80.~~A82. ~~For the audits of governmental entities, p~~Particular laws or regulations may affect the entity's operations, for example governmental entities. Such elements may be an essential consideration when obtaining an understanding of the entity and its environment.

Other External Factors (Ref: par. 19*a*(ii))

~~A81.~~A83. Other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

*Measures Used by Management to Assess the Entity's Financial Performance (Ref: par. 19*a(iii)*)*

Why the Auditor Understands Measures Used by Management

~~A82.~~A84. An understanding of the entity's measures assists the auditor in considering whether such measures, whether used externally or internally, create pressures on the entity to achieve performance targets. These pressures may motivate management to take actions that increase the susceptibility to misstatement due to management bias or fraud (for example, to improve the business performance or to intentionally misstate the financial statements) (see AU-C section 240 for requirements and guidance in relation to the risks of fraud).

~~A83.~~A85. Measures may also indicate to the auditor the likelihood of risks of material misstatement of related financial statement information. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry.

Measures Used by Management

~~A84.~~A86. Management and others ordinarily measure and review those matters they regard as important. Inquiries of management may reveal that it relies on certain key indicators, regardless of public availability, for evaluating financial performance and taking action. In such cases, the auditor may identify relevant performance measures, whether internal or external, by considering the information that the entity uses to manage its business. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

~~A85.~~A87. Key indicators used for evaluating financial performance may include the following:

[36] Paragraph .12 of AU-C section 250.

- Key performance indicators (financial and nonfinancial) and key ratios, trends, and operating statistics
- Period-on-period financial performance analyses
- Budgets, forecasts, variance analyses, segment information and divisional, departmental, or other level performance reports
- Employee performance measures and incentive compensation policies
- Comparisons of an entity's performance with that of competitors

Scalability (Ref: par. 19*a*(iii))

~~A86.~~A88. The procedures undertaken to understand the entity's measures may vary depending on the size or complexity of the entity as well as the involvement of owners or those charged with governance in the management of the entity.

Other Considerations

~~A87.~~A89. External parties may also review and analyze the entity's financial performance, in particular, for entities in which financial information is publicly available. The auditor may also consider publicly available information to help the auditor further understand the business or identify contradictory information, such as information from the following sources:

- Analysts or credit agencies
- News and other media, including social media
- Taxation authorities
- Regulators
- Trade unions
- Providers of finance

Such financial information can often be obtained from the entity being audited.

~~A88.~~A90. The measurement and review of financial performance is not the same as the monitoring of the system of internal control (discussed as a component of the system of internal control in paragraphs A131~~A125~~–A140~~A134~~), though their purposes may overlap:

Commented [MR57]: A132-A141

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- In contrast, monitoring of the system of internal control is concerned with monitoring the effectiveness of controls including those related to management's measurement and review of financial performance.

In some cases, however, performance indicators also provide information that enables management to identify control deficiencies.

Considerations Specific to Governmental Entities

~~A89.~~A91. In addition to considering relevant measures used by a governmental entity to assess the entity's financial performance, auditors of governmental entities may also consider nonfinancial information, such as achievement of public benefit outcomes (for example, the number of people assisted by a specific program).

The Applicable Financial Reporting Framework (Ref: par. 19b)

Understanding the Applicable Financial Reporting Framework and the Entity's Accounting Policies

~~A90.~~A92. 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 following:

- The entity's financial reporting practices in terms of the applicable financial reporting framework, such as
  - accounting principles and industry-specific practices, including for industry-specific significant classes of transactions, account balances, and related disclosures in the financial statements (for example, loans and investments for banks or research and development for pharmaceuticals)
  - revenue recognition
  - accounting for financial instruments, including related credit losses
  - foreign currency assets, liabilities, and transactions
  - accounting for unusual or complex transactions, including those in controversial or emerging areas (for example, accounting for cryptocurrency)
- An understanding of the entity's selection and application of accounting policies, including any changes thereto as well as the reasons therefor, may encompass the following matters:
  - 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

~~A91.~~A93. Obtaining an understanding of the entity and its environment may assist the auditor in considering where changes in the entity's financial reporting (for example, from prior periods) may be expected. For example, if the entity has had a significant business combination during the period, the auditor would likely expect changes in classes of transactions, account balances, and disclosures associated with that business combination. Alternatively, if there were no significant changes in the financial reporting framework during the period, the auditor's understanding may help confirm that the understanding obtained in the prior period remains applicable.

Considerations Specific to Governmental Entities

~~A92.~~A94. The applicable financial reporting framework for a governmental entity may be generally accepted accounting principles established by the Federal Accounting Standards Advisory Board or GASB, or a special purpose framework.

How Inherent Risk Factors Affect Susceptibility of Assertions to Misstatement (Ref: par. 19c)

~~A93.~~A95. Appendix B provides examples of events and conditions that may give rise to the existence of risks of material misstatement, categorized by inherent risk factor.

Why the Auditor Understands Inherent Risk Factors When Understanding the Entity and Its Environment, and the Applicable Financial Reporting Framework

~~A94.~~A96. Understanding the entity and its environment, and the applicable financial reporting framework, assists the auditor in identifying events or conditions, the characteristics of which may affect the susceptibility of assertions about classes of transactions, account balances, or disclosures to misstatement. These characteristics are inherent risk factors. Inherent risk factors may affect susceptibility of assertions to misstatement by influencing the likelihood of occurrence of a misstatement or the magnitude of the misstatement if it were to occur. Understanding how inherent risk factors affect the susceptibility of assertions to misstatement may assist the auditor with a preliminary understanding of the likelihood or magnitude of misstatements, which assists the auditor in identifying risks of material misstatement at the assertion level in accordance with paragraph 31*b*. Understanding the degree to which inherent risk factors affect susceptibility of assertions to misstatement also assists the auditor in assessing the likelihood and magnitude of a possible misstatement when assessing inherent risk in accordance with paragraph ~~31*b*~~34*a*. Accordingly, understanding the inherent risk factors may also assist the auditor in designing and performing further audit procedures in accordance with AU-C section 330.

~~A95.~~A97. The auditor's identification of risks of material misstatement at the assertion level and assessment of inherent risk may also be influenced by audit evidence obtained by the auditor in performing other risk assessment procedures, further audit procedures, or in fulfilling other requirements in GAAS ~~(see paragraph A105)~~.

Commented [RMM58]: The ISA includes several references to various paragraphs addressing the evaluation of internal control and the design and implementation of internal control. A single reference is misleading and the statement is sufficient without including specific cross-references to other guidance.

The Effect of Inherent Risk Factors on a Class of Transactions, Account Balance, or Disclosure

~~A96.~~A98. The extent of susceptibility to misstatement of a class of transactions, account balance, or disclosure arising from complexity or subjectivity is often closely related to the extent to which it is subject to change or uncertainty. For example, if the entity has an accounting estimate that is based on assumptions, the selection of which are subject to significant judgment, the measurement of the accounting estimate is likely to be affected by both subjectivity and uncertainty.

~~A97.~~A99. The greater the extent to which a class of transactions, account balance, or disclosure is susceptible to misstatement because of complexity or subjectivity, the greater the need for the auditor to apply professional skepticism. Further, when a class of transactions, account balance, or disclosure is susceptible to misstatement because of complexity, subjectivity, change, or uncertainty, these inherent risk factors may create opportunity for management bias, whether unintentional or intentional, and affect susceptibility to misstatement due to management bias. The auditor's identification of risks of material misstatement, and assessment of inherent risk at the assertion level, are also affected by the interrelationships among inherent risk factors.

~~A98.~~A100. Events or conditions that may affect susceptibility to misstatement due to management bias may also affect susceptibility to misstatement due to other fraud risk factors. Accordingly, this may be relevant information for use in accordance with AU-C section 240,[37] which requires the auditor to evaluate whether the information obtained from the other risk assessment procedures and related activities indicates that one or more fraud risk factors are present.

Obtaining an Understanding of the Entity's System of Internal Control (Ref: par. 21–30)

~~A99.~~A101. Appendix C further describes the nature of the entity's system of internal control and inherent limitations of internal control, respectively. Appendix C also provides further explanation of the components of a system of internal control for purposes of GAAS.

A102. The components of the entity's system of internal control for the purpose of this proposed SAS may not necessarily reflect how an entity designs, implements, and maintains its system of internal control, or how it may classify any particular component. Management might use an internal control framework with components that differ from the components identified in this proposed SAS, or those specified by COSO or the Green Book, when designing, implementing, and maintaining the entity's system of internal control. In some instances, management may not use a framework at all. ~~Entities may use different terminology or frameworks to describe the various aspects of the system of internal control.~~ For the purpose of an audit, the auditor~~s~~ may ~~also~~ use the framework used by management or may use different terminology or frameworks to describe the various aspects of a system of internal control and their effect on the audit, provided all the components described in this proposed SAS are addressed.

~~A100.~~A103. Auditors of ~~governmental~~ some entities ~~often~~ may have additional responsibilities with respect to internal control~~, for example, to report on compliance with an established code of practice or reporting on spending against budget~~. As a result, their considerations about the system of internal control may be broader and more detailed. For example, ~~A~~auditors of governmental

[37] Paragraph .~~20~~ 24 of AU-C section 240.

Commented [RMM59]: See Issue B (May 2021)

Commented [HH60]: Moved from below

Commented [MM61R61]: Hiram – was this moved?

Commented [RMM62]: Clarified the guidance to respond to comments received.

Commented [RMM63]: From paragraph .A38 of AU-C section 940

entities may ~~also~~ have responsibilities to report on compliance with law, regulation, or other authority. ~~As a result, their considerations about the system of internal control may be broader and more detailed.~~

How the understanding of the components of the entity's system of internal control differs from understanding specific controls

The entity's system of internal control is a dynamic, iterative, and integrated process. Embedded within this process are controls consisting of policies and procedures. The components of the entity's system of internal control represent what is required to achieve the entity's financial reporting objectives. An audit does not require an understanding of all the processes or controls within each component.

A104.

A105. For the control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control components, the auditor's understanding includes the ongoing tasks and activities, or processes, geared to the achievement of the entity's financial reporting objectives. For the information system and communication component, the auditor's understanding includes the flows of transactions and other aspects of the entity's information-processing activities as well as the entity's communication of significant matters, as required by paragraph 25*a*-*b*. Inquiry alone may not be sufficient to obtain the required understanding of these components and to perform the evaluation required by paragraphs 21*b*, 22*b*, 24*c*, and 25*c*. Accordingly, ~~Risk assessment procedures to obtain an understanding of the control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control include a combination of inquiry, observation, and inspection, as required by paragraph 14.~~audit evidence for the auditor's understanding and evaluation may be obtained through a combination of inquiries and other risk assessment procedures (for example, corroborating inquiries about the entity's processes through observation or inspection of documents).

~~**A101.** Inquiry alone is not sufficient to obtain an understanding of or to evaluate each of these components as required by this proposed SAS.The auditor may identify, in accordance with paragraphs 26 and , controls within these components for which the auditor also evaluates design and determines implementation as required by paragraph (see paragraphs A101, A108, and A165).~~

A106. ~~For the information system and communication~~Controls within the information system and communication, and control activities components of the entity's system of internal control~~, controls~~ are primarily more direct in addressing assertion-level risks (see paragraphs A5 and A141). ~~Accordingly, this~~This proposed SAS requires performing risk assessment procedures, beyond inquiry, to evaluate whether the controls identified in accordance with paragraphs 27~~26~~ and 28 are effectively designed and determine whether those controls have been implemented (see paragraph ~~26d~~29). This evaluation includes forming a conclusion as to whether the identified controls achieve the control objectives and have been implemented as designed. An audit does not require an understanding, including evaluating the design or determining the implementation, of all ~~the~~ controls ~~activities~~ related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them.

Commented [HH64]: See July 2021 Issues Paper

Previously a consideration specific to governmental entity. Made it broader and moved it here from below.

Commented [RMM65]: Language adapted from COSO

Commented [RMM66]: Used language in ISA 315 (Revised 2019), which is in the context of the control environment. However, modified the parenthetical to be an example instead.

Commented [MR67]: Should this be 27? 26 refers to 27-29

Commented [MM68R68]: Hiram – do we delete this comment? Also, I think we need to only show the deletion from the proposed SAS. So, should we delete the second sentence?

~~A102.~~A107. The auditor may identify, in accordance with paragraphs 27 and 28, controls within the control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control for which the auditor also evaluates design and determines implementation as required by paragraph 29 (see paragraphs A106, A113, and A171). ~~The auditor may identify, in accordance with paragraph 26, direct controls within the other components of the entity's system of internal control for which the auditor evaluates design and determines implementation (see paragraphs A108 and A165).~~

~~The components of the entity's system of internal control for the purpose of this proposed SAS may not necessarily reflect how an entity designs, implements, and maintains its system of internal control, or how it may classify any particular component. proposed SASor the Green Book, designing, implementing, Entities may use different terminology or frameworks to describe the various aspects of the system of internal control. For the purpose of an audit, the auditors may also use the framework used by management or may use different terminology or frameworks to describe the various aspects of a system of internal control and their effect on the audit, provided all the components described in this proposed SAS are addressed.~~ ***Scalability***

~~A103.~~A108. The way in which the entity's system of internal control is designed, implemented, and maintained varies with an entity's size and complexity. For example, less complex entities may use less structured or simpler controls (that is, policies and procedures) to achieve their objectives.

~~A104.~~A109. The auditor's understanding of the entity's system of internal control is obtained through risk assessment procedures performed to understand and evaluate ~~each of~~ the components of the system of internal control as set out in paragraphs 21–30. The nature, timing, and extent of procedures that are necessary to understand and evaluate the components of the entity's system of internal control depend on the following:

a. the size and complexity of the entity;

b. the auditor's existing knowledge of the entity's controls;

c. the nature of the entity's controls, including the entity's use of IT;

d. the nature and extent of changes in entity's systems and operations; and

e. the nature and form of the entity's documentation of its controls.

~~An audit does not require an understanding of all the controls within each component.~~

~~Considerations Specific to Governmental Entities~~

Commented [RMM69]: Moved to A207 and revised.

Commented [MM70]: Maybe indicate where this moved to. Also, can we only show the changes from the proposed SAS and not previous versions?

Commented [RMM71]: Clarified the guidance to respond to comments received.

Commented [RMM72]: From paragraph .A38 of AU-C section 940

Commented [HH73]: Moved from for A102

Commented [RMM74]: There is no separate evaluation of the control activities component.

Commented [RMM75]: Language adapted from paragraph 19 of PCAOB AS 2110. The language also took into account paragraph A60 of this proposed SAS

Commented [MM76]: Indicate where this moved to

Commented [HH77]: See July 21 Issues Paper Moved it above

IT in the Components of the Entity's System of Internal Control

~~A105.~~A110. Appendix E provides further guidance on understanding the entity's use of IT in the components of the system of internal control.

~~A106.~~A111. The ~~requirements of the auditor to obtain sufficient appropriate audit evidence~~overall objectives ~~in an audit does~~of the auditor do not differ whether an entity operates in a mainly manual environment, a completely automated environment, or an environment involving some combination of manual and automated elements (that is, manual and automated controls and other resources, including service organizations, used in the entity's system of internal control).

Commented [RMM78]: To address comments received; this language is clearer

Understanding the Nature of the Components of the Entity's System of Internal Control

~~A107.~~A112. The auditor's understanding and evaluation ~~of each~~ of the components of the entity's system of internal control provides a preliminary understanding of how the entity identifies business risks relevant to financial reporting and how it responds to them. It may also influence the auditor's identification and assessment of the risks of material misstatement in different ways (see paragraph A97). The auditor's identification and assessment of the risks of material misstatement assists the auditor in designing and performing further audit procedures, including any plans to test the operating effectiveness of controls. Examples follow:

Commented [RMM79]: Added "evaluation to address comment received.

Also deleted "each." The "control activities" component does not have a separate evaluation. It addresses requirements related to design and implementation instead.

- The auditor's understanding of the entity's control environment, the entity's risk assessment process, and the entity's process to monitor controls components is more likely to affect the identification and assessment of risks of material misstatement at the financial statement level.
- The auditor's understanding of the entity's information system and communication, and the entity's control activities component, is more likely to affect the identification and assessment of risks of material misstatement at the assertion level.

Control Environment, the Entity's Risk Assessment Process, and the Entity's Process to Monitor the System of Internal Control (Ref: par. 21–24)

~~A108.~~A113. The controls in the control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control are primarily indirect controls (see paragraph A5). However, controls within these components may vary in nature and precision and, therefore, some controls within these components may also be direct controls that address risks of material misstatement at the assertion level (see paragraph A171).

Why the Auditor Is Required to Understand the Control Environment, The Entity's Risk Assessment Process, and the Entity's Process to Monitor the System of Internal Control

~~A109.~~A114. The control environment provides an overall foundation for the operation of the other components of the system of internal control. The control environment does not directly prevent, or detect and correct, misstatements. It may, however, influence the effectiveness of controls in the other components of the system of internal control. Similarly, the entity's risk

assessment process and its process for monitoring the system of internal control are designed to operate in a manner that also supports the entire system of internal control.

~~A110.~~A115. Because these components are foundational to the entity's system of internal control, 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 (see paragraphs A119, A128, and A139). Risks of material misstatement at the financial statement level affect the auditor's design of overall responses, including, as explained in AU-C section 330, an influence on the nature, timing, and extent of the auditor's further procedures.[38]

Obtaining an Understanding of the Control Environment (Ref: par. 21)

Scalability

~~A111.~~A116. The nature of the control environment in a less complex entity is likely to be different from the control environment in a more complex entity. For example, those charged with governance in less complex entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager when there are no other owners. Accordingly, some considerations about the entity's control environment may be less relevant or may not be applicable.

~~A112.~~A117. In addition, audit evidence about elements of the control environment in less complex entities may not be available in documentary form, in particular, where communication between management and other personnel is informal, but the evidence may still be appropriately relevant and reliable in the circumstances. Examples are as follows:

- The organizational structure in a less complex entity will likely be simpler and may include a small number of employees involved in roles related to financial reporting.
- If the role of governance is undertaken directly by the owner-manager, the auditor may determine that the independence of those charged with governance is not relevant (see paragraph A68~~A66~~).
- Less complex entities 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 a less complex entity's control environment.

Understanding the Control Environment (Ref: par. 21a)

[38] Paragraphs .A1–.A3 of AU-C section 330.

~~A113.~~A118. In considering the extent to which management demonstrates a commitment to integrity and ethical values, the auditor may obtain an understanding through inquiries of management and employees and through considering information from external sources about

- how management communicates to employees its views on business practices and ethical behavior, and
- inspecting management's written code of conduct and observing whether management acts in a manner that supports that code.

*Evaluating the Control Environment (Ref: par. 21*b*)*

Why the Auditor Evaluates the Control Environment

~~A114.~~A119. The auditor's evaluation of how the entity demonstrates behavior consistent with the entity's commitment to integrity and ethical values; whether the control environment provides an appropriate foundation for the other components of the entity's system of internal control; and whether ~~any~~ identified control deficiencies undermine the other components of the system of internal control, assists the auditor in identifying potential issues in the other components of the system of internal control ~~as well as the controls the auditor might identify in accordance with paragraph 26~~. This is because the control environment is foundational to the other components of the entity's system of internal control. This evaluation may also assist the auditor in understanding risks faced by the entity and, therefore, in identifying and assessing the risks of material misstatement at the financial statement and assertion levels (see paragraph A112). The auditor may also identify control deficiencies in the control environment, the severity of which may be indicative of a fraud risk factor. In addition, the auditor's understanding and evaluation of the control environment may influence the controls the auditor might identify in accordance with paragraphs 27–28 based on the auditor's knowledge of the presence or absence of such controls in other components.

The Auditor's Evaluation of the Control Environment

~~A115.~~A120. The auditor's evaluation of the control environment is based on the understanding obtained in accordance with paragraph 21*a*. The evaluation is focused on the matters included in paragraph 21*b*, and therefore, does not require evaluating the design or determining the implementation of individual controls within the control environment. However, as described in paragraph A107, the auditor may identify, in accordance with paragraphs 27~~26~~–28, controls within the control environment component for which the auditor also evaluates design and determines implementation as required by paragraph 29 (see paragraphs A113 and A171).

~~A116.~~A121. 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. For 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

Commented [RMM80]: See Issue B (May 2021)

Commented [RMM81]: The reference to "fraud risk factors" was adapted from paragraph 25 of PCAOB AS 2110.

Commented [RMM82]: Notion of the "presence or absences of controls" comes from paragraph 34 of PCAOB AS 2110.

Commented [RMM83]: See Issue B (May 2021)

Commented [MM84]: Check reference

Commented [HH85R85]: fixed

Commented [MR86]: Should this be 27? 26 references 27-29

knowledge and authority can also lead to an increased susceptibility to misstatement through management override of controls.

~~A117.~~A122. 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.

~~A118.~~A123. 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. For example, human resource policies and procedures directed toward hiring competent financial, accounting, and IT personnel may mitigate the risk of errors in processing and recording financial information. However, such policies and procedures may not mitigate the risk of management override of controls ~~by senior management~~ (for example, fraudulent financial reporting that involves senior management ~~to~~ overstate~~e~~ing earnings).

Commented [RMM87]: Modified to align closer with AU-C section 240.

~~A119.~~A124. The auditor's evaluation of the control environment as it relates to the entity's use of IT may include such matters as the following:

- Whether governance over IT is commensurate with the nature and complexity of the entity and its business operations enabled by IT, including the complexity or maturity of the entity's technology platform or architecture and the extent to which the entity relies on IT applications to support its financial reporting
- The management organizational structure regarding IT and the resources allocated (for example, whether the entity has invested in an appropriate IT environment and necessary enhancements or whether a sufficient number of appropriately skilled individuals have been employed, including when the entity uses commercial software [with no or limited modifications])

Obtaining an Understanding of the Entity's Risk Assessment Process (Ref: par. 22–23)

Understanding the Entity's Risk Assessment Process (Ref: par. 22*a*)

~~A120.~~A125. As explained in paragraph A71, not all business risks give rise to risks of material misstatement, whether due to error or fraud. In understanding how management and those charged with governance have identified business risks relevant to the preparation of the financial statements, and decided about actions to address those risks, matters the auditor may consider include how management or, as appropriate, those charged with governance, has done the following:

- Specified the entity's objectives with sufficient precision and clarity to enable the identification and assessment of the risks relating to the objectives
- Identified the risks to achieving the entity's objectives and analyzed the risks as a basis for determining how the risks should be managed
- Assesses changes that could significantly impact the system of internal control

Commented [MM88]: See July 2021 Issues Paper and COSO Analysis

- Considered the potential for fraud when considering the risks to achieving the entity's objectives[39]

~~A121.~~A126. Paragraph 22 of this proposed SAS requires the auditor to obtain an understanding of the entity's process for identifying business risks. AU-C section 240[40] requires the auditor to make inquiries of management regarding, among other things, management's process for identifying, responding to, and monitoring the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist.

~~A122.~~A127. The auditor may consider the implications of such business risks for the preparation of the entity's financial statements and other aspects of its system of internal control.

Evaluating the Entity's Risk Assessment Process (Ref: par. 22*b*)

Why the Auditor Evaluates Whether the Entity's Risk Assessment Process Is Appropriate

~~A123.~~A128. The auditor's evaluation of the entity's risk assessment process may assist the auditor in understanding where the entity has identified risks ~~that may occur~~ and how the entity has responded to those risks. The auditor's evaluation of how the entity identifies its business risks and how it assesses and addresses those risks assists the auditor in understanding whether the risks faced by the entity have been identified, assessed, and addressed, as appropriate, to the nature and complexity of the entity. This evaluation may also assist the auditor with identifying and assessing financial-statement-level and assertion-level risks of material misstatement (see paragraph A112).

~~The auditor's awareness of ineffective aspects of the entity's risk assessment process, including the absence of a process that would ordinarily be expected to have been established, may affect the nature and extent of the auditor's risk assessment procedures as well as the overall audit strategy and audit plan because of the potential higher likelihood that management may not identify a risk of material misstatement and respond to such risk. This also may influence the auditor's evaluation of the control environment considering the importance management places on controls.~~

Evaluating Whether the Entity's Risk Assessment Process Is Appropriate (Ref: par. 22*b*)

~~A124.~~A129. The auditor's evaluation of the appropriateness of the entity's risk assessment process is based on the understanding obtained in accordance with paragraph 22*a*. The evaluation is focused on the matters included in paragraph 22*b*, and therefore, does not require evaluating the design or determining the implementation of individual controls within the entity's risk assessment process. However, as described in paragraph A102, the auditor may identify, in accordance with paragraphs 27–28, controls within the entity's risk assessment process component for which the auditor also evaluates design and determines implementation as required by paragraph 29 (see paragraphs A113 and A171).

Commented [RMM89]: Modified based on comments received. While COSO uses this term, it is rather limited.

Commented [MM90]: Hiram – We were supposed to delete this. I don't want to mess up your numbering here.

Commented [RMM91]: See Issue B (May 2021)

Commented [MM92R92]: Delete comment too

Commented [RMM93]: See Issue B (May 2021)

[39] Paragraph .18 of AU-C section 240.

[40] Paragraph .17 of AU-C section 240.

Scalability

~~A125.~~A130. Whether the entity's risk assessment process is appropriate to the entity's circumstances, considering the nature and complexity of the entity, is a matter of the auditor's professional judgment. For example, in some less complex entities, and particularly owner-managed entities, an appropriate risk assessment may be performed through the direct involvement of management or the owner-manager (for example, the manager or owner-manager may routinely devote time to monitoring the activities of competitors and other developments in the market place to identify emerging business risks). The evidence of this risk assessment occurring in these types of entities is often not formally documented, but it may be evident from, for example, discussions the auditor has with management, corroborated by e-mails or other correspondence between management and other personnel, that management is, in fact, performing risk assessment procedures.

Obtaining an Understanding of the Entity's Process to Monitor the Entity's System of Internal Control (Ref: par. 24)

Scalability

~~A126.~~A131. In less complex entities, and in particular, owner-manager entities, the auditor's understanding of the entity's process to monitor the system of internal control is often focused on how management or the owner-manager is directly involved in operations because there may not be any other monitoring activities. For example, management may receive complaints from customers about inaccuracies in their monthly statement that alerts the owner-manager to issues with the timing of when customer payments are being recognized in the accounting records.

~~A127.~~A132. For entities in which there is no formal process for monitoring the system of internal control, understanding the process to monitor the system of internal control may include understanding periodic reviews of management accounting information that are designed to contribute to how the entity prevents, or detects and corrects, misstatements.

Commented [RMM94]: Added for consistency with clarified standards

Understanding the Entity's Process to Monitor the System of Internal Control (Ref: par. ~~2~~24*a*(i))

~~A128.~~A133. Matters that may be relevant for the auditor to consider when understanding how the entity monitors its system of internal control include the following:

- The design of the monitoring activities, for example, whether it is periodic or ongoing monitoring
- The performance and frequency of the monitoring activities
- The evaluation of the results of the monitoring activities, on a timely basis, to determine whether the controls have been effective
- How identified control deficiencies have been addressed through appropriate remedial actions, including timely communication of such deficiencies to those responsible for taking remedial action

Commented [RMM95]: Added to use consistent terminology throughout

~~A129.~~A134. The auditor may also consider how the entity's process to monitor the system of internal control addresses monitoring information-processing controls that involve the use of IT. This may include, for example

- controls to monitor complex IT environments that
  - evaluate the continuing design effectiveness of information-processing controls and modify them, as appropriate, for changes in conditions or
  - evaluate the operating effectiveness of information-processing controls.
- controls that monitor the permissions applied in automated information-processing controls that enforce the segregation of duties.
- controls that monitor how errors or control deficiencies related to the automation of financial reporting are identified and addressed.

Understanding the Entity's Internal Audit Function (Ref: par. 24*a*(ii))

~~A130.~~A135. Appendix D sets out further considerations for understanding the entity's internal audit function.

~~A131.~~A136. The auditor's inquiries of appropriate individuals within the internal audit function help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function. This understanding, together with the information obtained from the auditor's inquiries, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, AU-C section 610, *Using the Work of Internal Auditors*, applies.

Other Sources of Information Used in the Entity's Process to Monitor the System of Internal Control

Understanding the Sources of Information (Ref: par. ~~2~~24*b*)

~~A132.~~A137. Management's monitoring activities may use information in communications from external parties, such as customer complaints or regulator comments, that may indicate problems or highlight areas in need of improvement.

Why the Auditor Is Required to Understand the Sources of Information Used for the Entity's Monitoring of the System of Internal Control

~~A133.~~A138. The auditor's understanding of the sources of information used by the entity in monitoring the entity's system of internal control, including whether the information used is relevant and reliable, assists the auditor in evaluating whether the entity's process to monitor the entity's system of internal control is appropriate. If management assumes that information used for monitoring is relevant and reliable without having a basis for that assumption, errors that may exist in the information could potentially lead management to draw incorrect conclusions from its monitoring activities.

Evaluating The Entity's Process to Monitor The System of Internal Control

Why the Auditor Evaluates Whether the Entity's Process to Monitor the System of Internal Control Is Appropriate (Ref: par. 24*c*)

~~A134.~~A139. The auditor's evaluation about how the entity undertakes ongoing and separate evaluations for monitoring the effectiveness of controls assists the auditor in understanding whether the other components of the entity's system of internal control are present and functioning and, therefore, assists with understanding the other components of the entity's system of internal control. This evaluation may also assist the auditor with identifying and assessing financial-statement-level and assertion-level risks of material misstatement (see paragraph A112) and with designing tests of controls.[41]

Evaluating Whether the Entity's Process to Monitor the System of Internal Control Is Appropriate (Ref: par. 24*c*)

~~A135.~~A140. The auditor's evaluation of the appropriateness of the entity's process to monitor the system of internal control is based on the auditor's understanding of the entity's process to monitor the system of internal control. The evaluation is focused at the matters included in paragraph 24*c*, and therefore, does not require evaluating the design or determining the implementation of individual controls within the entity's process to monitor the system of internal control. However, as described in paragraph A107, the auditor may identify, in accordance with paragraphs 27–28, controls within the entity's process to monitor the system of internal control component for which the auditor also evaluates design and determines implementation as required by paragraph 29 (see paragraphs A113 and A171).

Commented [RMM96]: See Issue B (May 2021)

Information System and Communication, and Control Activities (Ref: par. 25–26)

~~A136.~~A141. The controls in the information system and communication, and control activities components are primarily direct controls (that is, controls that are sufficiently precise to prevent, detect, or correct misstatements at the assertion level).

Why the Auditor Is Required to Understand the Information System and Communication and Controls in the Control Activities Component

~~A137.~~A142. The auditor is required to understand the entity's information system and communication because understanding ~~the entity's policies that define~~ the flows of transactions

Commented [RMM97]: Reference to policies includes "controls" – the requirements related to the control activities component addresses controls within the information system and communication component

[41] Paragraph .08 of section 330.

and other aspects of the entity's information-processing activities relevant to the preparation of the financial statements, and evaluating whether the component appropriately supports the preparation of the entity's financial statements, supports the auditor's identification and assessment of risks of material misstatement at the assertion level. This understanding and evaluation may also result in the identification of risks of material misstatement at the financial statement level when the results of the auditor's procedures are inconsistent with expectations about the entity's system of internal control that may have been set based on information obtained during the engagement acceptance or continuance process (see paragraph A112).

~~A138.~~A143. The auditor is required to identify specific controls in the control activities component, and evaluate the design and determine whether the controls have been implemented, because it assists the auditor's understanding about management's approach to addressing certain risks; therefore, it provides a basis for the design and performance of further audit procedures responsive to these risks as required by AU-C section 330. The higher on the spectrum of inherent risk a risk is assessed, the more persuasive the audit evidence needs to be. Even when the auditor does not plan to test the operating effectiveness of identified controls, the auditor's understanding may still affect the design of the nature, timing, and extent of substantive procedures that are responsive to the related risks of material misstatement (see paragraph A210).

The Iterative Nature of the Auditor's Understanding and Evaluation of the Information System and Communication, and Control Activities

~~A139.~~A144. As explained in paragraph A57, the auditor's understanding of the entity and its environment, and the applicable financial reporting framework, may assist the auditor in developing initial expectations about the classes of transactions, account balances, and disclosures that may be significant classes of transactions, account balances, and disclosures. In obtaining an understanding of the information system and communication component in accordance with paragraph 25*a*, the auditor may use these initial expectations ~~for the purpose of determining~~to determine the extent of understanding of the entity's information-processing activities to be obtained.

~~A140.~~A145. The auditor's understanding of the information system includes understanding the policies that define flows of information relating to the entity's significant classes of transactions, account balances, and disclosures, and other related aspects of the entity's information-processing activities. This information and the information obtained from the auditor's evaluation of the information system may confirm or further influence the auditor's expectations about the significant classes of transactions, account balances, and disclosures initially identified (see paragraph A144~~A140~~).

Commented [MR98]: References itself. May be A145

~~A141.~~A146. In obtaining an understanding of how information relating to significant classes of transactions, account balances, and disclosures flows into, through, and out of the entity's information system, the auditor may also identify controls in the control activities component that are required to be identified in accordance with paragraph 27~~26*a*~~ and 28. For example, the auditor's identification and evaluation of controls in the control activities component may first focus on controls over journal entries and other adjustments and controls that the auditor plans to test the operating effectiveness of in designing the nature, timing, and extent of substantive procedures.

Commented [MM99]: Added for consistency with requirement.

~~A142.~~A147. The auditor's assessment of inherent risk may also influence the identification of controls in the control activities component. For example, controls that address significant risks may be identifiable only when the auditor has assessed inherent risk at the assertion level in accordance with paragraph 34. Furthermore, controls addressing risks for which the auditor has determined that substantive procedures alone do not provide sufficient appropriate audit evidence (in accordance with paragraph 36) may also be identifiable only once the auditor's inherent risk assessments have been undertaken.

~~A143.~~A148. The auditor's identification and assessment of risks of material misstatement at the assertion level is influenced by both of the following:

- The auditor's understanding of the entity's policies for its information-processing activities in the information system and communication component
- The auditor's identification and evaluation of controls in the control activities component

Obtaining an Understanding of the Information System and Communication (Ref: par. 25)

~~A144.~~A149. Appendix C[42] sets out further considerations relating to the information system and communication.

Scalability

~~A145.~~A150. The information system, and related business processes, in less complex entities are likely to be less sophisticated than in larger entities and are likely to involve a less complex IT environment; however, the role of the information system is just as important. For example, l~~L~~ess complex entities with direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the relevant aspects of the entity's information system may, therefore, require less effort in an audit of a less complex entity and may involve a greater amount of inquiry than observation or inspection of documentation. The need to obtain an understanding, however, remains important to provide a basis for the design of further audit procedures in accordance with AU-C section 330 and may further assist the auditor in identifying or assessing risks of material misstatement (see paragraph A112).

Obtaining an Understanding of the Information System (Ref: par. 25*a*)

A151. Included within the entity's system of internal control are aspects that relate to the entity's reporting objectives, including its financial reporting objectives, but may also include aspects that relate to its operations or compliance objectives, when such aspects are relevant to financial reporting. Understanding how the entity initiates transactions and captures information as part of the auditor's understanding of the information system may include information about the entity's systems (its policies) designed to address compliance and operations objectives because such information is relevant to the preparation of the financial statements. Further, some entities may

[42] Paragraphs 11–15 of appendix C, "Understanding the Entity's System of Internal Control."

have information systems that are highly integrated such that controls may be designed in a manner to simultaneously achieve financial reporting, compliance and operational objectives, and combinations thereof.

~~A146.~~A152.

~~A147.~~A153. The auditor's understanding of the entity's information system and communication required under paragraph 25*a* results in obtaining an understanding of the process of reconciling detailed records to the general ledger.

~~A148.~~A154. Understanding the entity's information system also includes an understanding of the resources to be used in the entity's information-processing activities. Information about the human resources involved that may be relevant to understanding risks to the integrity of the information system include the following:

- The competence of the individuals undertaking the work
- Whether there are adequate resources
- Whether there is appropriate segregation of duties

~~A149.~~A155. Matters the auditor may consider when understanding the policies that define the flows of information relating to the entity's significant classes of transactions, account balances, and disclosures in the information system and communication component include the nature of

a. the data or information relating to transactions, other events, and conditions to be processed;

b. the information processing to maintain the integrity of that data or information; and

c. the information processes, personnel, and other resources used in processing information.

~~A150.~~A156. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor in obtaining an understanding of the entity's information system in a manner that is appropriate to the entity's circumstances.

~~A151.~~A157. The auditor's understanding of the information system may be obtained in various ways and may include some or all of the following:

- Inquiries of relevant personnel about the procedures used to initiate, record, process, and report transactions or about the entity's financial reporting process
- Inspection of policy or process manuals or other documentation of the entity's information system
- Observation of the performance of the policies or procedures by entity's personnel

- Selecting transactions and tracing them through the applicable process in the information system (that is, performing a walk-through, as described in paragraphs A204–A205)

Automated Tools and Techniques

~~A152.~~A158. The auditor may also use automated techniques to obtain direct access to, or a digital download from, the databases in the entity's information system that store accounting records of transactions. By applying automated tools or techniques to this information, the auditor may confirm the understanding obtained about how transactions flow through the information system by tracing journal entries, or other digital records related to a particular transaction, or an entire population of transactions from initiation in the accounting records through to recording in the general ledger. Analysis of complete or large sets of transactions may also result in the identification of variations from the normal, or expected, processing procedures for these transactions, which may result in the identification of risks of material misstatement.

Information Obtained From Outside of the General and Subsidiary Ledgers

~~A153.~~A159. Financial statements may contain information that is obtained from outside of the general and subsidiary ledgers. Examples of such information that the auditor may consider are as follows:

- Information obtained from lease agreements relevant to disclosures in the financial statements
- Information disclosed in the financial statements that is produced by an entity's risk management system
- Fair value information produced by management's specialists and disclosed in the financial statements
- Information disclosed in the financial statements that has been obtained from models or from other calculations used to develop accounting estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as
  - assumptions developed internally that may affect an asset's useful life, or
  - data such as interest rates that are affected by factors outside the control of the entity
- Information disclosed in the financial statements about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions
- Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records

- Information disclosed in the financial statements that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern[43]

~~A154.~~A160. Certain amounts or disclosures in the entity's financial statements (such as disclosures about credit risk, liquidity risk, and market risk) may be based on information obtained from the entity's risk management system. However, the auditor is not required to understand all aspects of the risk management system and uses professional judgment in determining the necessary understanding.

The Entity's Use of IT in the Information System

Why Does the Auditor Understand the IT Environment Relevant to the Information System

~~A155.~~A161. The auditor's understanding of the information system includes the IT environment relevant to the flows of transactions and processing of information in the entity's information system because the entity's use of IT applications or other aspects in the IT environment may give rise to risks arising from the use of IT.

~~A156.~~A162. The understanding of the entity's business model and how it integrates the use of IT may also provide useful context to the nature and extent of IT expected in the information system.

Understanding the Entity's Use of IT

~~A157.~~A163. The auditor's understanding of the IT environment may focus on identifying, and understanding the nature and number of, the specific IT applications and other aspects of the IT environment that are relevant to the flows of transactions and processing of information in the information system. Changes in the flow of transactions, or information within the information system, may result from program changes to IT applications or direct changes to data in databases involved in processing or storing those transactions or information.

~~A158.~~A164. The auditor may identify the IT applications and supporting IT infrastructure concurrently with the auditor's understanding of how information relating to significant classes of transactions, account balances, and disclosures flow into, through, and out of the entity's information system.

Obtaining an Understanding of the Entity's Communication (Ref: par. 25*b*)

Scalability

[43] Paragraphs .21–.22 of AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

~~A159.~~A165. In ~~larger,~~ more complex entities, information the auditor may consider when understanding the entity's communication may come from policy manuals and financial reporting manuals.

~~A160.~~A166. In less complex entities, communication may be less structured (for example, formal manuals may not be used) due to fewer levels of responsibility and management's greater visibility and availability. Regardless of the size of the entity, open communication channels facilitate the reporting of exceptions and acting on them.

Evaluating Whether the Relevant Aspects of the Information System Support the Preparation of the Entity's Financial Statements (Ref: par. 25*c*)

~~A161.~~A167. The auditor's evaluation of whether the entity's information system and communication appropriately supports the preparation of the financial statements is based on the understanding obtained in paragraph 25*a–b*. The evaluation is focused on the matters included in paragraph 25*c*, and therefore, does not require evaluating the design or determining the implementation of individual controls within the information system and communication. Appendix C[44] sets out further considerations relating to the information system and communication component.

Commented [RMM100]: See Issue D (May 2021)

Control Activities (Ref: par. 26)

Controls in the Control Activities Component (Ref: par. 26)

~~A162.~~A168. Appendix C[45] sets out further considerations relating to controls in the control activities component.

~~A163.~~A169. In obtaining an understanding of the other components of internal control, the auditor may have identified some controls described in paragraph 27. The control activities component includes controls that are designed to ensure the proper application of policies (which are also controls) in all the other components of the entity's system of internal control and includes both direct and indirect controls. For example, the controls that an entity has established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the risks of material misstatement relevant to the existence and completeness assertions for the inventory account balance.

Commented [RMM101]: Notion consistent with PCAOB standards. Also see paragraph A118

Commented [MM102R102]: Are all of the paragraphs added by Marianna in these notes correct?

~~A164.~~A170. The auditor's identification and evaluation of controls in the control activities component is focused on information-processing controls, which are controls ~~applied during~~relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address ~~the risks of material misstatement. This may include risks arising from IT such as risk relating~~ risks to the integrity of information (that is, 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

Commented [RMM103]: Modified to align with the definition of information-processing controls.

[44] Paragraphs 15–16 of appendix C.
[45] Paragraphs 15–16 of appendix C.

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.

~~A165.~~A171. Direct controls may exist in the control environment, the entity's risk assessment process, or the entity's process to monitor the system of internal control, which may be identified in accordance with paragraphs 27 ~~26~~ 28. An example is a management review control designed to detect misstatements by using key performance indicators or other types of information to develop sufficiently precise expectations of reported amounts. The more indirect the relationship between controls that support other controls and the control that is being considered, the less effective that control may be in preventing, or detecting and correcting, related misstatements. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is indirectly related only to the risks of material misstatement relevant to the completeness assertion for sales revenue. Accordingly, it may be less effective in addressing those risks than controls more directly related thereto, such as matching shipping documents with billing documents.

~~A166.~~A172. Paragraph 28 ~~26 also~~ requires the auditor to identify and evaluate general IT controls for IT applications and other aspects of the IT environment that the auditor has determined to be subject to risks arising from the use of IT because general IT controls support the continued effective functioning of information-processing controls. A general IT control alone is typically not sufficient to address a risk of material misstatement at the assertion level.

~~A167.~~A173. The controls that the auditor is required to identify and evaluate the design, and determine the implementation of, in accordance with paragraph 29 ~~26~~ are as follows:

- Controls that the auditor plans to test the operating effectiveness of in determining the nature, timing, and extent of substantive procedures. The evaluation of such controls provides the basis for the auditor's design of tests of controls ~~procedures~~ in accordance with AU-C section 330. These controls also include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.
- Controls that address significant risks ~~and~~ as well as controls over journal entries and other adjustments as required by AU-C section 240. The auditor's identification and evaluation of such controls may also influence the auditor's identification and assessment of the risks of material misstatement, including the identification of additional risks of material misstatement (see paragraph A112). This understanding also provides the basis for the auditor's design of the nature, timing, and extent of substantive procedures that are responsive to the related assessed risks of material misstatement.
- Other controls that the auditor considers 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.

~~A168.~~A174. Controls in the control activities component are required to be identified when such controls meet one or more of the criteria included in paragraphs 27~~26a~~~~26~~ or 28. However, when

Commented [RMM104]: Tests of controls is the defined term in AU-C section 330

Commented [RMM105]: To align with the revised requirement

multiple controls each achieve the same objective, it is unnecessary to identify each of the controls related to such objective. An audit does not require an understanding, or evaluating the design or determining the implementation, of all the controls related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them (see paragraph A104~~A101~~).

Commented [RMM106]: Added in response to comments received. Repeated guidance from A104

Commented [MR107]: May be A104

Types of Controls in the Control Activities Component (Ref: par. 26)

~~A169.~~A175. Examples of controls in the control activities component include authorizations and approvals, reconciliations, verifications (such as edit and validation checks or automated calculations), segregation of duties, and physical or logical controls, including those addressing safeguarding of assets.

~~A170.~~A176. Controls in the control activities component may also include controls established by management that address risks of material misstatement related to disclosures not being prepared in accordance with the applicable financial reporting framework. Such controls may relate to information included in the financial statements that is obtained from outside of the general and subsidiary ledgers.

~~A171.~~A177. Regardless of whether controls are within the IT environment or manual systems, controls may have various objectives and may be applied at various organizational and functional levels.

Scalability (Ref: par. 26)

~~A172.~~A178. Controls in the control activities component for less complex entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, in less complex entities, more controls may be directly applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions.

~~A173.~~A179. It may be less practicable to establish segregation of duties in less complex entities that have fewer employees. However, in an owner-managed entity, the owner-manager may be able to exercise more effective oversight through direct involvement than in a larger entity, which may compensate for the generally more limited opportunities for segregation of duties. Although, as also explained in AU-C section 240, domination of management by a single individual can be a potential control deficiency because there is an opportunity for management override of controls.[46]

Controls That Address Risks of Material Misstatement at the Assertion Level (Ref: par. 27~~26~~a)

Controls That Address Risks That Are Determined to Be a Significant Risk (Ref: par. 27~~26~~*a*~~(i)~~))

~~A174.~~A180. Regardless of whether the auditor plans to test the operating effectiveness of controls that address significant risks, the understanding obtained about management's approach

[46] Paragraph .A33 of AU-C section 240.

to addressing those risks may provide a basis for the design and performance of substantive procedures responsive to significant risks as required by AU-C section 330.[47] Although risks relating to significant nonroutine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. For example, when there are nonroutine events, such as a significant business acquisition, consideration of the entity's response may include such matters as whether it has been referred to appropriate specialists (such as internal or external valuation specialists), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements. The auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from nonroutine or judgmental matters may include whether and how management responds to the risks. Such responses may include the following:

- Controls, such as a review of assumptions by senior management or specialists
- Documented processes for accounting estimations
- Approval by those charged with governance

~~A175.~~A181. AU-C section 240[48] requires the auditor to understand controls related to assessed risks of material misstatement due to fraud (which are treated as significant risks) and further explains that it is important for the auditor to obtain an understanding of the controls that management has designed, implemented, and maintained to prevent and detect fraud.

Controls Over Journal Entries and Other Adjustments (Ref: par. ~~26*a*~~*27b*~~(ii)~~)

~~A176.~~A182. ~~Controls that address risks of material misstatement at the assertion level that are expected to be identified for all audits are controls over journal entries because the manner in which an entity incorporates information from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or nonstandard, or automated or manual. Paragraph 25*a* requires the auditor to obtain an understanding of the flows of information in the entity's information system for significant classes of transactions, account balances, and disclosures. The understanding required by paragraph 26*a*(ii) includes controls over adjustments to significant classes of transactions, account balances, and disclosures that may not be subject to controls over processing of routine transactions. Further, the auditor may have identified no related party transactions that meet the definition of *significant unusual transactions* in accordance with AU-C section 240,[49] other significant risks, or other risks of material misstatement for which it is necessary for the auditor to evaluate the design of controls and determine that they have been implemented. In such an audit, the auditor may determine that there are no identified controls other than the entity's controls over journal entries.~~How an entity incorporates information from transaction processing in the general ledger ordinarily involves the use of journal entries, whether standard or non-standard, or automated or manual. AU-C section 240 requires the auditor to obtain an understanding of the entity's financial reporting process and controls over journal entries and

Commented [RMM108]: Modified to align with changes to the requirement, as described in **Issue F (May 2021)**

Commented [RMM109]: Sentence is consistent with paragraph A160 of ISA 315 (Revised 2019).

[47] Paragraph .22 of AU-C section 330.

[48] Paragraphs .27 and .A37 of AU-C section 240.

~~[49] Paragraph .11 of AU-C section 240.~~

other adjustments, including controls over nonstandard journal entries used to record significant unusual transactions in response to the risk of management override of controls.

Automated Tools and Techniques

~~A177.~~A183. In manual general ledger systems, nonstandard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and, therefore, may be more easily identified through the use of automated techniques. For example, in the audit of a less complex entity, the auditor may be able to extract a total listing of all journal entries into a simple spreadsheet. It may then be possible for the auditor to sort the journal entries by applying a variety of filters such as currency amount, name of the preparer or reviewer, journal entries that gross up the balance sheet and income statement only, or to view the listing by the date the journal entry was posted to the general ledger, to assist the auditor in designing responses to the risks identified relating to journal entries.

Controls for Which the Auditor Plans to Test the Operating Effectiveness (Ref: par. 27~~26*c*a(iii)~~)

~~A178.~~A184. The auditor determines whether there are any risks of material misstatement at the assertion level for which it is not possible to obtain sufficient appropriate audit evidence through substantive procedures alone. The auditor is required, in accordance with AU-C section 330,[50] to design and perform tests of controls that address such risks of material misstatement when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level. As a result, when such controls exist that address these risks, they are required to be identified and evaluated.

~~A179.~~A185. In other cases, when the auditor plans to take into account the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures in accordance with AU-C section 330, such controls are also required to be identified because AU-C section 330[51] requires the auditor to design and perform tests of those controls. For example, the auditor may plan to test the operating effectiveness of controls

- over routine classes of transactions because such testing may be more effective or efficient for large volumes of homogenous transactions.
- over the completeness and accuracy of information produced by the entity (for example, controls over the preparation of system-generated reports) to determine the reliability of that information, when the auditor intends to take into account the operating effectiveness of those controls in designing and performing further audit procedures.
- relating to operations and compliance objectives when they relate to data the auditor evaluates or uses in applying audit procedures.

[50] Paragraph .08*b* of AU-C section 330.

[51] Paragraph .08*a* of AU-C section 330.

~~A180.~~A186. The auditor's decision whether 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 control deficiencies are identified related to the control environment, this may affect the auditor's overall expectations about the operating effectiveness of direct controls.

Other Controls That the Auditor Considers Appropriate (Ref: par. 27~~26a(iv~~*d*))

~~A181.~~A187. In addition to the controls set out in paragraphs 27*a-c*, ~~Other controls that~~ the auditor may consider it appropriate to identify and evaluate the design and determine the implementation of other controls to have an appropriate basis for the identification and assessment of risks of material misstatement at the assertion level, in accordance with paragraph 13. Such controls may include some or all of the following:

- 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
- Controls related to accounting estimates
- Complementary user entity controls, if using a service organization[52]

A188. The auditor's knowledge about the presence or absence of controls obtained from the understanding of the other components may inform the auditor's professional judgment in determining the extent to which it is necessary to devote additional attention to other controls.

Identifying IT Applications and Other Aspects of the IT Environment, Risks Arising From the Use of IT, and General IT Controls (Ref: par. 28~~26*b–e*~~)

~~A182.~~A189. Appendix E includes example characteristics of IT applications and other aspects of the IT environment, and guidance related to those characteristics, that may be relevant in identifying IT applications and other aspects of the IT environment subject to risks arising from the use of IT.

Identifying IT Applications and Other Aspects of the IT Environment (Ref: par. ~~26*b*~~28)

Why the Auditor Identifies Risks Arising From the Use of IT and General IT Controls Related to Identified IT Applications and Other Aspects of the IT Environment

~~A183.~~A190. For controls listed in paragraph ~~26a~~27, paragraph ~~26b~~ 28 requires the auditor to identify related IT applications and other aspects of the IT environment that are subject to the risks described in paragraph ~~26c~~28*a*~~(i)~~. Paragraph ~~26b~~28~~*(ii)*~~*b* then requires the auditor to identify general IT controls that address such risks. Such identification is necessary in order for the auditor to effectively perform the evaluation of design and determination of implementation of identified controls in accordance with paragraph ~~26*d*~~ 29 because general IT controls that address these risks may affect the design and implementation of the controls listed in paragraph ~~26a~~27.

Commented [MM110]: Modified to use consistent terminology throughout

Commented [RMM111]: In response to comments received, revisions were made in this section to include additional guidance regarding other controls.

Commented [RMM112]: Adapted from paragraph .24 of PCAOB AS 2110

[52] AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization.*

~~A184.~~A191. Understanding the risks arising from the use of IT and the general IT controls implemented by the entity to address those risks may affect some or all of the following:

- The auditor's decision about whether to test the operating effectiveness of controls to address risks of material misstatement at the assertion level. For example, when general IT controls are not designed effectively or appropriately implemented to address risks arising from the use of IT (for example, controls do not appropriately prevent or detect unauthorized program changes or unauthorized access to IT applications), this may affect the auditor's decision to rely on automated controls within the affected IT applications.
- The auditor's assessment of control risk at the assertion level. For example, the ongoing operating effectiveness of an information-processing control may depend on certain general IT controls that prevent or detect unauthorized program changes to the IT information-processing control (that is, program change controls over the related IT application). In such circumstances, the expected operating effectiveness (or lack thereof) of the general IT control may affect the auditor's assessment of control risk (for example, control risk may be higher when such general IT controls are expected to be ineffective or if the auditor does not plan to test the general IT controls).
- The auditor's strategy for testing information produced by the entity that is produced by or involves information from the entity's IT applications. For example, when information produced by the entity to be used as audit evidence is produced by IT applications, the auditor may determine to test controls over system-generated reports, including identification and testing of the general IT controls that address risks of inappropriate or unauthorized program changes or ~~the integrity of the~~direct data changes ~~that appears in the~~to such reports.
- The auditor's assessment of inherent risk at the assertion level. For example, when there are significant or extensive programming changes to an IT application to address new or revised reporting requirements of the applicable financial reporting framework, this may be indicative of the complexity of the new requirements and their effect on the entity's financial statements. When such extensive programming or data changes occur, the IT application is also likely to be subject to risks arising from the use of IT.
- The design of further audit procedures. For example, if information-processing controls depend on general IT controls, the auditor may determine to test the operating effectiveness of the general IT controls, which will then require the design of tests of controls for such general IT controls. If, in the same circumstances, the auditor determines not to test the operating effectiveness of the general IT controls, or the general IT controls are expected to be ineffective, the related risks arising from the use of IT may need to be addressed through the design of substantive procedures. However, in such circumstances, the risks arising from the use of IT may not be able to be addressed when such risks relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. In ~~such circumstances~~addition, the auditor may need to consider the implications for the audit opinion.

Commented [MM113]: Modified based on comments received. Unauthorized program changes also relate to the integrity of reports.

Identifying IT Applications That Are Subject to Risks Arising From the Use of IT

~~A185.~~A192. For the IT applications relevant to the information system, understanding the nature and complexity of the specific IT processes and general IT controls that the entity has in place may assist the auditor in determining which IT applications the entity is relying upon to accurately process and maintain the integrity of information in the entity's information system. Such IT applications may be subject to risks arising from the use of IT.

~~A186.~~A193. Identifying the IT applications that are subject to risks arising from the use of IT involves taking into account controls identified by the auditor because such controls may involve the use of IT or rely on IT. The auditor may focus on whether an IT application includes automated controls that management is relying on and that the auditor has identified, including controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. The auditor may also consider how information is stored and processed in the information system relating to significant classes of transactions, account balances, and disclosures and whether management is relying on general IT controls to maintain the integrity of that information.

~~A187.~~A194. The controls identified by the auditor in accordance with paragraph 27 may depend on system-generated reports, in which case, the IT applications that produce those reports may be subject to risks arising from the use of IT. ~~In other cases, the~~The auditor may plan to ~~not to rely on controls over the system-generated reports and plan to~~ directly test the inputs and outputs of ~~the report generation process~~such system-generated reports, rather than rely on controls over such reports to accurately process and maintain the integrity of information. In such circumstances, ~~in which case,~~ the auditor may not identify the related IT applications as ~~not~~ being subject to risks arising from the use of IT and, thus, ~~these~~ such controls may not be subject to the requirements in paragraph~~s~~ 28~~26~~*b*~~*c–d*~~.

Commented [RMM114]: Modified to clarify by changing the auditor's plans into a positive and not a negative.

Commented [MM115]: Modified to use the defined term. A search was performed and changes were made throughout for consistency.

Scalability

~~A188.~~A195. The extent of the auditor's understanding of the IT processes, including the extent to which the entity has general IT controls in place, will vary with the nature and circumstances of the entity and its IT environment and will also be based on the nature and extent of controls identified by the auditor. The number of IT applications that are subject to risks arising from the use of IT also will vary based on these factors. Examples are as follows:

- An entity that uses commercial software and does not have access to the source code to make any program changes is unlikely to have a process for program changes but may have a process or procedures to configure the software (for example, the chart of accounts, reporting parameters, or thresholds). In addition, the entity may have a process or procedures to manage access to the application (for example, a designated individual with administrative access to the commercial software). In such circumstances, the entity is unlikely to have ~~or need~~ formalized general IT controls.
- In contrast, ~~a larger~~an entity may ~~rely on IT to a great extent. In such cases, the IT environment may involve~~use multiple IT applications, and the IT processes to manage the IT environment may be complex (for example, a dedicated IT department exists

Commented [RMM116]: Modified to streamline and eliminate the notion of a "larger" entity

that develops and implements program changes and manages access rights)~~.~~. In such circumstances, ~~including that~~ the entity likely has implemented formalized general IT controls over its IT processes.

- When management is not relying on automated controls or general IT controls to support complete and accurate transaction processing ~~transactions~~ or maintain the data, and the auditor has not identified any automated controls or other information-processing controls (or any that depend on general IT controls), the auditor may plan to directly test any information produced by the entity involving IT and may not identify any IT applications that are subject to risks arising from the use of IT.
- When management relies on an IT application to process or maintain data and the volume of data is significant, and management relies upon the IT application to perform automated controls that the auditor has also identified, the IT application is likely to be subject to risks arising from the use of IT.

See paragraph 15 of Appendix E, *Considerations for Understanding Information Technology*, for example characteristics of an IT application that is likely not subject to risks arising from the use of IT.

Commented [MM117]: Added to further assist auditors understand risks arising from the use of IT by pointing to the specific examples.

~~A189.~~A196. When an entity has greater complexity in its IT environment, identifying the IT applications and other aspects of the IT environment, determining the related risks arising from the use of IT, and identifying general IT controls is likely to require the involvement of team members with specialized skills or knowledge in IT. Such involvement is likely to be essential and may need to be extensive for complex IT environments.

Identifying Other Aspects of the IT Environment That Are Subject to Risks Arising From the Use of IT

~~A190.~~A197. The other aspects of the IT environment that may be subject to risks arising from the use of IT include the network, operating system and databases, and, in certain circumstances, interfaces between IT applications. Other aspects of the IT environment are generally not identified when the auditor does not identify IT applications that are subject to risks arising from the use of IT. When the auditor has identified IT applications that are subject to risks arising from the use of IT, other aspects of the IT environment (for example, database, operating system, network) are likely to be identified because such aspects support and interact with the identified IT applications.

Identifying Risks Arising From the Use of IT and General IT Controls (Ref: par. 28~~26c~~)

~~A191.~~A198. ~~Appendixes~~ Appendix ~~E~~ F sets out considerations for understanding general IT controls.

~~A192.~~A199. In identifying the risks arising from the use of IT, the auditor may consider the nature of the identified IT application or other aspect of the IT environment and the reasons for it being subject to risks arising from the use of IT. For some identified IT applications or other aspects of the IT environment, the auditor may identify applicable risks arising from the use of IT that relate primarily to unauthorized access or unauthorized program changes as well as risks

related to inappropriate data changes (for example, the risk of inappropriate changes to the data through direct database access or the ability to directly manipulate information).

~~A193.~~A200. The extent and nature of the applicable risks arising from the use of IT vary depending on the nature and characteristics of the identified IT applications and other aspects of the IT environment. Applicable IT risks may result when the entity uses external or internal service providers for identified aspects of its IT environment (for example, 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). It is more likely that there will be more risks arising from the use of IT when the volume or complexity of automated application controls is higher and management is placing greater reliance on those controls for effective processing of transactions or the effective maintenance of the integrity of underlying information. Applicable risks arising from the use of IT may also be identified related to cybersecurity.

Evaluating the Design and Determining Implementation of Identified Controls in the Control Activities Component (Ref: par. ~~26d~~29)

~~A194.~~A201. Evaluating the design of an identified control involves the auditor's consideration of whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements.

~~A195.~~A202. The auditor determines the implementation of an identified control by establishing that the control exists and that the entity is using it. There is little point in the auditor assessing the implementation of a control that is not designed effectively. Therefore, the auditor typically evaluates the design of a control first. An improperly designed control may represent a control deficiency.

~~A196.~~A203. Risk assessment procedures to obtain audit evidence about the design and implementation of identified controls in the control activities component may include

- inquiring of entity personnel.
- observing the performance of specific controls.
- inspecting documents and reports.
- reperforming the specific controls

Inquiry alone, however, is not sufficient for such purposes.

~~A197.~~A204. A walk-through involves following a transaction from origination through the entity's processes, including information systems, until it is reflected in the entity's financial records, using the same documents and IT that entity personnel use. ~~The auditor may perform walk~~Walk-throughs may assist the auditor in understanding the information system as required by paragraph 25 and in evaluating the design of controls that address the risks of material misstatement and determining whether those controls have been implemented as required by paragraph 29. Walk-through procedures usually include a combination of inquiry, observation,

Commented [RMM118]: Added as this is a procedure that can be performed to evaluate design and test operating effectiveness.

Commented [RMM119]: Modified to clarify walkthroughs in the context of understanding the information system and evaluating design and determining implementation.

inspection of relevant documentation, and reperformance of controls. Such walk-throughs, as described in paragraph A205, ordinarily are sufficient to evaluate design and determine implementation when risk assessment procedures beyond inquiry A196 are performed. A walk-through involves following a transaction from origination through the entity's processes, including information systems, until it is reflected in the entity's financial records, using the same documents and IT that entity personnel use. Walk-through procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and reperformance of controls.

A198.A205. In performing a walk-through, at the points at which important processing procedures occur, the auditor inquires of the entity's personnel about their understanding of what is required by the entity's prescribed procedures and controls particularly for the application of manual controls. These inquiries, combined with the other walk-through procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, inquiries that go beyond a narrow focus on the single transaction used as the basis for the walk-through allow the auditor to gain an understanding of the different types of significant transactions handled by the process.[53]

A199.A206. The auditor may expect, based on experience from the previous audit or based on current period risk assessment procedures, that management does not have effectively designed or implemented controls to address a significant risk. In such instances, the procedures performed to address the requirement in paragraph 26*d* 2926 may consist of determining that such controls have not been effectively designed or implemented. If the results of the procedures indicate that controls have been newly designed or implemented, the auditor is required to perform the procedures in paragraph 2926*a-bb* d on the newly designed or implemented controls.

A200.A207. The auditor may conclude that a control, which is effectively designed and implemented, may be appropriate to test in order to take its operating effectiveness into account in designing substantive procedures. However, when a control is not designed or implemented effectively, there is no benefit in testing it. When the auditor plans to test the operating effectiveness of a control, the information obtained about the extent to which the control addresses the risk or risks of material misstatement is may be an input to the auditor's control risk assessment at the assertion level (see paragraph A256).

Commented [RMM120]: This may be one way to assess control risk. Included a reference to how control risk might be assessed.

Commented [MR121]: A248

A201.A208. Evaluating the design and determining the implementation of identified controls in the control activities component is not sufficient to test their operating effectiveness. However, for automated controls, if the procedures performed to evaluate the design of the controls and determine whether they have been implemented meets the requirements of a test of operating effectiveness in AU-C section 330,[54] the auditor may use the results of these procedures as a test of the operating effectiveness of the automated controls for the audit period by ifidentifying and testing general IT controls that provide for the consistent operation of the automated controls. Obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the

[53]

[54] Paragraph .08 of AU-C section 330.

period under audit. Tests of the operating effectiveness of controls, including tests of indirect controls, are further described in AU-C section 330.[55]

~~A202.~~A209. When the auditor does not plan to test the operating effectiveness of identified controls, the auditor's evaluation of the design and determination of the implementation of certain controls may still assist in the design of the nature, timing, and extent of substantive procedures that are responsive to the related risks of material misstatement. Examples are as follows:

- These ~~results of these~~ risk assessment procedures may provide a basis for the auditor's consideration of possible ~~deviations~~ misstatements or likely sources of misstatements in a population when designing substantive procedures.
- ~~Performance of t~~These risk assessment procedures may lead the auditor to identify ~~a fraud risk related to~~ inadequate segregation of duties ~~in the payroll function, and the auditor may decide to perform certain~~that may impact the design of the auditor's substantive procedures (for example, inadequate segregation of duties in the payroll function may indicate ~~to address the~~a fraud risk resulting from the ability to create~~of~~ fictitious employees for which the auditor's substantive procedures are required to be responsive to that risk) ~~as a result~~.
- These risk assessment procedures may lead the auditor to identify missing controls that may impact the design of the auditor's substantive procedures (for example, the auditor may become aware that~~During the process of evaluating the design of certain~~ identified controls related to sales~~, the auditor may become aware that the~~ do not address the entity's~~entity enters into~~ bill-and-hold transactions with customers resulting in different substantive procedures for such transactions~~, and the auditor may design specific substantive procedures related to the agreements with the customers to test appropriateness of revenue recognition under the applicable financial reporting framework~~)

~~A203.~~A210. In addition, when identified controls are designed effectively and implemented, risk assessment procedures may generally influence the auditor's determination of the nature and timing of substantive procedures to be performed (for example, the auditor may determine to perform inspection rather than external confirmation or to perform procedures at an interim date rather than at period end).

Control Deficiencies Within the Entity's System of Internal Control (Ref: par. 30)

~~A204.~~A211. In performing the evaluations of each of the components of the entity's system of internal control, as described in paragraphs .21*b*, .22*b*, .24*c*, .25*c*, and .29~~26*d*~~a, the auditor may determine that certain of the entity's policies in a component are not appropriate to the nature and circumstances of the entity. Such ~~a~~ determination may be an indicator that ~~assists the auditor in identifying~~ a control deficiency~~ies~~ exists.

Commented [RMM122]: See Issue G (May 2021)

Commented [RMM123]: Deviations are typically linked to tests of operating effectiveness.

Commented [RMM124]: Modified to be more general and include the more specific example in a parenthetical.

Commented [RMM125]: Modified similarly to be broader along with an example. Also clarified the example.

Commented [RMM126]: The auditor is not required to identify control deficiencies in each component of internal control. The auditor considers whether one or more deficiencies have been identified.

[55] Paragraphs .08–.11 of AU-C section 330.

~~A205.~~A212. If the auditor has identified one or more control deficiencies, AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*,[56] requires the auditor to determine whether, individually or in combination, the deficiencies constitute a material weakness or a significant deficiency. The auditor uses professional judgment in determining whether a control deficiency represents a material weakness or a significant ~~control~~ deficiency. AU-C section 265 set out indicators of significant deficiencies and matters to be considered in determining whether a deficiency, or a combination of deficiencies, in internal control constitute a significant deficiency.[57]

Commented [RMM127]: Significant deficiency is the defined term.

Commented [MM128]: Elevated from the footnote based on clarity drafting conventions.

Identifying and Assessing the Risks of Material Misstatement (Ref: par. 31–40)

Why the Auditor Identifies and Assesses the Risks of Material Misstatement

~~A206.~~A213. Risks of material misstatement are identified and assessed by the auditor in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

~~A207.~~A214. Information gathered by performing risk assessment procedures is used as audit evidence to provide the basis for the identification and assessment of the risks of material misstatement. For example, the audit evidence obtained when evaluating the design of identified controls and determining whether those controls have been implemented in the control activities component is used as audit evidence to support the risk assessment. Such evidence also provides a basis for the auditor to design overall responses to address the assessed risks of material misstatement at the financial statement level as well as designing and performing further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level, in accordance with AU-C section 330.

Identifying Risks of Material Misstatement (Ref: par. 31)

~~A208.~~A215. The identification of risks of material misstatement is performed before consideration of any related controls (that is, the determination is based on inherent risk) and is based on the auditor's preliminary consideration of misstatements that have a reasonable possibility of both occurring and being material if they were to occur.

Commented [RMM129]: Modified for consistency; this suggested edit was provided by the ASB during the March meeting.

~~A209.~~A216. Identifying the risks of material misstatement also provides the basis for the auditor's determination of relevant assertions, which assists the auditor's determination of the significant classes of transactions, account balances, and disclosures.

Assertions

[56] Paragraph .08 of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*.

[57] Paragraphs .A6–.A7 of AU-C section 265 ~~set out indicators of significant deficiencies and matters to be considered in determining whether a deficiency, or a combination of deficiencies, in internal control constitute a significant deficiency~~.

Why the Auditor Uses Assertions

~~A210.~~A217. In identifying and assessing the risks of material misstatement, the auditor uses assertions to consider the different types of potential misstatements that may occur. Assertions for which the auditor has identified related risks of material misstatement are relevant assertions.

The Use of Assertions

~~A211.~~A218. In identifying and assessing the risks of material misstatement, the auditor may use the categories of assertions as described in subsequent paragraph A219*a–b* or may express them differently, provided all aspects described in paragraphs A219*a–b* 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.

~~A212.~~A219. Assertions used by the auditor in considering the different types of potential misstatements that may occur may fall into the following categories:

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

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

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

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

iv. *Cutoff*. Transactions and events have been recorded in the correct accounting period.

v. *Classification*. Transactions and events have been recorded in the proper accounts.

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

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

i. *Existence*. Assets, liabilities, and equity interests exist.

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

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

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

v. *Classification*. Assets, liabilities, and equity interests have been recorded in the proper accounts.

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

~~A213.~~A220. The assertions described in preceding paragraph A219*a–b*, adapted as appropriate, may also be used by the auditor in considering the different types of misstatements that may occur in disclosures not directly related to recorded classes of transactions, events, or account balances. For example, such a disclosure may be a description, required by the applicable financial reporting framework, of an entity's exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies, and processes for managing the risks; and the methods used to measure the risks.

Considerations Specific to Governmental Entities

~~A214.~~A221. When making assertions about the financial statements of governmental entities, in addition to those assertions set out in paragraph A219*a–b*, management may often assert that transactions and events have been carried out in accordance with law, regulation, or other authority. Such assertions may fall within the scope of the financial statement audit.

Risks of Material Misstatement at the Financial Statement Level (Ref: par. 31a and 33~~29~~)

Why the Auditor Identifies and Assesses Risks of Material Misstatement at the Financial Statement Level

~~A215.~~A222. The auditor identifies risks of material misstatement at the financial statement level to determine whether the risks have a pervasive effect on the financial statements and, therefore, would require an overall response in accordance with AU-C section 330.[58]

~~A216.~~A223. In addition, risks of material misstatement at the financial statement level may also affect individual assertions, and identifying these risks may assist the auditor in assessing risks of material misstatement at the assertion level and in designing further audit procedures to address the identified risks.

Identifying and Assessing Risks of Material Misstatement at the Financial Statement Level

~~A217.~~A224. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions.

[58] Paragraph .05 of AU-C section 330.

Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level (for example, risk of management override of controls). Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level. The auditor's evaluation of whether risks identified relate pervasively to the financial statements supports the auditor's assessment of the risks of material misstatement at the financial statement level. In other cases, a number of assertions may also be identified as susceptible to the risk and, therefore, may affect the auditor's risk identification and assessment of risks of material misstatement at the assertion level (see paragraph A246~~A238~~). ~~For 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 financial reporting framework may require management to evaluate whether there is substantial doubt about the entity remaining a going concern, and the auditor may determine that there is a significant risk associated with this determination.~~

Commented [HH130]: Moved example to A238

~~A218.~~A225. ~~For governmental entities, the~~Depending upon the entity's nature and its environment, the identification of risks at the financial statement level may include consideration of matters related to the political climate, public interest, and ~~program~~ sensitivity of programs or activities.

Commented [HH131]: See July 21 Issues Paper

Previously a consideration specific to governmental entity. Made it broader and moved it here from below.

~~A219.~~A226. The auditor's identification and assessment of risks of material misstatement at the financial statement level is influenced by the auditor's understanding of the entity's system of internal control, in particular, the auditor's understanding of the control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control, in addition to the following:

- The outcome of the related evaluations required by paragraphs 21*b*, 22*b*, 24*c*, and 25~~26~~*c*
- Any control deficiencies identified in accordance with paragraph 30

In particular, risks at the financial statement level may arise from control deficiencies in the control environment or from external events or conditions such as declining economic conditions. For example, control deficiencies such as a lack of management competence or a lack of oversight over the preparation and fair presentation of the financial statements may have a more pervasive effect on the financial statements and may require an overall response by the auditor in accordance with AU-C section 330.[59]

Commented [RMM132]: An example was included to respond to comments received. This example comes from paragraph A127 of extant AU-C section 315

~~A220.~~A227. Risks of material misstatement due to fraud may be particularly relevant to the auditor's consideration of the risks of material misstatement at the financial statement level. For example, the auditor understands from inquiries of management that the entity's financial statements are to be used in discussions with lenders in order to secure further financing to maintain working capital. The auditor also understands from such inquiries and other procedures that current loan agreements with these lenders contain financial covenants that the entity is at risk of failing to meet and identifies this condition as a fraud risk factor. Therefore, the auditor may determine that there is a greater susceptibility to misstatement due to this identified fraud risk factor, which affects inherent risk (that is, the susceptibility of the financial statements to material misstatement

[59] Paragraph .05 of AU-C section 330.

because of the risk of fraudulent financial reporting, such as overstatement of assets and revenue and understatement of liabilities and expenses to ensure that the covenants are met). The auditor may then identify assertion-level risks with respect to existence, accuracy, or valuation of certain assets and completeness of certain liabilities that are susceptible to material misstatement as a result of this financial-statement-level risk.

~~A221.~~A228. 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 when withdrawal is possible under applicable law or regulation. Examples are as follows:

- 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 that it could cause the auditor to conclude that the risk of intentional misrepresentation by management in the financial statements is such that an audit cannot be conducted.
- As a result of evaluating the entity's information system and communication, the auditor determines that significant changes in the IT environment have been poorly managed, with little oversight from management and those charged with governance. The auditor concludes that there are significant concerns about the condition and reliability of the entity's accounting records. In such circumstances, the auditor may determine that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

~~A222.~~A229. AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report,* establishes requirements and provides guidance in determining whether there is a need for the auditor to express a qualified opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement when withdrawal is possible under applicable law or regulation.

~~Considerations Specific to Governmental Entities~~

Commented [HH133]: See July 2021 Issues Paper

Moved it above.

~~A223.~~

*Risks of Material Misstatement at the Assertion Level (Ref: par. 31*b*)*

~~A224.~~A230. Appendix B sets out examples, in the context of inherent risk factors, of events or conditions that may indicate susceptibility to misstatement that may be material.

~~A225.~~A231. Risks of material misstatements that do not relate pervasively to the financial statements are risks of material misstatement at the assertion level.

Relevant Assertions and Significant Classes of Transactions, Account Balances, and Disclosures (Ref: par. 32)

Why Relevant Assertions and Significant Classes of Transactions, Account Balances, and

Disclosures Are Determined

~~A226.~~A232. Risks of material misstatement are assessed at the assertion level for significant classes of transactions, account balances, or disclosures in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. An approach to identifying and assessing risks of material misstatement may begin at the financial statement level and, with the auditor's overall understanding through risk assessment procedures, work down to significant classes of transactions, account balances, and disclosures and their relevant assertions. Further, ~~D~~determining ~~relevant assertions and~~ the significant classes of transactions, account balances, and disclosures provides the basis for the scope of the auditor's understanding of the entity's information system required to be obtained in accordance with paragraph 25*a*. As described in paragraph A145~~A140~~, the information obtained from the auditor's understanding and evaluation of the information system may confirm or further influence the auditor's expectations about the significant classes of transactions, account balances, and disclosures initially identified. This understanding may further assist the auditor in identifying and assessing risks of material misstatement (see paragraph A97~~A93~~).

Commented [RMM134]: Modified to include a top-down approach as an example to risk assessment, as discussed in AU-C section 940 (paragraphs A32 and A33) and PCAOB standards.

Commented [RMM135]: Included to reinforce that this is an iterative, dynamic process – bridging the top-down approach in AU-C section 940 with the guidance in AU-C section 315.

Automated Tools and Techniques

~~A227.~~A233. The auditor may use automated techniques to assist in the identification of significant classes of transactions, account balances, and disclosures. Examples are as follows:

- An entire population of transactions may be analyzed using automated tools and techniques to understand their nature, source, size, and volume. By applying automated techniques, the auditor may, for example, identify that an account with a zero balance at period end comprised numerous offsetting transactions and journal entries occurring during the period, indicating that the account balance or class of transactions may be significant (for example, a payroll clearing account). This same payroll clearing account may also identify expense reimbursements to management (and other employees), which could be a significant disclosure due to these payments being made to related parties.
- By analyzing the flows of an entire population of revenue transactions, the auditor may more easily identify a significant class of transactions that had not previously been identified.

Disclosures That May Be Significant

~~A228.~~A234. Significant disclosures include both quantitative and qualitative disclosures for which there is one or more relevant assertions. Examples of disclosures that have qualitative aspects and that may have relevant assertions and, therefore, may be considered significant by the auditor include disclosures about the following:

- Accounting and reporting complexities associated with an account
- Exposure to losses in an account

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

Assessing Risks of Material Misstatement at the Assertion Level

Assessing Inherent Risk (Ref: par. 34–36)

Assessing the Likelihood and Magnitude of Misstatement (Ref: par. 34)

Why the Auditor Assesses Likelihood and Magnitude of Misstatement

~~A229.~~A235. The auditor assesses the likelihood and magnitude of misstatement for identified risks of material misstatement because the significance of the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement were the misstatement to occur determines where on the spectrum of inherent risk the identified risk is assessed, which informs the auditor's design of further audit procedures to address the risk.

~~A230.~~A236. Assessing the inherent risk of identified risks of material misstatement also assists the auditor in determining significant risks. The auditor determines significant risks because specific responses to significant risks are required in accordance with AU-C section 330 and other AU-C sections.

~~A231.~~A237. Inherent risk factors influence the auditor's assessment of the likelihood and magnitude of misstatement for the identified risks of material misstatement at the assertion level. The greater the degree to which a class of transactions, account balance, or disclosure is susceptible to material misstatement, the higher the inherent risk assessment is likely to be. Considering the degree to which inherent risk factors affect the susceptibility of an assertion to misstatement assists the auditor in appropriately assessing inherent risk for risks of material misstatement at the assertion level and in designing a more precise response to such a risk.

Spectrum of Inherent Risk

~~A232.~~A238. In assessing inherent risk, the auditor uses professional judgment in determining the significance of the combination of the likelihood and magnitude of a misstatement.

~~A233.~~A239. The assessed inherent risk relating to a particular risk of material misstatement at the assertion level represents a judgment within a range, from lower to higher, on the spectrum of inherent risk. The judgment about where in the range inherent risk is assessed may vary based on the nature, size, and complexity of the entity and takes into account the assessed likelihood and magnitude of the misstatement and inherent risk factors.

~~A234.~~A240. In considering the likelihood of a misstatement, the auditor considers the possibility that a misstatement may occur based on consideration of the inherent risk factors.

~~A235.~~A241. In considering the magnitude of a misstatement, the auditor considers the qualitative and quantitative aspects of the possible misstatement (that is, misstatements in assertions about classes of transactions, account balances, or disclosures may be judged to be material due to size, nature, or circumstances).

~~A236.~~A242. The auditor uses the significance of the combination of the likelihood and magnitude of a possible misstatement in determining where on the spectrum of inherent risk (that is, the range) inherent risk is assessed. The higher the combination of likelihood and magnitude, the higher the assessment of inherent risk; the lower the combination of likelihood and magnitude, the lower the assessment of inherent risk.

~~A237.~~A243. For a risk to be assessed as higher on the spectrum of inherent risk, it does not mean that both the magnitude and likelihood need to be assessed as high. Rather, it is the intersection of the magnitude and likelihood of the material misstatement on the spectrum of inherent risk that will determine whether the assessed inherent risk is higher or lower on the spectrum of inherent risk. A higher inherent risk assessment may also arise from different combinations of likelihood and magnitude, for example, a higher inherent risk assessment could result from a lower likelihood but a very high magnitude.

~~A238.~~A244. In order to develop appropriate strategies for responding to risks of material misstatement, the auditor may designate risks of material misstatement within categories along the spectrum of inherent risk, based on their assessment of inherent risk. These categories may be described in different ways, such as in quantitative terms or in nonquantitative terms. For example, the auditor may use percentages or classifications (for example, low, medium, or high; lower or higher; normal or elevated; or other type of nominal or arithmetic scale) to describe the level of inherent risk. Regardless of the method ~~of categorization~~ used, the auditor's assessment of inherent risk is appropriate when the design and implementation of further audit procedures to address the identified risks of material misstatement at the assertion level is appropriately responsive to the assessment of inherent risk and the reasons for that assessment.

Commented [RMM136]: From paragraph A44 of AU-C section 200

Commented [RMM137]: Additional guidance was provided to respond to comments received. This matter was discussed by the ASB at the March meeting. Specific examples are provided with respect to control risk. Accordingly, specific examples were also provided with respect to inherent risk, consistent with the views of several ASB members.

Pervasive Risks of Material Misstatement at the Assertion Level (Ref: par. 34*b*)

~~A239.~~A245. In assessing the identified risks of material misstatement at the assertion level, the auditor may conclude that some risks of material misstatement relate more pervasively to the financial statements as a whole and potentially affect many assertions, in which case, the auditor may update the identification of risks of material misstatement at the financial statement level.

~~A240.~~ In circumstances in which risks of material misstatement are identified as financial-statement-level risks due to their pervasive effect on a number of assertions and are identifiable with specific assertions, the auditor is required to take into account those risks when assessing inherent risk for risks of material misstatement at the assertion level. Further, identified risks of material misstatement at the financial statement level may affect the auditor's assessment of significant risks at the assertion level.[60] For example, ~~the~~an entity may face~~s~~ operating losses and liquidity issues and ~~is~~be reliant on funding that has not yet been secured. In such a circumstance, the financial reporting framework may require management to evaluate whether there is substantial doubt about the entity remaining a going concern, and the auditor may determine that there is a significant risk associated with ~~this determination~~the related disclosures in the entity's financial statements.

~~Considerations Specific to Governmental Entities~~

~~A241.~~A246. ~~In exercising professional judgment regarding the assessment of the risk of material misstatement, governmental auditors may consider the complexity of laws and regulations, and the risks of noncompliance therewith.~~

Significant Risks (Ref: par. 35)

Why Significant Risks Are Determined and the Implications for the Audit

~~A242.~~A247. The determination of significant risks allows for the auditor to focus more attention on those risks that are on the upper end of the spectrum of inherent risk , through the performance of certain required responses, including the following:

- Controls that address significant risks are required to be identified in accordance with paragraph 27~~26A~~*a*~~(i)~~ of this proposed SAS, with a requirement to evaluate whether the control has been designed effectively and implemented in accordance with paragraph ~~26d~~ 29~~26C~~ of this proposed SAS.
- AU-C section 330 requires controls that address significant risks to be tested in the current period (when the auditor intends to rely on the operating effectiveness of such controls) and substantive procedures to be planned and performed that are specifically responsive to the identified significant risk.[61]
- AU-C section 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk.[62] In addition to the requirements and guidance

Commented [RMM138]: Included to bridge the new definition of significant risks in the proposed SAS to the definition of a significant risk in PCAOB standards, which could include financial statement level risks.

Commented [RMM139]: Moved from paragraph A225

Commented [HH140]: Deleted, as deemed not necessary. Appropriately covered by AU-C section 250

Commented [MM141]: Modified to use defined term

Commented [RMM142]: Included to further bridge the definition of a significant risk in the proposed SAS to the definition in PCAOB standards, particularly for auditors that apply both US GAAS and PCAOB standards. Significant risks would not be determined differently under each set of standards.

[60] See paragraph A214 of this proposed SAS.

[61] Paragraphs .15 and. 22 of AU-C section 330.

[62] Paragraph .07*b* of AU-C section 330.

in this proposed SAS, AU-C section 330 includes special audit considerations in the form of specific requirements related to significant risks because of the nature of the risk and the likelihood and potential magnitude of misstatement related to the risk.

- AU-C section 260 requires communicating with those charged with governance about the significant risks identified by the auditor.[63]
- AU-C section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, if applicable, requires the auditor to take into account significant risks when determining those matters that required significant auditor attention, which are matters that may be key audit matters.[64]
- ~~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.[65]~~
- AU-C section 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.[66]

Commented [RMM143]: Moved below as bullet was not similar to the others.

A248. -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. [67]~~68~~

Determining Significant Risks

~~A243.~~A249. In determining significant risks, the auditor may first identify those assessed risks of material misstatement that have been assessed higher on the spectrum of inherent risk to form the basis for considering which risks may be close to the upper end. Being close to the upper end of the spectrum of inherent risk will differ from entity to entity and will not necessarily be the same for an entity period on period. It may depend on the nature and circumstances of the entity for which the risk is being assessed.

~~A244.~~A250. The determination of which of the assessed risks of material misstatement are close to the upper end of the spectrum of inherent risk and, therefore, are significant risks, is a matter of professional judgment, unless the risk is of a type specified to be treated as a significant risk in accordance with the requirements of another AU-C section. AU-C section 240 and AU-C section 550 provide further requirements and guidance in relation to the identification and assessment of

[63] Paragraph .15 of AU-C section 260.

[64] Paragraph .08 of AU-C section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

~~[65] Paragraphs .19 and .A17 of AU-C section 220.~~

[66] Paragraphs .57–.58 of AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*.

[67] Paragraphs .19 and .A17 of AU-C section 220.

the risks of material misstatement due to fraud and ~~transactions with~~ related ~~parties~~party transactions that are also significant unusual transactions.[69,70] Examples are as follows:

- 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.

~~A245.~~A251. The auditor also takes into account the relative effects of inherent risk factors when assessing inherent risk. The lower the effect of inherent risk factors, the lower the assessed risk is likely to be. Risks of material misstatement that may be assessed as having higher inherent risk and, therefore, may 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[71]
- Accounting for unusual or complex transactions, including those in controversial ~~or emerging~~ areas (for example, accounting for revenue with multiple performance obligations that are difficult to value)
- Emerging areas (for example, accounting for digital assets)
- Complexity in data collection and processing to support account balances
- Account balances or quantitative disclosures that involve complex calculations
- Accounting principles that may be subject to differing interpretation
- Changes in the entity's business that involve changes in accounting, for example, mergers and acquisitions

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: par. 36)

Commented [RMM144]: Modified to align with the requirement in AU-C section 550.

Commented [RMM145]: AICPA staff to check all references to other AU-C sections based on new SASs. This might be paragraph 20 of AU-C section 500.

Commented [HH146]: Separated emerging areas from previous bullets and included an example

[69] Paragraphs .25–.27 of AU-C section 240.

[70] Paragraph .~~19~~ 18 of AU-C section 550, *Related Parties*.

[71] Paragraphs .10–.11 of AU-C section 540, *Auditing Accounting Estimates and Related Disclosures*.

Why Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence Are Required to Be Identified

~~A246.~~A252. Due to the nature of a risk of material misstatement, and the controls ~~activities~~ that address that risk, in some circumstances, the only way to obtain sufficient appropriate audit evidence is to test the operating effectiveness of controls. Accordingly, there is a requirement for the auditor to identify any such risks because of the implications for the design and performance of further audit procedures in accordance with AU-C section 330 to address risks of material misstatement at the assertion level.

~~A247.~~A253. Paragraph ~~26a~~27~~26 *(iii)*~~*c* also requires the identification of controls that address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence because the auditor is required, in accordance with AU-C section 330,[72] to design and perform tests of such controls.

Determining Risks f~~F~~or Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence.

~~A248.~~A254. When routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. This may be the case in circumstances in which a significant amount of an entity's information is initiated, recorded, processed, or reported in the financial statements only in electronic form~~, such as in an information system that involves a high degree of integration across its IT functions~~. For 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, controls testing is typically performed to determine that the origination and completion of calls and data activity is correctly captured (for example, minutes of a call or volume of a download) and recorded correctly in the entity's billing system. In such cases

Commented [RMM147]: This does not necessarily indicate that substantive procedures alone are not sufficient. Extant refers to "such as in an integrated system"

- 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.

~~A249.~~A255. AU-C section 540 provides further guidance related to accounting estimates about risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.[73] In relation to accounting estimates, this may not be limited to automated processing but may also be applicable to complex models.

Assessing Control Risk (Ref: par. 37)

[72] Paragraph .08 of AU-C section 330.ve

[73] Paragraphs .A87–.A89 of AU-C section 540.

~~A250.~~A256. The auditor's plans to test the operating effectiveness of controls is based on the expectation that controls are operating effectively, and this will form the basis of the auditor's assessment of control risk. The initial expectation of the operating effectiveness of controls is based on the auditor's evaluation of the design and the determination of implementation of the identified controls in the control activities component. The results of tests of ~~Once the auditor has tested~~ the operating effectiveness of the controls in accordance with AU-C section 330~~,~~ provide the basis for the auditor's ~~will be able to confirm~~ determination of whether the initial expectation about the operating effectiveness of controls remains appropriate. If the controls are not operating effectively as expected, then the auditor will need to revise the control risk assessment in accordance with paragraph 40.

Commented [MM148]: Modified to clarify based on comments received during exposure.

~~A251.~~A257. The auditor's assessment of control risk may be performed in different ways, depending on preferred audit techniques or methodologies, and may be expressed in different ways. For instance, the control risk assessment may be expressed using qualitative terms (such as control risk assessed as maximum, moderate, or minimum) or in terms of the auditor's expectation of how effective the controls are in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls. In accordance with paragraph 34, tests of the operating effectiveness of controls are required to support a control risk assessment below the maximum level.

Commented [RMM149]: See Issue G (May 2021)

Commented [RMM150]: This is from paragraph A71 of SAS 143

Commented [RMM151]: The last sentence was adapted from paragraph 33 of PCAOB AS 2301

~~A252.~~A258. 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.

~~A253.~~A259. 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 AU-C section 330.[74]

~~A254.~~A260. Regardless of whether the auditor plans to test the operating effectiveness of controls for the purpose of assessing control risk, the auditor's understanding of the entity and its

[74] Paragraphs .A32–.A33 of AU-C section 330.

environment, the financial reporting framework, and the entity's system of internal control informs the auditor's design of further audit procedures. Examples follow:

- The auditor's understanding of the entity's system of internal control may indicate that controls are not designed or implemented appropriately, or the entity's control environment does not support the effective operation of control. In this case, there is no point in testing the operating effectiveness of controls; the further audit procedures will consist solely of substantive procedures. If the auditor determines, pursuant to paragraph 36, that substantive procedures alone cannot provide sufficient appropriate audit evidence, the auditor may need to consider the effect on the auditor's report, as described in AU-C section 330.[75]
- The auditor's understanding of the entity's information system and communication will inform the auditor about the nature of documentation available for testing. For example, if the entity's records are all electronic, the auditor may design audit procedures differently than if the entity's records are in paper format.

Commented [MM152]: Modified to use defined term

Commented [MM153]: Modified to use defined term

Commented [MM154]: Modified to clarify tests of operating effectiveness

Evaluating the Audit Evidence Obtained From the Risk Assessment Procedures (Ref: par. 38)

Why the Auditor Evaluates the Audit Evidence From the Risk Assessment Procedures

~~A255.~~A261. Audit evidence obtained from performing risk assessment procedures provides the basis for the identification and assessment of the risks of material misstatement. This provides the basis for the auditor's design of the nature, timing, and extent of further audit procedures responsive to the assessed risks of material misstatement, at the assertion level, in accordance with AU-C section 330. Accordingly, the audit evidence obtained from the risk assessment procedures provides a basis for the identification and assessment of risks of material misstatement whether due to fraud or error at the financial statement and assertion levels.

The Evaluation of the Audit Evidence

~~A256.~~A262. Audit evidence from risk assessment procedures comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.[76]

Professional Skepticism

~~A257.~~A263. In evaluating the audit evidence from the risk assessment procedures, the auditor considers whether sufficient understanding about the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control has been obtained to be able to identify the risks of material misstatement as well as whether there is any evidence that is contradictory that may indicate a risk of material misstatement.

[75] Paragraph .29 of AU-C section 330.
[76] Paragraph .A1 of AU-C section 500.

Classes of Transactions, Account Balances, and Disclosures That Are Not Significant but Are Material (Ref: par. 39)

~~A258.~~A264. As explained in AU-C section 320,[77] materiality and audit risk are considered when identifying and assessing the risks of material misstatement in classes of transactions, account balances, and disclosures. The auditor's determination of materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements.[78] For purposes of this proposed SAS, classes of transactions, account balances, or disclosures are material if there is a substantial likelihood that omitting, misstating, or obscuring information about them would influence the judgment made by a reasonable user based on the financial statements.

~~A259.~~A265. There may be classes of transactions, account balances, or disclosures that are material but have not been determined to be significant classes of transactions, account balances, or disclosures (that is, there are no relevant assertions identified). For example, the entity may have a disclosure about executive compensation for which the auditor has not identified a risk of material misstatement. However, the auditor may determine that this disclosure is material based on the considerations in paragraph A264.

Revision of Risk Assessment (Ref: par. 40)

~~A260.~~A266. During the audit, new or other information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the entity's risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures, the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity, and the further planned audit procedures may not be effective in detecting material misstatements. AU-C section 330[79] provides further guidance about evaluating the operating effectiveness of controls.

Documentation (Ref: par. 41)

~~A261.~~A267. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

~~A262.~~A268. AU-C section 230, *Audit Documentation*, notes that among other considerations, although there may be no single way in which the auditor's exercise of professional skepticism is documented, the audit documentation may, nevertheless, provide evidence of the auditor's exercise of professional skepticism.[80] For example, when the audit evidence obtained from risk assessment procedures includes evidence that both corroborates and contradicts management's

[77] Paragraph .A1 of AU-C section 320

[78] Paragraph .04 of AU-C section 320.

[79] Paragraphs .16–.17 of AU-C section 330.

[80] Paragraph .A9 of AU-C section 230.

assertions, the documentation may include how the auditor evaluated that evidence, including the professional judgments made in evaluating whether the audit evidence provides an appropriate basis for the auditor's identification and assessment of the risks of material misstatement. Examples of other requirements in this proposed SAS for which documentation may provide evidence of the exercise of professional skepticism by the auditor include the following:

- Paragraph 13, which requires the auditor to design and perform risk assessment procedures in a manner that is not biased toward obtaining audit evidence that may corroborate the existence of risks or toward excluding audit evidence that may contradict the existence of risks
- Paragraph 17, which requires a discussion among key engagement team members of the application of the applicable financial reporting framework and the susceptibility of the entity's financial statements to material misstatement
- Paragraphs 19*b* and 20, which require the auditor to obtain an understanding of the reasons for any changes to the entity's accounting policies and to evaluate whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework
- Paragraphs 21*b*, 22*b*, 23*b*, 24*c*, *28~~26e~~*, *29~~26d~~*, and 30, which require the auditor to evaluate, based on the required understanding obtained, whether the components of the entity's system of internal control are appropriate to the entity's circumstances considering the nature and complexity of the entity, and to determine whether one or more control deficiencies have been identified
- Paragraph 38, which requires the auditor to take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management, and to evaluate whether the audit evidence obtained from the risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement
- Paragraph 39, which requires the auditor to evaluate, when applicable, whether the auditor's determination that there are no risks of material misstatement for a material class of transactions, account balance, or disclosure remains appropriate

Scalability (Ref: par. 41)

~~A263.~~A269. The form and extent of the auditor's documentation is influenced by the nature, size, and complexity of the entity and its system of internal control, availability of information from the entity, and the audit methodology and technology used in the course of the audit. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor may include those on which the auditor based the assessment of the risks of material misstatement. However, the auditor is not required to document every inherent risk factor that was taken into account in identifying and assessing the risks of material misstatement at the assertion level.

Commented [HH155]: Moved from A262

~~A264.~~A270. The manner in which the requirements of paragraph 41 are documented is for the auditor to determine using professional judgment.

~~A265.~~A271. More detailed documentation that is sufficient to enable an experienced auditor having no previous experience with the audit to understand the nature, timing, and extent of the audit procedures performed and a conclusion or the basis for a conclusion not otherwise readily determinable from the documentation of the work performed or audit evidence obtained[81] may be required to support the rationale for difficult judgments made. An example of such a circumstance may be the rationale for significant judgments related to the inherent risk of an identified risk of material misstatement, when such rationale is not otherwise evident from the audit documentation.

~~A266.~~A272. For the audits of less complex entities, the form and extent of documentation may be simple and relatively brief. ~~The form and extent of the auditor's documentation is influenced by the nature, size, and complexity of the entity and its system of internal control, availability of information from the entity, and the audit methodology and technology used in the course of the audit. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements[82] of understanding documented by the auditor may include those on which the auditor based the assessment of the risks of material misstatement. However, the auditor is not required to document every inherent risk factor that was taken into account in identifying and assessing the risks of material misstatement at the assertion level.~~ In audits of less complex entities, audit documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.[83] Similarly, for example, the results of the risk assessment may be documented separately or as part of the auditor's documentation of further audit procedures.[84]

A273. ~~A264.~~ AU-C section 200 states that GAAS typically refer to the risks of material misstatement, rather than inherent risk and control risk separately.[85] However, this proposed SAS requires inherent risk to be assessed separately from control risk to provide a basis for designing and performing audit procedures to respond to the assessed risks of material misstatement at the assertion level in accordance with AU-C section 330. Accordingly, the auditor may, but is not required to, document a combined assessment of inherent risk and control risk (see paragraphs A244 ~~-~~and A257).

Commented [RMM156]: Moved to beginning of this section

Commented [RMM157]: **Issue I (May 2021)**

Clarified that a combined risk assessment is not required to be documented.

Commented [MR158]: Should be .A44

~~81 See paragraph .A4 of AU-C section 230.~~
~~82 Paragraph .08 of AU-C section 230.~~

83 Paragraphs .07, .09, and .A12 of AU-C section 300, *Planning an Audit*.

84 Paragraph .30 of AU-C section 330.

85 Paragraph .~~A45~~.A44 of AU-C section 200.

Appendix A — Considerations for Understanding the Entity and Its Business Model (Ref: par. A69–A77)

This appendix explains the objectives and scope of the entity's business model and provides examples of matters that the auditor may consider in understanding the activities of the entity that may be included in the business model. The auditor's understanding of the entity's business model, and how it is affected by its business strategy and business objectives, may assist the auditor in identifying business risks that may have an effect on the financial statements. In addition, this may assist the auditor in identifying risks of material misstatement.

Objectives and Scope of an Entity's Business Model

1. An entity's business model describes how an entity considers, for example, its organizational structure, operations or scope of activities, business lines (including competitors and customers thereof), processes, growth opportunities, globalization, regulatory requirements, and technologies. The entity's business model describes how the entity creates, preserves, and captures financial or broader value for its stakeholders.

2. *Strategies* are the approaches by which management plans to achieve the entity's objectives, including how the entity plans to address the risks and opportunities that it faces. An entity's strategies are changed over time by management to respond to changes in its objectives and in the internal and external circumstances in which it operates.

3. A description of a business model typically includes the following:

- The scope of the entity's activities and why it does them
- The entity's structure and scale of its operations
- The markets or geographical or demographic spheres, and parts of the value chain, in which it operates, how it engages with those markets or spheres (main products, customer segments, and distribution methods), and the basis on which it competes
- The entity's business or operating processes (for example, investment, financing, and operating processes) employed in performing its activities, focusing on those parts of the business processes that are important in creating, preserving, or capturing value
- The resources (for example, financial, human, intellectual, environmental, and technological) and other inputs and relationships (for example, customers, competitors, suppliers, and employees) that are necessary or important to its success
- How the entity's business model integrates the use of IT in its interactions with customers, suppliers, lenders, and other stakeholders through IT interfaces and other technologies

4. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial

statement level. For example, the business risk arising from a significant fall in real estate market values may increase the risk of material misstatement associated with the valuation assertion for a lender of medium-term real-estate-backed loans. However, the same risk, particularly in combination with a severe economic downturn that concurrently increases the underlying risk of lifetime credit losses on its loans, may also have a longer-term consequence. The resulting net exposure to credit losses may cast ~~significant~~ substantial doubt on the entity's ability to continue as a going concern. If so, this could have implications for management's, and the auditor's, conclusion regarding the appropriateness of the entity's use of the going concern basis of accounting and determination about whether ~~a material uncertainty~~substantial doubt exists; therefore, whether a business risk may result in a risk of material misstatement is considered in light of the entity's circumstances. Examples of events and conditions that may give rise to the existence of risks of material misstatement are indicated in appendix B, "Understanding Inherent Risk Factors."

Commented [RMM159]: Modifications to align with US GAAS terminology

Activities of the Entity

5. The following are some examples of matters that the auditor may consider when obtaining an understanding of the activities of the entity (included in the entity's business model):

a. Business operations:

i. Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities

ii. Conduct of operations (for example, stages and methods of production or activities exposed to environmental risks)

iii. Alliances, joint ventures, and outsourcing activities

iv. Geographic dispersion and industry segmentation

v. Location of production facilities, warehouses, and offices, and location and quantities of inventories

vi. Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post-employment benefits, stock options or incentive bonus arrangements, and government regulation related to employment matters)

vii. Research and development activities and expenditures

viii. Transactions with related parties

b. Investments and investment activities:

i. Planned or recently executed acquisitions or divestitures

ii. Investments and dispositions of securities and loans

iii. Capital investment activities

iv. Investments in nonconsolidated entities, including noncontrolled partnerships, joint ventures, and noncontrolled variable interest entities

c. Financing and financing activities:

i. Ownership structure of major subsidiaries and associated entities, including consolidated and nonconsolidated structures

ii. Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements

iii. Beneficial owners (local, foreign, business reputation, and experience) and related parties

iv. Use of derivative financial instruments

Nature of Variable Interest Entities

6. A *variable interest entity* is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitization of financial assets or to carry out research and development activities. It may take the form of a corporation, trust, partnership, or unincorporated entity. The entity on behalf of which the variable interest entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, whereas other parties may provide the funding to the latter. As ~~AU-C section 550, *Related Parties*, indicates, in~~ In some circumstances, a variable interest entity may be a related party of the entity.[1]

Commented [MM160]: This is not included in AU-C section 550. Accordingly, this was generalized.

7. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control or circumstances under which the variable interest entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the variable interest entity.

~~[1] Paragraph .A12 of AU-C section 550, *Related Parties*.~~

~~A267.~~A274.

Appendix B — Understanding Inherent Risk Factors (Ref: par. 12, 19, A9–A11, A34 A69, A95–A100, and A230)

This appendix provides further explanation about inherent risk factors as well as matters that the auditor may consider in understanding and applying the inherent risk factors in identifying and assessing the risks of material misstatement at the assertion level.

The Inherent Risk Factors

1. *Inherent risk factors* are characteristics of events or conditions that affect susceptibility of an assertion about a class of transactions, account balance, or disclosure, to misstatement, whether due to fraud or error, and before consideration of controls. Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other fraud risk factors[1] insofar as they affect inherent risk. In obtaining the understanding of the entity and its environment, and the applicable financial reporting framework and entity's accounting policies, in accordance with paragraph 19*a–b*, the auditor also understands how inherent risk factors affect susceptibility of assertions to misstatement in the preparation of the financial statements.

2. Inherent risk factors relating to the preparation of information required by the applicable financial reporting framework (referred to in this paragraph as *required information*) include the following:

- *Complexity.* Arises either from the nature of the information or in the way that the required information is prepared, including when such preparation processes are more inherently difficult to apply. For example, complexity may arise in one of the following circumstances:
  - In calculating supplier rebate provisions because it may be necessary to take into account different commercial terms with many different suppliers or many interrelated commercial terms that are all relevant in calculating the rebates due.
  - When there are many potential data sources with different characteristics used in making an accounting estimate, the processing of that data involves many interrelated steps and, therefore, the data is inherently more difficult to identify, capture, access, understand, or process.
- *Subjectivity*. Arises from inherent limitations in the ability to prepare required information in an objective manner, due to limitations in the availability of knowledge or information, such that management may need to make an election or subjective judgment about the appropriate approach to take and about the resulting information to include in the financial statements. Because of different approaches to preparing the required information, different outcomes could result from appropriately applying the requirements of the applicable financial reporting framework. As limitations in knowledge or data increase, the subjectivity in the judgments that could be made by

[1] Paragraphs .A28–.A32 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.

reasonably knowledgeable and independent individuals and the diversity in possible outcomes of those judgments will also increase.

- *Change*. Results from events or conditions that, over time, affect the entity's business or the economic, accounting, regulatory, industry, or other aspects of the environment in which it operates, when the effects of those events or conditions are reflected in the required information. Such events or conditions may occur during, or between, financial reporting periods. For example, change may result from developments in the requirements of the applicable financial reporting framework, in the entity and its business model, or in the environment in which the entity operates. Such change may affect management's assumptions and judgments, including as they relate to management's selection of accounting policies or how accounting estimates are made or related disclosures are determined.
- *Uncertainty*. Arises when the required information cannot be prepared based only on sufficiently precise and comprehensive data that is verifiable through direct observation. In these circumstances, an approach may need to be taken that applies the available knowledge to prepare the information using sufficiently precise and comprehensive observable data, to the extent available, and reasonable assumptions supported by the most appropriate available data, when it is not. Constraints on the availability of knowledge or data, which are not within the control of management (subject to cost constraints where applicable) are sources of uncertainty, and their effect on the preparation of the required information cannot be eliminated. For example, estimation uncertainty arises when the required monetary amount cannot be determined with precision, and the outcome of the estimate is not known before the date the financial statements are finalized.
- *Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.* Susceptibility to management bias results from conditions that create susceptibility to intentional or unintentional failure by management to maintain neutrality in preparing the information. Management bias is often associated with certain conditions that have the potential to give rise to management not maintaining neutrality in exercising judgment (indicators of potential management bias), which could lead to a material misstatement of the information that would be fraudulent if intentional. Such indicators include incentives or pressures insofar as they affect inherent risk (for example, as a result of motivation to achieve a desired result, such as a desired profit target or capital ratio) and opportunity, not to maintain neutrality. Factors relevant to the susceptibility to misstatement due to fraud in the form of fraudulent financial reporting or misappropriation of assets are described in AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.[2]

3. When complexity is an inherent risk factor, there may be an inherent need for more complex processes in preparing the information, and such processes may be inherently more difficult to apply. As a result, applying them may require specialized skills or knowledge and may require the use of a management's specialists.

[2] Paragraphs .A1–.A5 of AU-C section 240.

4. When management judgment is more subjective, the susceptibility to misstatement due to management bias, whether unintentional or intentional, may also increase. For example, significant management judgment may be involved in making accounting estimates that have been identified as having high estimation uncertainty, and conclusions regarding methods, data, and assumptions may reflect unintentional or intentional management bias.

Examples of Events or Conditions That May Give Rise to the Existence of Risks of Material Misstatement

5. The following are examples of events (including transactions) and conditions that may indicate the existence of risks of material misstatement in the financial statements at the financial statement level or the assertion level. The examples, grouped by inherent risk factor, cover a broad range of events and conditions; however, not all events and conditions are relevant to every audit engagement, and the list of examples is not necessarily complete. The events and conditions have been categorized by the inherent risk factor that may have the greatest effect in the circumstances. Importantly, due to the interrelationships among inherent risk factors, the example events and conditions also are likely to be subject to, or affected by, other inherent risk factors to varying degrees.

Relevant inherent risk factor	Examples of events and conditions that may indicate the existence of risks of material misstatement at the assertion level
Complexity	Regulatory: • Operations that are subject to a high degree of complex regulation. Business model: • The existence of complex alliances and joint ventures Applicable financial reporting framework: • Accounting measurements that involve complex processes Transactions: • Use of off-balance-sheet financing, variable interest entities, and other complex financing arrangements
Subjectivity	Applicable financial reporting framework: • A wide range of possible measurement criteria of an accounting estimate, for example, management's recognition of depreciation or construction income and expenses • Management's selection of a valuation technique or model for a noncurrent asset, such as investment properties
Change	Economic conditions:

Relevant inherent risk factor	Examples of events and conditions that may indicate the existence of risks of material misstatement at the assertion level
	• Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies Markets: • Operations exposed to volatile markets, for example, futures trading Customer loss: • Going concern and liquidity issues, including loss of significant customers Industry model: • Changes in the industry in which the entity operates Business model: • Changes in the supply chain • Developing or offering new products or services, or moving into new lines of business Geography: • Expanding into new locations Entity structure: • Changes in the entity, such as large acquisitions or reorganizations or other unusual events • Entities or business segments likely to be sold Human resources competence: • Changes in key personnel, including departure of key executives IT: • Changes in the IT environment • Installation of significant new IT systems related to financial reporting Applicable financial reporting framework: • Application of new accounting pronouncements Capital: • New constraints on the availability of capital and credit

Relevant inherent risk factor	Examples of events and conditions that may indicate the existence of risks of material misstatement at the assertion level
	Regulatory: • Investigations into the entity's operations or financial results by regulatory or government bodies • Impact of new legislation related to environmental protection
Uncertainty	Reporting: • Events or transactions that involve significant measurement uncertainty, including accounting estimates, and related disclosures • Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees, and environmental remediation
Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk	Reporting: • Incentives and pressures or Opportunities for management and employees to engage in fraudulent financial reporting, including omission or obscuring, of significant information in disclosures. See Appendix A — Examples of Fraud Risk Factors of AU-C section 240 for additional guidance regarding fraud risk factors Transactions: • Significant transactions with related parties • Significant amount of nonroutine or nonsystematic transactions, including intercompany transactions and large revenue transactions at period end • Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold, and classification of marketable securities

Other events or conditions that may indicate risks of material misstatement at the financial statement level:

- Lack of personnel with appropriate accounting and financial reporting skills
- Control deficiencies, particularly in the control environment, the entity's risk assessment process, and the entity's process for monitoring the system of internal control, and especially those not addressed by management
- Past misstatements, history of errors, or a significant amount of adjustments at period end

Commented [MM161]: Clarified to include incentives and pressures as well as opportunities and to also include a reference to AU-C section 240.

Commented [RMM162]: Modified to align with terminology used throughout.

~~A268.~~A275.

Appendix C — Understanding the Entity's System of Internal Control (Ref: par. 12, 21–26, A101–~~A202~~A212)

1. The entity's system of internal control may be reflected in policy and procedures manuals, systems and forms, and the information embedded therein, and is effected by people. The entity's system of internal control is implemented by management, those charged with governance, and other personnel based on the structure of the entity. The entity's system of internal control can be applied based on the decisions of management, those charged with governance, or other personnel and in the context of legal or regulatory requirements to the operating model of the entity, the legal entity structure, or a combination of these.

2. This appendix further explains the components of, as well as the limitations of, the entity's system of internal control as set out in paragraphs 12(l), 21–26, and A101–A209 as they relate to a financial statement audit.

3. Included within the entity's system of internal control are aspects that relate to the entity's reporting objectives, including its financial reporting objectives, but it may also include aspects that relate to its operations or compliance objectives, when such aspects are relevant to financial reporting. For example, controls over compliance with laws and regulations may be relevant to financial reporting when such controls are relevant to the entity's preparation of disclosures of contingencies in the financial statements.

Components of the Entity's System of Internal Control

Control Environment

4. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's system of internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people, and provides the overall foundation for the operation of the other components of the entity's system of internal control.

5. An entity's control consciousness is influenced by those charged with governance because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. Therefore, the effectiveness of the design of the control environment in relation to participation by those charged with governance is influenced by such matters as the following:

- Their independence from management and their ability to evaluate the actions of management
- Whether they understand the entity's business transactions

- The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework, including whether the financial statements include adequate disclosures

6. The control environment encompasses the following elements:

a. *How management's oversight responsibilities are carried out, such as creating and maintaining the entity's culture and demonstrating management's commitment to integrity and ethical values*. The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards or codes of conduct, how they are communicated (for example, through policy statements), and how they are reinforced in practice (for example, through management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts). The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.

Commented [MM163]: Modified to align with requirements.

b. *When those charged with governance are separate from management, how those charged with governance demonstrate independence from management and exercise oversight of the entity's system of internal control*. An entity's control consciousness is influenced by those charged with governance. Considerations may include whether there are sufficient individuals who are independent from management and objective in their evaluations and decision making; how those charged with governance identify and accept oversight responsibilities and whether those charged with governance retain oversight responsibility for management's design, implementation, and conduct of the entity's system of internal control. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle-blower procedures.

c. *How the entity assigns authority and responsibility in pursuit of its objectives.* This may include the following considerations:

- Key areas of authority and responsibility and appropriate lines of reporting
- Policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties
- Policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable

d. *How the entity attracts, develops, and retains competent individuals in alignment with its objectives.* This includes how the entity ensures the individuals have the knowledge and skills necessary to accomplish the tasks that define the individual's job, such as the following:

- Standards for recruiting the most qualified individuals, with an emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior
- Training policies that communicate prospective roles and responsibilities, including practices such as training schools and seminars that illustrate expected levels of performance and behavior
- Periodic performance appraisals driving promotions that demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility

e. *How the entity holds individuals accountable for their responsibilities in pursuit of the objectives of the entity's system of internal control.* This may be accomplished through some of the following examples:

- Mechanisms to communicate and hold individuals accountable for performance of controls responsibilities and implement corrective actions as necessary
- Establishing performance measures, incentives, and rewards for those responsible for the entity's system of internal control, including how the measures are evaluated and maintain their relevance
- How pressures associated with the achievement of control objectives affect the individual's responsibilities and performance measures
- How the individuals are disciplined as necessary

The appropriateness of the preceding matters will be different for every entity depending on its size, the complexity of its structure, and the nature of its activities.

The Entity's Risk Assessment Process

7. The entity's risk assessment process is an iterative process for identifying and analyzing risks to achieving the entity's objectives and forms the basis for how management or those charged with governance determine the risks to be managed.

8. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements or considers risks of fraud.

9. Risks relevant to reliable financial reporting include external and internal events, transactions, or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial information consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific

risks, or it may decide to assume a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment*. Changes in the regulatory, economic, or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel*. New personnel may have a different focus on or understanding of the entity's system of internal control.
- *New or revamped information system*. Significant and rapid changes in the information system can change the risk relating to the entity's system of internal control.
- *Rapid growth*. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology*. Incorporating new technologies into production processes or the information system may change the risk associated with the entity's system of internal control.
- *New business models, products, or activities*. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with the entity's system of internal control.
- *Corporate restructurings*. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with the entity's system of internal control.
- *Expanded foreign operations*. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements*. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.
- *Use of IT*. Risks relating to
  - maintaining the integrity of data and information processing;
  - risks to the entity business strategy that arise if the entity's IT strategy does not effectively support the entity's business strategy; or
  - changes or interruptions in the entity's IT environment or turnover of IT personnel or when the entity does not make necessary updates to the IT environment or such updates are not timely.
- *Climate events or conditions*. Climate change may affect businesses in various industries. In particular, climate events or conditions may impact an entity in terms of the following

Commented [MM164]: See July 2021 Issues Paper

- **The entity's business model**. Climate events or conditions may influence the entity's business model, including the entity's supply chain, resulting in different risks.
- **Industry factors**. New technological developments to address climate change may have a significant impact on the industry, which may create new or unique risks related to the entity's operations or processes.
- **Regulatory factors**. Governments may change climate-related laws and regulations that could affect risks related to taxation or the entity's business model through increased environmental requirements.
- **Other external factors**. Climate events or conditions may impact risks related to general economic conditions, interest rates and availability of financing, commodity prices and inflation, or currency revaluation.

The Entity's Process to Monitor the System of Internal Control

10. The entity's process to monitor the system of internal control is a continual process to evaluate the effectiveness of the entity's system of internal control and to take necessary remedial actions on a timely basis. The entity's process to monitor the entity's system of internal control may consist of ongoing activities, separate evaluations (conducted periodically), or some combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and may include regular management and supervisory activities. The entity's process will likely vary in scope and frequency depending on the assessment of the risks by the entity.

11. The objectives and scope of internal audit functions typically include activities designed to evaluate or monitor the effectiveness of the entity's system of internal control.[1] The entity's process to monitor the entity's system of internal control may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

12. Controls related to the entity's process to monitor the entity's system of internal control, including those that monitor underlying automated controls, may be automated or manual, or a combination of both. For example, an entity may use automated monitoring controls over access to certain technology with automated reports of unusual activity to management, who manually investigate identified anomalies.

13. When distinguishing between a monitoring activity and a control related to the information system, the underlying details of the activity are considered, especially when the activity involves

[1] AU-C section 610, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements," and appendix D, "Considerations for Understanding an Entity's Internal Audit Function," of this proposed SAS provide further guidance related to internal audit.

some level of supervisory review. Supervisory reviews are not automatically classified as monitoring activities, and it may be a matter of judgment whether a review is classified as a control related to the information system or a monitoring activity. For example, the intent of a monthly completeness control would be to detect and correct errors, whereas a monitoring activity would determine why errors are occurring and assign management the responsibility of fixing the process to prevent future errors. In simple terms, a control related to the information system responds to a specific risk, whereas a monitoring activity assesses whether controls within each of the five components of the entity's system of internal control are operating as intended.

14. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of the entity's system of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider in performing monitoring activities any communications relating to the entity's system of internal control from external auditors.

The Information System and Communication

165. Business processes result in the transactions that are recorded, processed, and reported by the information system. An entity's business processes include the activities designed to

- develop, purchase, produce, sell, and distribute an entity's products and services;
- ensure compliance with laws and regulations; and
- record information, including accounting and financial reporting information.

17. The information system, and related business processes, includes the financial reporting process used to prepare the entity's financial statements, including disclosures.

~~15~~18. The information system relevant to the preparation of the financial statements consists of activities and policies, and accounting and supporting records, designed and established to do the following:

- Initiate, record, and process entity transactions (as well as to capture, process, and disclose information about events and conditions other than transactions, such as changes in fair values or indicators of impairment) and to maintain accountability for the related assets, liabilities, and equity
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis
- Process and account for system overrides or bypasses to controls
- Incorporate information from transaction processing in the general ledger (for example, transferring of accumulated transactions from various data tables)

Commented [MM165]: Moved from below and added paragraph 17 to align with the requirement in the proposed SAS and AU-C section 940, which provides more granularity related to the entity's financial reporting process.

- Capture and process information relevant to the preparation of the financial statements for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of assets
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements

~~16. An entity's business processes include the activities designed to~~

~~• develop, purchase, produce, sell, and distribute an entity's products and services;~~

~~• ensure compliance with laws and regulations; and~~

~~• record information, including accounting and financial reporting information.~~

~~Business processes result in the transactions that are recorded, processed, and reported by the information system.~~

~~17~~19. The quality of information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

~~18~~20. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to the entity's system of internal control, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

~~19~~21. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to the entity's system of internal control relevant to financial reporting. It may include such matters as the extent to which personnel understand how their activities in the information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity.

Control Activities

~~20~~22. Controls in the control activities component are identified in accordance with paragraph 26. Such controls include information-processing controls and general IT controls, both of which may be manual or automated in nature. The greater the extent of automated controls, or controls involving automated aspects, that management uses and relies on in relation to its financial reporting, the more important it may become for the entity to implement general IT controls that address the continued functioning of the automated aspects of information-processing controls. Controls in the control activities component may pertain, for example, to the following:

- *Authorization and approvals*. An authorization affirms that a transaction is valid (that is, it represents an actual economic event or is within an entity's policy). An authorization typically takes the form of an approval by a higher level of management or of verification and a determination if the transaction is valid. For example, a supervisor approves an expense report after reviewing whether the expenses seem reasonable and within policy. An example of an automated approval is when an invoice

unit cost is automatically compared with the related purchase order unit cost within a pre-established tolerance level. Invoices within the tolerance level are automatically approved for payment. Those invoices outside the tolerance level are flagged for additional investigation.

- *Reconciliations*. Reconciliations compare two or more data elements. If differences are identified, action is taken to bring the data into agreement. Reconciliations generally address the completeness or accuracy of processing transactions.
- *Verifications*. Verifications compare two or more items with each other or compare an item with a policy and will likely involve a follow-up action when the two items do not match or the item is not consistent with policy. Verifications generally address the completeness, accuracy, or validity of processing transactions.
- *Physical or logical controls, including those that address security of assets against unauthorized access, acquisition, use, or disposal.* Controls that encompass the following:
  - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records
  - The authorization for access to computer programs and data files (that is, logical access)
  - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security, and inventory counts with accounting records)

  The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation depends on circumstances such as when assets are highly susceptible to misappropriation.
- *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

For example, a manager authorizing credit sales is not responsible for maintaining accounts receivable records or handling cash receipts. If one person is able to perform all these activities he or she could, for example, create a fictitious sale that could go undetected. Similarly, salespersons should not have the ability to modify product price files or commission rates.

Sometimes, segregation is not practical, cost effective, or feasible. For example, smaller and less complex entities may lack sufficient resources to achieve ideal segregation, and the cost of hiring additional staff may be prohibitive. In these situations, management may institute alternative controls. In the preceding example, if the salesperson can modify product price files, a detective control activity can be put in place to have personnel unrelated to the sales function periodically review whether and under what circumstances the salesperson changed prices.

~~21~~23. Certain controls may depend on the existence of appropriate supervisory controls established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, nonroutine transactions such as major acquisitions or divestments may require specific high-level approval, including, in some cases, that of shareholders.

Limitations of Internal Control

~~22~~24. The entity's system of internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision making can be faulty, and that breakdown in the entity's system of internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as when information produced for the purposes of the entity's system of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

~~23~~25. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of controls. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in an IT application that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

~~24~~26. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

~~A269.~~A276.

Appendix D — Considerations for Understanding an Entity's Internal Audit Function (Ref: par. A31–A32 and A135)

This appendix provides further considerations relating to understanding the entity's internal audit function when such a function exists.

Objectives and Scope of the Internal Audit Function

1. The objectives and scope of an internal audit function, the nature of its responsibilities, and its status within the organization, including the function's authority and accountability, vary widely and depend on the size, complexity, and structure of the entity and the requirements of management and, when applicable, those charged with governance. These matters may be set out in an internal audit charter or terms of reference.

2. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, the entity's system of internal control, and governance processes. If so, the internal audit function may play an important role in the entity's process to monitor the entity's system of internal control. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency, and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting.

Inquiries of the Internal Audit Function

3. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity and its environment, the applicable financial reporting framework, the entity's system of internal control, the auditor's risk assessments, or other aspects of the audit. Therefore, the auditor's inquiries are made regardless of whether the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.[1] Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.

4. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit of the financial statements, the

[1] The relevant requirements are contained in AU-C section 610, *Using the Work of Internal Auditors*.

auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.

5. In addition, in accordance with AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*,[2] if the internal audit function provides information to the auditor regarding any actual, suspected, or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.

6. Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience, and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

Consideration of the Internal Audit Function in Understanding the Control Environment

7. In understanding the control environment, the auditor may consider how management has responded to the findings and recommendations of the internal audit function regarding identified control deficiencies relevant to the preparation of the financial statements, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

Understanding the Role That the Internal Audit Function Plays in the Entity's Process to Monitor the System of Internal Control

8. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the complexity of the entity and the nature of its operations and has a direct reporting relationship to those charged with governance.

9. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, AU-C section 610 applies.

10. As is further discussed in AU-C section 610, the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as

[2] Paragraph .19 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.

reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

11. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. AU-C section 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

~~A270.~~A277.

Appendix E — Considerations for Understanding Information Technology (Ref: par. 12, 25*a*, 27~~26*b*~~–~~*c*~~28, A110, and A192)

This appendix provides further matters that the auditor may consider in understanding the entity's use of information technology (IT) in its system of internal control.

Understanding the Entity's Use of IT in the Components of the Entity's System of Internal Control

1. An entity's system of internal control contains manual elements and automated elements (that is, manual and automated controls and other resources used in the entity's system of internal control). An entity's mix of manual and automated elements varies with the nature and complexity of the entity's use of IT. An entity's use of IT affects the manner in which the information relevant to the preparation of the financial statements in accordance with the applicable financial reporting framework is processed, stored, and communicated and, therefore, affects the manner in which the entity's system of internal control is designed and implemented. Each component of the entity's system of internal control may use some extent of IT.

Generally, IT benefits an entity's system of internal control by enabling an entity to do the following:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data
- Enhance the timeliness, availability, and accuracy of information
- Facilitate the additional analysis of information
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures
- Reduce the risk that controls will be circumvented
- Enhance the ability to achieve effective segregation of duties by implementing security controls in IT applications, databases, and operating systems

2. The characteristics of manual or automated elements are relevant to the auditor's identification and assessment of the risks of material misstatement and further audit procedures based thereon. Automated controls may be more reliable than manual controls because they cannot be as easily bypassed, ignored, or overridden, and they are also less prone to simple errors and mistakes. Automated controls may be more effective than manual controls in the following circumstances:

- High volume of recurring transactions, or in situations in which errors that can be anticipated or predicted can be prevented, or detected and corrected, through automation

- Controls in which the specific ways to perform the control can be adequately designed and automated

Understanding the Entity's Use of IT in the Information System (Ref: par. 25a)

3. The entity's information system may include the use of manual and automated elements, which also affect the manner in which transactions are initiated, recorded, processed, and incorporated in the general ledger and reported in the financial statements. In particular, procedures to initiate, record, process, and report transactions may be enforced through the IT applications used by the entity and how the entity has configured those applications. In addition, records in the form of digital information may replace or supplement records in the form of paper documents.

Commented [HH166]: Aligned with paragraph 25(a)(i)

4. In obtaining an understanding of the IT environment relevant to the flows of transactions and information processing in the information system, the auditor gathers information about the nature and characteristics of the IT applications used as well as the supporting IT infrastructure and IT. This may include, for example, the complexity or level of customization related to IT applications, third-party hosting or outsourcing, and the use of interfaces, data warehouses, or report writers. ~~The following table includes examples of matters that the auditor may consider in obtaining the understanding of the IT environment and includes examples of typical characteristics of IT environments based on the complexity of IT applications used in the entity's information system. However, such characteristics are directional (that is, complexity typically increases as the level of customization increases) and may differ depending on the nature of the specific IT applications in use by an entity.~~

Commented [MM167]: See July 2021 Issues paper

The table will be relocated to the Audit Guide

	~~Examples of typical characteristics of specific types of IT applications~~		
	~~Less complex Ppurchased applications with no customization~~	~~Purchased applications or simple legacy or low-end enterprise resource planning (ERP) applications with little or no customization~~	~~Custom-developed applications or more complex ERP applications with significant customization~~
~~Matters related to extent of automation and use of data:~~			
~~• The extent of automated procedures for processing, and the complexity of those procedures, including~~	~~N/A~~	~~N/A~~	~~Extensive and often complex automated procedures~~

~~whether there is highly automated, paperless processing~~			
• ~~The extent of the entity's reliance on system-generated reports in the processing of information~~	~~Simple automated report logic~~	~~Simple relevant automated report logic~~	~~Complex automated report logic; report-writer software~~
• ~~How data is input (that is, manual input, customer or vendor input, or file load)~~	~~Manual data inputs~~	~~Small number of data inputs or simple interfaces~~	~~Large number of data inputs or complex interfaces~~
• ~~How IT facilitates communication between applications, databases, or other aspects of the IT environment, internally and externally, as appropriate, through system interfaces~~	~~No automated interfaces (manual inputs only)~~	~~Small number of data inputs or simple interfaces~~	~~Large number of data inputs or complex interfaces~~
• ~~The volume and complexity of data in digital form being processed by the information system, including whether accounting records or other information are stored in digital form and the location of stored data~~	~~Low volume of data or simple data that is able to be verified manually; data available locally~~	~~Low volume of data or simple data~~	~~Large volume of data or complex data; data warehouses;[1] use of internal or external IT service providers (for example, third-party storage or hosting of data)~~
~~Matters related to IT applications and IT infrastructure:~~			

[1] ~~A *data warehouse* is a central repository of integrated data from one or more disparate sources (such as multiple databases) from which reports may be generated or that may be used by the entity for other data analysis activities. A *report-writer* is an IT application that is used to extract data from one or more sources (such as a data warehouse, a database, or an IT application) and present the data in a specified format.~~

• The complexity of the nature of the IT applications and the underlying IT infrastructure	Small, simple laptop or client-server-based solution	Mature and stable mainframe, small or simple client server, software as a service cloud	Complex mainframe, large or complex client server, web-facing, infrastructure as a service cloud
• Whether there is third-party hosting or outsourcing of IT	If outsourced, competent, mature, proven provider (for example, cloud provider)	If outsourced, competent, mature, proven provider (for example, cloud provider)	Competent, mature, proven provider for certain applications and new or start-up provider for others
• Whether the entity is using emerging technologies that affect its financial reporting	No use of emerging technologies	Limited use of emerging technologies in some applications	Mixed use of emerging technologies across platforms
Matters related to IT processes:			
• The personnel involved in maintaining the IT environment (the number and skill level of the IT support resources that manage security and changes to the IT environment)	Few personnel with limited IT knowledge to process vendor upgrades and manage access	Limited personnel with IT skills/dedicated to IT	Dedicated IT departments with skilled personnel, including programming skills
• The complexity of processes to manage access rights	Single individual with administrative access manages access rights	Few individuals with administrative access manages access rights	Complex processes managed by IT department for access rights
• The complexity of the security over the IT environment, including vulnerability of the IT applications, databases, and other aspects of the	Simple on-premise access with no external web-facing elements	Some web-based applications with primarily simple, role-based security	Multiple platforms with web-based access and complex security models

~~IT environment to cyber risks, particularly when there are web-based transactions or transactions involving external interfaces~~			
• ~~Whether program changes have been made to the manner in which information is processed and the extent of such changes during the period~~	~~Commercial software with no source code installed~~	~~Some commercial applications with no source code and other mature applications with a small number or simple changes; traditional systems development life cycle~~	~~New or large number of complex changes, several development cycles each year~~
• ~~The extent of change within the IT environment (for example, new aspects of the IT environment or significant changes in the IT applications or the underlying IT infrastructure)~~	~~Changes limited to version upgrades of commercial software~~	~~Changes consist of commercial software upgrades, ERP version upgrades, or legacy enhancements~~	~~New or large number of complex changes, several development cycles each year, heavy ERP customization~~
• ~~Whether there was a major data conversion during the period and, if so, the nature and significance of the changes made, and how the conversion was undertaken~~	~~Software upgrades provided by vendor; no data conversion features for upgrade~~	~~Minor version upgrades for commercial software applications with limited data being converted~~	~~Major version upgrade, new release, platform change~~

Emerging Technologies

5. Entities may use emerging technologies (for example, blockchain, robotics, or artificial intelligence) because such technologies may present specific opportunities to increase operational efficiencies or enhance financial reporting. When emerging technologies are used in the entity's information system relevant to the preparation of the financial statements, the auditor may include such technologies in the identification of IT applications and other aspects of the IT environment that are subject to risks arising from the use of IT. Although emerging technologies may be seen to be more sophisticated or more complex compared to

existing technologies, the auditor's responsibilities in relation to IT applications and identified general IT controls in accordance with paragraph 28~~26~~ remain unchanged.

Commented [MR168]: Should this be paragraphs 26-29

Scalability

6. Obtaining an understanding of the entity's IT environment may be more easily accomplished for a less complex entity that uses commercial software and when the entity does not have access to the source code to make any program changes. Such entities may not have dedicated IT resources but may have a person assigned in an administrator role for the purpose of granting employee access or installing vendor-provided updates to the IT applications. Specific matters that the auditor may consider in understanding the nature of a commercial accounting software package, which may be the single IT application used by a less complex entity in its information system, may include the following:

   - The extent to which the software is well established and has a reputation for reliability.
   - The extent to which it is possible for the entity to modify the source code of the software to include additional modules (that is, add-ons) to the base software or to make direct changes to data.
   - The nature and extent of modifications that have been made to the software. Although an entity may not be able to modify the source code of the software, many software packages allow for configuration (for example, setting or amending reporting parameters). These do not usually involve modifications to source code; however, the auditor may consider the extent to which the entity is able to configure the software when considering the completeness and accuracy of information produced by the software that is used as audit evidence.
   - The extent to which data related to the preparation of the financial statements can be directly accessed (that is, direct access to the database without using the IT application) and the volume of data that is processed. The greater the volume of data, the more likely the entity may need controls that address maintaining the integrity of the data, which may include general IT controls over unauthorized access and changes to the data.

7. Complex IT environments may include highly customized or highly integrated IT applications and, therefore, may require more effort to understand. Financial reporting processes or IT applications may be integrated with other IT applications. Such integration may involve IT applications that are used in the entity's business operations and that provide information to the IT applications relevant to the flows of transactions and information processing in the entity's information system. In such circumstances, certain IT applications used in the entity's business operations may also be relevant to the preparation of the financial statements. Complex IT environments also may require dedicated IT departments that have structured IT processes supported by personnel that have software development and IT environment maintenance skills. In other cases, an entity may use internal or external

service providers to manage certain aspects of, or IT processes within, its IT environment (for example, third-party hosting).

Identifying IT Applications That Are Subject to Risks Arising From the Use of IT

8. Through understanding the nature and complexity of the entity's IT environment, including the nature and extent of information-processing controls, the auditor may determine which IT applications the entity is relying upon to accurately process and maintain the integrity of financial information. The identification of IT applications on which the entity relies, may affect the auditor's decision to test the automated controls within such IT applications, assuming that such automated controls address identified risks of material misstatement. Conversely, if the entity is not relying on an IT application, the automated controls within such IT application are unlikely to be appropriate or sufficiently precise for purposes of operating effectiveness tests. Automated controls that may be identified in accordance with paragraph ~~26a~~ 27 may include, for example, automated calculations or input and processing and output controls, such as a three-way match of a purchase order, vendor shipping document, and vendor invoice. When automated controls are identified by the auditor and the auditor determines through the understanding of the IT environment that the entity is relying on the IT application that includes those automated controls, it may be more likely for the auditor to identify the IT application as one that is subject to risks arising from the use of IT.

9. In considering whether the IT applications for which the auditor has identified automated controls are subject to risks arising from the use of IT, the auditor is likely to consider whether, and the extent to which, the entity may have access to source code that enables management to make program changes to such controls or the IT applications. The extent to which the entity makes program or configuration changes and the extent to which the IT processes over such changes are formalized may also be relevant considerations. The auditor is also likely to consider the risk of inappropriate access or changes to data.

10. System-generated reports that the auditor may intend to use as audit evidence may include, for example, a trade receivable aging report or an inventory valuation report. For such reports, the auditor may obtain audit evidence about the completeness and accuracy of the reports by substantively testing the inputs and outputs of the report generating process. In other cases, the auditor may plan to test the operating effectiveness of the controls over the preparation and maintenance of the report, in which case, the IT application from which it is produced is likely to be subject to risks arising from the use of IT. In addition to testing the completeness and accuracy of the report, the auditor may plan to test the operating effectiveness of general IT controls that address risks related to inappropriate or unauthorized program changes to, or data changes in, the report.

Commented [MM169]: Testing inputs and outputs relate to the process not directly testing the report.

11. Some IT applications may include report-writing functionality within them, whereas some entities may also use separate report-writing applications (that is, report writers). In such cases, the auditor may need to determine the sources of system-generated reports (that is, the application that prepares the report and the data sources used by the report) to determine the IT applications subject to risks arising from the use of IT.

12. The data sources used by IT applications may be databases that, for example, can be accessed only through the IT application or by IT personnel with database administration privileges. In other cases, the data source may be a data warehouse that may itself be considered to be an IT application subject to risks arising from the use of IT.

13. The auditor may have identified a risk for which substantive procedures alone are not sufficient because of the entity's use of highly automated and paperless processing of transactions, which may involve multiple integrated IT applications. In such circumstances, the controls identified by the auditor are likely to include automated controls. Further, the entity may be relying on general IT controls to maintain the integrity of the transactions processed and other information used in processing. In such cases, the IT applications involved in the processing and storage of the information are likely subject to risks arising from the use of IT.

End-User Computing

14. Although audit evidence may also come in the form of system-generated output that is used in a calculation performed in an end-user computing tool (for example, spreadsheet software or simple databases), such tools are not typically identified as IT applications in the context of paragraph 28~~26b~~. Designing and implementing controls around access and change to end-user computing tools may be challenging, and such controls are rarely equivalent to, or as effective as, general IT controls. Rather, the auditor may consider a combination of information-processing controls, taking into account the purpose and complexity of the end-user computing involved, such as some or all of the following:

    - Information-processing controls over the initiation and processing of the source data, including relevant automated or interface controls to the point from which the data is extracted (~~that is~~for example, the data warehouse)
    - Controls to check that the logic is functioning as intended, for example, controls that "prove" the extraction of data, such as reconciling the report to the data from which it was derived, comparing the individual data from the report to the source and vice versa, and controls that check the formulas or macros
    - Use of validation software tools, which systematically check formulas or macros, such as spreadsheet integrity tools

Commented [MM170]: This is an example and not a definition of a data warehouse

Scalability

15. The entity's ability to maintain the integrity of information stored and processed in the information system may vary based on the complexity and volume of the related transactions and other information. The greater the complexity and volume of data that supports a significant class of transactions, account balance, or disclosure, the less likely it may become for the entity to maintain integrity of that information through information-processing controls alone (for example, input and output controls or review controls). It also becomes less likely that the auditor will be able to obtain audit evidence about the completeness and accuracy of such information through substantive ~~testing~~ procedures alone when such information is used as audit evidence. In some circumstances, when volume and complexity

Commented [RMM171]: Modified to use the defined term in US GAAS

of transactions are lower, management may have an information-processing control that is sufficient to verify the accuracy and completeness of the data (for example, individual sales orders processed and billed may be reconciled to the hard copy originally entered into the IT application). When the entity relies on general IT controls to maintain the integrity of certain information used by IT applications, the auditor may determine that the IT applications that maintain that information are subject to risks arising from the use of IT.

Example characteristics of an IT application that is likely not subject to risks arising from the use of IT	Example characteristics of an IT application that is likely subject to risks arising from the use of IT
• Stand-alone applications. • The volume of data (transactions) is not significant. • The application's functionality is not complex. • Each transaction is supported by original hard copy documentation.	• Applications are interfaced. • The volume of data (transactions) is significant. • The application's functionality is complex because – the application automatically initiates transactions, and – there are a variety of complex calculations underlying automated entries.
IT application is likely not subject to risks arising from the use of IT because of the following: • The volume of data is not significant and, therefore, management is not relying upon general IT controls to process or maintain the data. • Management does not rely on automated controls or other automated functionality. The auditor has not identified automated controls in accordance with paragraph ~~26a~~27~~26A~~. • Although management uses system-generated reports in their controls, they do not rely on ~~these reports~~the IT application to produce complete and accurate reports. Instead, they reconcile the reports back to the hard copy documentation and verify the calculations in the reports.	IT application is likely subject to risks arising from the use of IT because • management relies on an application system to process or maintain data because the volume of data is significant. • management relies upon the application system to perform certain automated controls that the auditor has also identified.

Commented [MM172]: To clarify in the context of risks arising from the use of IT. It is not clear in saying that management uses reports that it does not rely on.

• The auditor will directly test information produced by the entity used as audit evidence.	

Other Aspects of the IT Environment That Are Subject to Risks Arising From the Use of IT

16. When the auditor identifies IT applications that are subject to risks arising from the use of IT, other aspects of the IT environment are also typically subject to risks arising from the use of IT. The IT infrastructure includes databases, operating system, and network. Databases store the data used by IT applications and may consist of many interrelated data tables. Data in databases may also be accessed directly through database management systems by IT or other personnel with database administration privileges. The operating system is responsible for managing communications between hardware, IT applications, and other software used in the network. As such, IT applications and databases may be directly accessed through the operating system. A network is used in the IT infrastructure to transmit data and to share information, resources, and services through a common communications link. The network also typically establishes a layer of logical security (enabled through the operating system) for access to the underlying resources.

17. When IT applications are identified by the auditor to be subject to risks arising from the use of IT, the databases that store the data processed by an identified IT application is typically also identified. Similarly, because an IT application's ability to operate is often dependent on the operating system and IT applications and databases may be directly accessed from the operating system, the operating system is typically subject to risks arising from the use of IT. The network may be identified when it is a central point of access to the identified IT applications and related databases, when an IT application interacts with vendors or external parties through the internet, or when web-facing IT applications are identified by the auditor.

Identifying Risks Arising From the Use of IT and General IT Controls

18. Examples of risks arising from the use of IT include risks related to inappropriate reliance on IT applications that are inaccurately processing data, processing inaccurate data, or both, as follows:

    - Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions. Particular risks may arise when multiple users access a common database.
    - The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
    - Unauthorized changes to data in master files.
    - Unauthorized changes to IT applications or other aspects of the IT environment.
    - Failure to make necessary changes to IT applications or other aspects of the IT environment.

- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

19. The auditor's consideration of unauthorized access may include risks related to unauthorized access by internal or external parties ~~(often referred to as *cybersecurity risks*).~~ . Such risks (for example, cybersecurity risks). may not necessarily affect financial reporting, as an entity's IT environment may also include IT applications and related data that address operational or compliance needs. It is important to note that cyber incidents usually first occur through the perimeter and internal network layers, which tend to be further removed from the IT application, database, and operating systems that affect the preparation of the financial statements. Accordingly, if information about a security breach has been identified, the auditor ordinarily considers the extent to which such a breach had the potential to affect financial reporting. If financial reporting may be affected, the auditor may decide to understand, and test the related controls to determine the possible impact or scope of potential misstatements in the financial statements or may determine that the entity has provided adequate disclosures in relation to such security breach.

20. In addition, laws and regulations that may have a direct or indirect effect on the entity's financial statements may include data protection legislation. Considering an entity's compliance with such laws or regulations, in accordance with AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, may involve understanding the entity's IT processes and general IT controls that the entity has implemented to address the relevant laws or regulations.

21. General IT controls are implemented to address risks arising from the use of IT. Accordingly, the auditor uses the understanding obtained about the identified IT applications and other aspects of the IT environment and the applicable risks arising from the use of IT in determining the general IT controls to identify. In some cases, an entity may use common IT processes across its IT environment or across certain IT applications, in which case, common risks arising from the use of IT and common general IT controls may be identified.

22. In general, a greater number of general IT controls related to IT applications and databases are likely to be identified than for other aspects of the IT environment. This is because these aspects are the most closely concerned with the information processing and storage of information in the entity's information system. In identifying general IT controls, the auditor may consider controls over actions of both end users and of the entity's IT personnel or IT service providers.

23. Appendix F provides further explanation of the nature of the general IT controls ~~typically~~ that may be implemented for different aspects of the IT environment. ~~In addition, examples of general IT controls for different IT processes are provided.~~

Commented [MM173]: Broadened unauthorized access beyond cybersecurity risks.

Commented [MM174]: All of the controls in Appendix F may not be "relevant" to the audit or "identified" controls in accordance with the proposed SAS. Accordingly, the language was softened.

Commented [MM175]: See July 2021 Issues Paper. The examples will be relocated to the Audit Guide.

~~A271.~~A278.

Appendix F — Considerations for Understanding General IT Controls (Ref: par. 28 ~~26c(ii)~~ and A190~~A184~~–A200~~A190~~)

This appendix provides further ~~matters that the auditor may consider in understanding general IT controls.~~ explanation of the nature of the general IT controls that may be implemented for different aspects of the IT environment.

1. The nature of the general IT controls ~~typically~~ that may be implemented for ~~each~~ different a ~~of the~~ aspects of the IT environment include the following.

   a. *Applications*. General IT controls at the IT application layer will correlate to the nature and extent of application functionality and the access paths allowed in the technology. For example, ~~more~~ different controls ~~will be relevant~~may be identified for highly integrated IT applications with complex security options than a legacy IT application supporting a small number of account balances with access methods only through transactions.

   b. *Database*. General IT controls at the database layer typically address risks arising from the use of IT related to unauthorized updates to financial reporting information in the database through direct database access or execution of a script or program.

   c. *Operating system*. General IT controls at the operating system layer typically address risks arising from the use of IT related to administrative access, which can facilitate the override of other controls. This includes actions such as compromising other user's credentials; adding new, unauthorized users; loading software that is not adequately tested, software containing an issue not yet fixed, or malware; or executing scripts or other unauthorized programs.

   d. *Network*. General IT controls at the network layer typically address risks arising from the use of IT related to network segmentation, remote access, and authentication. Network controls may be relevant when an entity has web-facing applications used in financial reporting. Network controls may be relevant when the entity has significant business partner relationships or third-party outsourcing, which may increase data transmissions and the need for remote access.

2. Examples of general IT controls that may exist, organized by IT process, include the following:

   a. Process to manage access:

      i. *Authentication*. Controls that ~~ensure~~ validate a user accessing the IT application or other aspect of the IT environment is using their own log-in credentials (that is, the user is not using another user's credentials).

Commented [MM176]: All of the controls may not be "relevant" to the audit or "identified" controls in accordance with the proposed SAS. Accordingly, the language was softened.

Commented [MM177]: Modified to eliminate the reference to "relevant" controls. Also, use of "different" controls is more appropriate here.

Commented [MM178]: Added additional examples

Commented [MM179]: The term "validate" is more common in the context of authentication.

ii. *Authorization*. Controls that allow users to access the information necessary for their job responsibilities and nothing further, which facilitates appropriate segregation of duties.

iii. *Provisioning*. Controls to authorize new users and modifications to existing users' access privileges.

iv. *Deprovisioning*. Controls to remove user access upon termination or transfer.

v. *Privileged access*. Controls over administrative or powerful users' access.

vi. *User-access reviews*. Controls to recertify or evaluate user access for ongoing authorization over time.

vii. *Security configuration controls*. Each technology generally has key configuration settings that help restrict access to the environment.

viii. *Physical access*. Controls over physical access to the data center and hardware because such access may be used to override other controls.

b. Process to manage program or other changes to the IT environment:

i. *Change-management process*. Controls over the process to design, program, test, and migrate changes to a production (that is, end user) environment.

ii. *Segregation of duties over change migration*. Controls that segregate access to make and migrate changes to a production environment.

iii. *Systems development or acquisition or implementation*. Controls over initial IT application development or implementation (or in relation to other aspects of the IT environment).

iv. *Data conversion*. Controls over the conversion of data during development, implementation, or upgrades to the IT environment.

c. Process to manage IT operations:

i. *Job scheduling*. Controls over access to schedule and initiate jobs or programs that may affect financial reporting.

ii. *Job monitoring*. Controls to monitor financial reporting jobs or programs for successful execution.

iii. *Backup and recovery*. Controls to ensure backups of financial reporting data occur as planned and that such data is available and able to be accessed for timely recovery in the event of an outage or attack.

iv. *Intrusion detection*. Controls to monitor for vulnerabilities or intrusions in the IT environment.

3. General IT controls need not be identified for every IT process. General IT controls are identified based on the risks arising from the use of IT. See paragraph 15 of Appendix E, *Considerations for Understanding Information Technology*, for examples characteristics of an IT application that is likely not subject to risks arising from the use of IT ~~The following table illustrates examples of general IT controls to address examples of risks arising from the use of IT, including for different IT applications, based on their nature.~~

Commented [MM180]: Added to clarify that not all of these general IT controls are "relevant" or "identified controls"

Commented [MM181]: Added additional guidance to reinforce the understanding of risks arising from the use of IT.

Commented [HH182]: See July 2021 Issues Paper

Table below deleted, thus introduction is no longer necessary.

~~Process~~	~~Risks~~	~~Controls~~	~~IT applications~~		
~~IT process~~	~~Example risks arising from the use of IT~~	~~Example general IT controls~~	~~Purchased applications with no customization – Applicable (yes/no)~~	~~Purchased applications or simple legacy or low-end ERP applications with little or no customization – Applicable (yes/no)~~	~~Custom-developed applications or more complex ERP applications with significant customization – Applicable (yes/no)~~
~~Manage access~~	~~User-access privileges: Users have access privileges beyond those necessary to perform their assigned duties, which may create improper segregation of duties.~~	~~Management approves the nature and extent of user-access privileges for new and modified user access, including standard application profiles and roles, critical financial reporting transactions, and segregation of duties.~~	~~Yes – instead of user-access reviews noted below~~	~~Yes~~	~~Yes~~
		~~Access for terminated or transferred users is removed or modified in a timely manner.~~	~~Yes – instead of user-access reviews noted below~~	~~Yes~~	~~Yes~~
		~~User access is periodically reviewed.~~	~~Yes – instead of provisioning and~~	~~Yes for certain applications~~	~~Yes~~

			~~deprovisioning controls above~~		
		~~Segregation of duties is monitored, and conflicting access is either removed or mapped to mitigating controls, which are documented and tested.~~	~~N/A – no system-enabled segregation~~	~~Yes for certain applications~~	~~Yes~~
		~~Privileged-level access (for example, configuration, data and security administrators) is authorized and appropriately restricted.~~	~~Yes – likely at IT application layer only~~	~~Yes at IT application and certain layers of IT environment for platform~~	~~Yes at all layers of IT environment for platform~~
~~Manage access~~	~~Direct data access: Inappropriate changes are made directly to financial data through means other than application transactions.~~	~~Access to application data files or database objects/tables/data is limited to authorized personnel, based on their job responsibilities and assigned roles, and such access is approved by management.~~	~~N/A~~	~~Yes for certain applications and databases~~	~~Yes~~
~~Manage access~~	~~System settings: Systems are not adequately configured or updated to restrict system access to properly authorized~~	~~Access is authenticated through unique user IDs and passwords or other methods as a mechanism for validating that users are authorized to gain access to the system.~~	~~Yes – password authentication only~~	~~Yes – mix of password and multifactor authentication~~	~~Yes~~

	~~and appropriate users.~~	~~Password parameters meet company or industry standards (for example, password minimum length and complexity, expiration, account lockout).~~			
		~~The key attributes of the security configuration are appropriately implemented.~~	~~N/A – no technical security configurations exist~~	~~Yes for certain applications and databases~~	~~Yes~~
~~Manage change~~	~~Application changes: Inappropriate changes are made to application systems or programs that contain relevant automated controls (that is, configurable settings, automated algorithms, automated calculations, and automated data extraction) or report logic.~~	~~Application changes are appropriately tested and approved before being moved into the production environment.~~	~~N/A – would verify no source code installed~~	~~Yes for noncommercial software~~	~~Yes~~
		~~Access to implement changes into the application production environment is appropriately restricted and segregated from the development environment.~~	~~N/A~~	~~Yes for noncommercial software~~	~~Yes~~
~~Manage change~~	~~Database changes: Inappropriate changes are made to the database structure and~~	~~Database changes are appropriately tested and approved before being moved into the production environment.~~	~~N/A – no database changes made at entity~~	~~Yes for noncommercial software~~	~~Yes~~

	~~relationships between the data.~~				
~~Manage change~~	~~System software changes: Inappropriate changes are made to system software (for example, operating system, network, change-management software, access-control software).~~	~~System software changes are appropriately tested and approved before being moved to production.~~	~~N/A – no system software changes are made at entity~~	~~Yes~~	~~Yes~~
~~Manage change~~	~~Data conversion: Data converted from legacy systems or previous versions introduces data errors if the conversion transfers incomplete, redundant, obsolete, or inaccurate data.~~	~~Management approves the results of the conversion of data (for example, balancing and reconciliation activities) from the old application system or data structure to the new application system or data structure and monitors that the conversion is performed in accordance with established conversion policies and procedures.~~	~~N/A – Addressed through manual controls~~	~~Yes~~	~~Yes~~
~~IT operations~~	~~Network: The network does not adequately prevent unauthorized users~~	~~Access is authenticated through unique user IDs and passwords or other methods as a mechanism~~	~~N/A – no separate network authentication method exists~~	~~Yes~~	~~Yes~~

	~~from gaining inappropriate access to information systems.~~	~~for validating that users are authorized to gain access to the system. Password parameters meet company or professional policies and standards (for example, password minimum length and complexity, expiration, account lockout).~~			
		~~Network is architected to segment web-facing applications from the internal network, where internal control over financial reporting relevant applications are accessed.~~	~~N/A – no network segmentation employed~~	~~Yes – with judgment~~	~~Yes – with judgment~~
		~~On a periodic basis, vulnerability scans of the network perimeter are performed by the network management team, which also investigates potential vulnerabilities.~~	~~N/A~~	~~Yes – with judgment~~	~~Yes – with judgment~~
		~~On a periodic basis, alerts are generated to provide notification of threats identified by the intrusion detection systems. These threats are investigated by~~	~~N/A~~	~~Yes – with judgment~~	~~Yes – with judgment~~

		the network management team.			
		Controls are implemented to restrict virtual private network (VPN) access to authorized and appropriate users.	N/A – no VPN	Yes – with judgment	Yes – with judgment
IT operations	Data backup and recovery: Financial data cannot be recovered or accessed in a timely manner when there is a loss of data.	Financial data is backed up on a regular basis according to an established schedule and frequency.	N/A – relying on manual backups by finance team	Yes	Yes
IT operations	Job scheduling: Production systems, programs, or jobs result in inaccurate, incomplete, or unauthorized processing of data.	Only authorized users have access to update batch jobs (including interface jobs) in the job-scheduling software.	N/A – no batch jobs	Yes for certain applications	Yes
		Critical systems, programs, or jobs are monitored, and processing errors are corrected to ensure successful completion.	N/A – no job monitoring	Yes for certain applications	Yes

~~A272.~~A279.

Appendix G — Amendments to Various Statements on Auditing Standards (SAS), as Amended, and to Various Sections in SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as Amended

(***Boldface italics*** denotes new language. Deleted text is shown in ~~strikethrough~~.)

Amendment to SAS No. 117, *Compliance Audits*, as Amended (AICPA, *Professional Standards*, AU-C sec. 935)

1. The amendment to AU-C section 935 in this appendix is effective for audits of financial statements for periods ending on or after December 15, 2023.

~~AU-C section 935, *Compliance Audits*~~

~~[No amendment to paragraphs .01–.A13.]~~

~~**.A14** Performing risk assessment procedures to obtain an understanding of the entity's internal control over compliance includes an evaluation of the design of controls and whether the controls have been implemented. Internal control consists of the following five interrelated components: the control environment, the entity's risk assessment ***process***, information and communication systems, control activities, and ***the entity's process to*** monitoring ***the system of internal control***.[fn 12] Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, contains a detailed discussion of these components.~~

~~[fn 12] [Footnote omitted for purposes of this proposed SAS.]~~

~~[No further amendment to AU-C section 935.]~~

Amendment to SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA* (AICPA, *Professional Standards*, AU-C sec. 703)

2. The amendment to AU-C section 703 in this appendix is effective for audits of financial statements for periods ending on or after December 15, 2023.

AU-C section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*

[No amendment to paragraphs .01–.17.]

.18 Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, addresses the auditor's responsibility to identify and assess the

Commented [HH183]: See July 2021 Issues Paper

Changes affecting AU-C 935 will be addressed separately following the completion of AU-C 935

Commented [MM184]: Additional conforming amendments have been included for SAS 136 and SAS 142.

risks of material misstatement in the financial statements through understanding the entity and its environment, ***the applicable financial reporting framework, and*** ~~including~~ ***its*** ~~the entity's~~ internal control. The plan instrument is essential to understanding the plan and identifying and performing audit procedures that are responsive to assessed risks. (Ref: par. .A18–.A21)

[No amendment to paragraphs .19–.A18.]

.A19 Obtaining an understanding of the plan and its environment, ***the applicable financial reporting framework, and its*** ~~including~~ its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. The auditor's understanding of the plan establishes a frame of reference for planning the audit and exercising professional judgment throughout the audit when the auditor does the following:

[No further amendment to AU-C section 703.]

Amendment to SAS No. 142, *Audit Evidence* (AICPA, *Professional Standards*, AU-C sec. 500)

3. The amendment to AU-C section 500 in this appendix is effective for audits of financial statements for periods ending on or after December 15, 2023.

AU-C section 500, *Audit Evidence*

[No amendment to paragraphs .01–.A66.]

Appendix A — Considerations Regarding the Use of External Information Sources (Ref: par. .A12*b*)

.A67

…

8. The nature and extent of the auditor's consideration takes into account the assessed risks of material misstatement at the assertion level to which the use of the external information is relevant, the degree to which the use of that information is relevant to the reasons for the assessed risks of material misstatement, and the possibility that the information from the external information source may not be reliable (for example, whether it is from a credible source). Based on the auditor's consideration of the matters described in paragraph 5 of this appendix, the auditor may determine that

1. *a.* further understanding of the entity and its environment, ***the applicable financial reporting framework, and*** ~~including~~ ~~it's the~~ ***entity's system of*** internal

control, is needed, in accordance with section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, or

…

[No further amendment to AU-C section 500.]

Amendments to Various Sections in SAS No. 122, as Amended (AICPA, *Professional Standards*, AU-C secs. 200, 210, 230, 240, 250, 260, 265, 330, 402, 501, 530, 550, 600, 620, 805 and 930)

42. The amendment to each section is effective for audits of financial statements for periods ending on or after December 15, 2023.

AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*

[No amendment to paragraphs .01–.07.]

.08 GAAS contain objectives, requirements, and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. GAAS require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things

- identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, ***the applicable financial reporting framework, and*** ~~including~~ the entity's ***system of*** internal control.
- obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- form an opinion on the financial statements, or determine that an opinion cannot be formed, based on an evaluation of the audit evidence obtained.

[No amendment to paragraphs .09–.~~12~~13.]

Definitions

.~~13~~14 For purposes of GAAS, the following terms have the meanings attributed below:

…

Risk of material misstatement. The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level: ***(Ref: par. .A15)***

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 transactions, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's ~~internal~~ system of internal control~~s~~.

[No further amendment to paragraph .13; no amendment to paragraphs .~~14~~15–.A14.]

Definitions (Ref: par. .14)

Risk of Material Misstatement

.A15 For purposes of GAAS, a risk of material misstatement exists when

a. there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and

b. if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).

[No amendment to paragraphs .A15–.A41.]

[Paragraphs .A15–.A44 are renumbered as .A16–.A45.]

~~**.A42**~~ ***.A43*** Inherent risk is ***influenced by inherent risk factors.*** ~~higher for some assertions and related classes of transactions, account balances, and disclosures than for others.~~ ***Depending on the degree to which the inherent risk factors affect the susceptibility to misstatement of an assertion, the level of inherent risk varies on a scale that is referred to as the*** **spectrum of inherent risk**. ***The auditor determines significant classes of transactions, account balances, and disclosures, and their relevant assertions, as part of the process of identifying and assessing the risks of material misstatement.*** For example, ~~it may be higher for complex calculations or for~~ account~~s~~ ***balances*** consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty ***may be identified as significant account balances, and the auditor's assessment of inherent risk for the related risks at the assertion level may be higher because of the high estimation uncertainty***. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be

more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

~~**A43**~~ ***.A44*** Control risk is a function of the effectiveness of the design, implementation, and maintenance of ~~internal~~ control***s*** by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation and fair presentation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of ~~internal~~ control***s***. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. GAAS provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures to be performed. [fn 14]

[fn 14] [Footnote omitted for purposes of this proposed SAS.]

.A44 ***.A45*** GAAS ***typically*** ~~do not ordinarily~~ refer to ~~inherent risk and control risk separately~~, ~~but rather to a combined assessment~~ ~~of~~ the risks of material misstatement***, rather than inherent risk and control risk separately***. However***, AU-C section 315 requires inherent risk to be assessed separately from control risk to provide a basis for designing and performing audit procedures to respond to the assessed risks of material misstatement at the assertion level in accordance with AU-C section 330.*** ~~the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.~~ The assessment of the risks of material misstatement may be expressed in quantitative terms~~, such as in percentages~~ or in nonquantitative terms.[fn 15] In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

Commented [MM185]: Aligned with revised language in proposed SAS, which provides examples for inherent risk and control risk.

[fn 15] ***Paragraph A236 of AU-C section 315.***

Commented [MM186]: Hiram – I think we need a reference to the inherent risk guidance and the control risk guidance

.A46 Risks of material misstatement are assessed at the assertion level in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence.[fn 15]

fn ~~15~~ 16 Paragraph .06 of AU-C section 330.

[Former paragraphs .A45–.A67 are renumbered as paragraphs .A47–.A68. Subsequent footnotes renumbered.]

[No amendment to former paragraphs .A45–.A63.]

~~.A64~~ ***.A65*** When necessary, the application and other explanatory material provides further explanation of the requirements of an AU-C section and guidance for carrying them out. In particular, it may explain

- ~~In particular, it may explain~~ more precisely what a requirement means or is intended to cover~~.~~, ***including, in some AU-C sections, such as AU-C section 315, why a procedure is required***.
- Include examples of procedures that may be appropriate in the circumstances.

Although such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section. The auditor is required by paragraph .21 to understand the application and other explanatory material; how the auditor applies the guidance in the engagement depends on the exercise of professional judgment in the circumstances consistent with the objective of the AU-C section. The words "may," "might," and "could" are used to describe these actions and procedures. The application and other explanatory material may also provide background information on matters addressed in an AU-C section.

[No amendment to paragraphs .A64–.A68.]

~~*Considerations Specific to Smaller, Less Complex Entities*~~ ***Scalability Considerations***

.A70 Scalability considerations have been included in some AU-C sections (for example, AU-C section 315) to illustrate the application of the requirements to all entities, ~~whose~~ regardless of whether their nature and circumstances are less complex~~, as well as those that are~~ or more complex. Less complex entities are entities for which the characteristics in paragraph .A66 apply.

[Paragraphs .A69–.A85 are renumbered as paragraphs .A71–.A88.]

~~.A69~~A70 ***.A71.*** For purposes of specifying additional considerations to audits of smaller, less complex entities, a ~~*smaller*~~ *less complex entity* refers to an entity that typically possesses qualitative characteristics, such as the following:

Commented [MM187]: For consistency with other changes to focus on less complex versus size

a. Concentration of ownership and management in a small number of individuals

b. One or more of the following:

i. Straightforward or uncomplicated transactions

ii. Simple record keeping

iii. Few lines of business and few products within business lines

iv. ***Simpler systems of*** ~~Few~~ internal control

v. Few levels of management with responsibility for a broad range of controls

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

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

Considerations Specific to Automated Tools and Techniques

.A72 The considerations specific to "automated tools and techniques" included in some AU-C sections (for example, AU-C section 315) have been developed to explain how the auditor may apply certain requirements when using automated tools and techniques in performing audit procedures.

[Paragraphs .A72 and .A73 are renumbered as .A73 and .A74.

[No further amendment to AU-C section 200.]

AU-C section 210, *Terms of the Engagement*

[No amendment to paragraphs .01–.A15.]

.A16 Management has the responsibility to determine what internal control is necessary to enable the preparation and fair presentation of the financial statements. The term *internal control* encompasses a wide range of activities within components ***of the system of internal control*** that may be described as the control environment; the entity's risk assessment process; ***the entity's process to monitor the system of internal control,*** the information system~~, including the related business processes relevant to financial reporting,~~ and communication; ***and*** control activities~~; and monitoring of controls~~. This division, however, does not necessarily reflect how a particular entity may design, implement, and maintain its internal control or how it may classify any particular component. [fn 9] An entity's internal control will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulations.

[fn 9] [Footnote omitted for purposes of this proposed SAS.]

[No further amendment to section 210.]

AU-C section 230, *Audit Documentation*

[No amendment to paragraphs .01–.A19.]

.A20 When preparing audit documentation, the auditor of a smaller, less complex entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller, less complex entity include the understanding of the entity and its ***environment, the applicable financial reporting framework, and the entity's system of*** internal control; the overall audit strategy and audit plan; materiality; assessed risks, significant findings or issues noted during the audit; and conclusions reached.

[No further amendment to AU-C section 230.]

AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*

[No amendment to paragraphs .01–.06.]

.07 Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information, or override control***s*** ~~procedures~~ designed to prevent similar frauds by other employees.

[No amendment to paragraphs .08–.15.]

.16 When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, ***the applicable financial reporting framework and*** ~~including~~ the entity's ***system of*** internal control, required by section 315, the auditor should perform the procedures in paragraphs .17–.24 to obtain information for use in identifying the risks of material misstatement due to fraud. [fn 5]

[fn 5] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .17–.19.]

Those Charged With Governance

.20 Unless all of those charged with governance are involved in managing the entity, [fn 7] the auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the ~~internal~~ control***s*** that management has established to mitigate these risks. (Ref: par. .A21–.A23)

[fn 7] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .21–.26.]

.27 The auditor should treat those assessed risks of material misstatement due to fraud as significant risks and, accordingly, to the extent not already done so, the auditor should ~~obtain an understanding of the entity's related~~ ***identify the entity's*** controls~~, including control activities, relevant to~~ ***that address*** such risks ***and evaluate their design and determine whether they have been implemented.*** [fn 10] ~~including the evaluation of whether such controls have been suitably designed and implemented to mitigate such fraud risks.~~

[fn 10] ***Paragraphs 26a(i) and (d) of proposed SAS*** **Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.**

[No amendment to paragraphs .28–.~~42~~31. Subsequent footnotes renumbered.]

.32 Even if specific risks of material misstatement due to fraud are not identified by the auditor, a possibility exists that management override of controls could occur. Accordingly, the auditor should address the risk of management override of controls apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing audit procedures to

a. test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including entries posted directly to financial statement drafts. In designing and performing audit procedures for such tests, the auditor should (Ref: par. .A47–.A50 and .A56)

   i. obtain an understanding of the entity's financial reporting process and controls over journal entries and other adjustments,~~[12]~~ and***, in accordance with AU-C section 315, evaluate*** the ~~suitability of~~ design and ***determine whether the controls have been implemented***~~implementation of such controls~~[12];
   ii. make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
   iii. consider fraud risk indicators, the nature and complexity of accounts, and unusual entries processed;
   iv. select journal entries and other adjustments made at the end of a reporting period; and v. consider the need to test journal entries and other adjustments throughout the period.

b. review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor should

   i. evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor should reevaluate the accounting estimates taken as a whole, and

Commented [HH188]: This is a new addition. The addition was accepted in order to show the edits. Edits align with the changes in the proposed SAS.

Commented [MM189]: Hiram – should this refer to the proposed SAS instead of AU-C section 315?

ii. perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. Estimates selected for review should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management. (Ref: par. .A51–.A53)

c. evaluate, given the auditor's understanding of the entity and its environment and other information obtained during the audit, whether the business purpose (or the lack thereof) of significant unusual transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. The procedures should include the following: (Ref: par. .A54–.A55)

i. Reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction

ii. Determining whether the transaction has been authorized and approved in accordance with the entity's established policies and procedures

iii. Evaluating whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements

fn 12 Paragraph ~~.19~~ ***26A and 26C*** of section 315

[No amendment to paragraphs .33–.42. Subsequent footnotes renumbered.]

.43 The auditor should include in the audit documentation [fn 13] ~~of the auditor's understanding of the entity and its environment~~ ***the identification*** and the assessment of the risks of material misstatement required by AU-C section 315***, which includes*** the following***:*** [fn 14]

a. The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, and how and when the discussion occurred and the audit team members who participated

b. The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level (See paragraphs .16–.27.)

c. ***Identified controls in the control activities component that address assessed risks of material misstatement due to fraud.***

fn 13 and fn 14 [Footnotes omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .44–.A8.]

Professional Skepticism *(Ref: par. .12–.14)*

.A9 Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and ~~the~~ ***identified*** controls ***in the control activities, if any,*** over its preparation and maintenance ~~when relevant~~. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

[No amendment to paragraphs .A10–.A20.]

.A21 Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control, and compliance with the law. In some circumstances, governance practices are well-developed, and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and ~~of the relevant internal control~~ ***the controls that address such risks***. Because the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands the respective responsibilities of those charged with governance and management to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.[fn 18]

fn 18 [Footnote omitted for purposes of this proposed SAS.]

.A22 An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of ~~internal~~ control***s that address*** ~~over~~ risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings during which such discussions take place, reading the minutes from such meetings, or making inquiries of those charged with governance.

[No amendment to paragraphs .A23–.A26.]

.A27 In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment***, the applicable financial reporting framework, and the entity's system of internal control*** may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

[No amendment to paragraphs .A27–.A29.]

.A30 Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in appendix A, "Examples of Fraud Risk Factors." These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud
- A perceived opportunity to commit fraud
- An ability to rationalize the fraudulent action

The inability to observe one or more of these conditions does not necessarily mean that no risk of material misstatement due to fraud exists.

Fraud risk factors may relate to incentives, pressures, or opportunities ~~may~~ ***that arise from conditions that create susceptibility to misstatement before consideration of controls. Fraud risk factors, which include intentional management bias, are inherent risk factors insofar as they affect inherent risk. Fraud risk factors may also relate to conditions within the entity's system of internal control that provide opportunity to commit fraud or that may affect management's attitude or ability to rationalize fraudulent actions. Fraud r***~~R~~isk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information ***through, for example, the required understanding of the entity's control environment***.[fn 20] Although the fraud risk factors described in appendix A cover a broad range of situations that may be faced by auditors, they are only examples, and other risk factors may exist.

fn 20 Paragraph 28 of proposed SAS **Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.**

[No amendment to paragraphs .A31–.A36. Subsequent footnotes renumbered.]

.A37 It is, therefore, important for the auditor to obtain an understanding of the controls that management has designed, implemented, and maintained to prevent and detect fraud. ~~In doing so,~~ ***In identifying the controls that address the risks of material misstatement due to fraud,*** the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from ~~obtaining this understanding~~ ***identifying these controls and evaluating their design and determining whether they have been implemented*** may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

[No amendment to paragraphs .A38–.A47.]

.A48 The auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries [fn 20] is important because automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

[fn 20] ***Paragraph ~~26a~~27~~26A(ii)~~b of the proposed SAS*** **Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.**

[Subsequent footnotes renumbered.]

.A49 When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters may be relevant:

- *The **identification and** assessment of the risks of material misstatement due to fraud*. The presence of fraud risk factors and other information obtained during the auditor's ***identification and*** assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.

- *Controls that have been implemented over journal entries and other adjustments*. Effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.

- *The entity's financial reporting process and the nature of evidence that can be obtained*. For many entities, routine processing of transactions involves a combination of manual and automated ~~steps and~~ procedures ***and*** controls. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When IT is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.

- *The characteristics of fraudulent journal entries or other adjustments.* Inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (*a*) made to unrelated, unusual, or seldom-used accounts; (*b*) made by individuals who typically do not make journal entries; (*c*) recorded at the end of the period or as post-closing entries that have little or no explanation or description; (*d*) made either before or during the preparation of the financial statements that do not have account numbers; or (*e*) containing round numbers or consistent ending numbers.

- *The nature and complexity of the accounts*. Inappropriate journal entries or adjustments may be applied to accounts that (*a*) contain transactions that are complex or unusual in nature, (*b*) contain significant estimates and period-end adjustments, (*c*) have been prone to misstatements in the past, (*d*) have not been reconciled on a timely basis or contain unreconciled differences, (*e*) contain intercompany transactions, or (*f*) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.

- Journal entries or other adjustments processed outside the normal course of *business*. Nonstandard journal entries, and other entries such as consolidating adjustments, may not be subject to the same ~~level of internal~~ ***nature and extent of*** control***s*** as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements.

[No amendment to paragraphs .A50–.A74.]

Appendix A — Examples of Fraud Risk Factors (Ref: par. .11, .24, and .A30)

.A75

The fraud risk factors identified in this appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration — that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (*a*) incentives and pressures, (*b*) opportunities, and (*c*) attitudes and rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Fraud risk factors may relate to incentives or pressures, or opportunities that arise from conditions that create susceptibility to misstatement before consideration of controls (that is, the determination is based on inherent risk). Such factors are inherent risk factors and may be due to susceptibility to management bias. Fraud risk factors related to opportunities may also arise from other identified inherent risk factors (for example, complexity or uncertainty may create opportunities that result in susceptibility to misstatement due to fraud). Fraud risk factors related to opportunities may also relate to conditions within the entity's system of internal control, such as limitations or deficiencies in ~~the entity's~~ internal control that create such opportunities. Fraud risk factors related to attitudes or rationalizations

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may arise, in particular, from limitations or control deficiencies in the entity's control environment.

Commented [MM192]: Modified for consistency

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

…

~~Internal control components are deficient~~ ***Deficiencies in internal control are~~as~~*** a result of the following:

- Inadequate ~~monitoring of ***controls***~~ ***process to monitor the entity's system of internal control***, including automated controls and controls over interim financial reporting (when external reporting is required)
- High turnover rates or employment of staff in accounting, IT, or the internal audit function who are not effective
- Accounting and information systems that are not effective, including situations involving significant deficiencies or material weaknesses in internal control
- Weak controls over budget preparation and development and compliance with law or regulation

Risk Factors Arising From Misstatements Arising From Misappropriation of Assets

...

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when the following exist:

- Large amounts of cash on hand or processed
- Inventory items that are small in size, of high value, or in high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips
- Fixed assets that are small in size, marketable, or lack observable identification of ownership

Inadequate ~~internal~~ control***s*** over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because the following exist:

- Inadequate segregation of duties or independent checks
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements
- Inadequate management oversight of employees responsible for assets (for example, inadequate supervision or monitoring of remote locations)
- Inadequate job applicant screening of employees with access to assets
- Inadequate record keeping with respect to assets
- Inadequate system of authorization and approval of transactions (for example, in purchasing)
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets
- Lack of complete and timely reconciliations of assets
- Lack of timely and appropriate documentation of transactions (for example, credits for merchandise returns)
- Lack of mandatory vacations for employees performing key control functions
- Inadequate management understanding of IT, which enables IT employees to perpetrate a misappropriation
- Inadequate access controls over automated records, including controls over and review of computer systems event logs

Attitudes and Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- Disregard for ~~internal~~ control***s*** over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated
- The belief by some government or other officials that their level of authority justifies a certain level of compensation and personal privileges

- Tolerance of petty theft

Appendix B — Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud (Ref: par. .22 and .A46)

.A76

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly, they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

…

- If the work of an expert a specialist becomes particularly significant with respect to a financial statement item for which the assessed risk of ***material*** misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods, or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose

[No further amendment to section 240.]

AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

[No amendment to paragraphs .01–.A23.]

Evaluating the Implications of Noncompliance (Ref: par. .20)

.A24 As required by paragraph .20, the auditor evaluates the implications of noncompliance with regard to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular instances of noncompliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control***s*** ~~activities~~ and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity.

[No further amendment to AU-C section 250.]

AU-C section 260, *The Auditor's Communication With Those Charged With Governance*

[No amendment to paragraphs .01–.A19.]

.A20 Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they ***were determined to be significant risks*** ~~require special audit consideration~~. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

.A21 Other matters regarding the planned scope and timing of the audit may include the following:

- How the auditor plans to address the significant risks of material misstatement, whether due to fraud or error.
- How the auditor plans to address areas of higher assessed risks of material misstatement.
- The auditor's approach to ***the system of*** internal control***,*** ~~relevant to the audit~~ including, when applicable, whether the auditor will express an opinion on the effectiveness of internal control over financial reporting.
- …

[No further amendment to AU-C section 250.]

AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*

.01 This section addresses the auditor's responsibility to appropriately communicate to those charged with governance and management deficiencies in ~~***the entity's system of***~~ internal control that the auditor has identified in an audit of financial statements. This section does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control or designing and performing tests of controls over and above the requirements of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. Section 260, *The Auditor's Communication With Those Charged With Governance*, establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance regarding the audit.

.02 The auditor is required to obtain an understanding of ***the entity's system of*** internal control ~~relevant to the audit~~ when identifying and assessing the risks of material

Commented [RMM193]: Modified to use the defined term in US GAAS

Commented [MM194]: Deleted to remove "relevant to the audit" for consistency

misstatement. [fn 1] In making those risk assessments, the auditor considers ***the entity's system of*** internal control in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control (commonly referred to as ***control*** deficiencies) not only during this risk assessment process but also at any other stage of the audit. This section specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

Commented [RMM195]: US GAAS defines "deficiency in internal control." AU-C 315 uses "control deficiency." Added to bridge the two standards.

[fn 1] [Footnote omitted for purposes of this proposed SAS. Subsequent footnotes renumbered.]

[No amendment to paragraphs .03–.~~A2~~06.]

.07 For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

Commented [HH196]: This was not in the exposure draft. Added and accepted the edits to show the change (that is, the reference to new paragraph A1).

> **Deficiency in internal control.** A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively. (Ref: par. A1)

[No amendment to paragraphs .08–.16.]

NEW .A1 ***The proposed SAS*** **Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement** ***defines the term*** **system of internal control** ***and recognizes that internal control frameworks may use different terms that are similar to the concept of the system of internal control. This section defines the term*** **deficiency in internal control** ***in the context of a system of internal control over financial reporting to more clearly define the auditor's communication responsibilities in this section.***

Commented [RMM197]: Added to bridge AU-C section 315 and AU-C section 265. Adapted language that was exposed in relation to the amendments to AU-C section 940

[Paragraphs .A1–.A39 are renumbered as paragraphs .A2–.A40.]

[No amendment to paragraph A2.]

.A3 Although the concepts underlying ***controls in the*** control activities ***component*** in smaller entities are likely to be similar to those in larger entities, the formality with which controls operate will vary. Further, smaller entities may find that certain types of control***s*** ~~activities~~ are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant

purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed control***s*** ~~activities~~.

[No amendment to paragraphs .03–.A9.]

.A10 Controls may be designed to operate individually, or in combination, to effectively prevent, or detect and correct, misstatements. [fn 3] For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency or a material weakness. However, a combination of deficiencies affecting the same class of transactions, account balance, or disclosure, ~~relevant~~ assertion, or component of ***the entity's system of*** internal control may increase the risks of misstatement to such an extent to give rise to a significant deficiency or material weakness.

[fn 3] [Footnote omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 265.]

AU-C section 300, *Planning an Audit*

[No amendment to paragraphs .01–.A25.]

.A26 As discussed in paragraph .A12, a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity. For the audit plan, standard audit programs or checklists (see paragraph .A24) drawn up on the assumption of few ~~relevant~~ control***s*** ~~activities~~, which is likely to be the case in a smaller entity, may be used, provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

[No further amendment to AU-C section 300.]

AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

[No amendment to paragraphs .01–.07.]

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

.07 In designing the further audit procedures to be performed, the auditor should

a. consider the reasons for the assessed risk of material misstatement at the relevant assertion level for each ***significant*** class of transactions, account balance, and disclosure, including

i. the likelihood ***and magnitude*** of ~~material~~ misstatement due to the particular characteristics of the ~~relevant~~ ***significant*** class of transactions, account balance, or disclosure (the inherent risk) and

ii. whether the risk assessment takes account of ~~relevant~~ controls ***that address the risk of material misstatement*** (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~~ ***plans to test*** ~~on~~ the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures), and (Ref: par. .A10–.A19)

b. obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: par. .A20)

Tests of Controls

.08 The auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of ~~relevant~~ controls if

a. the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively (that is, the auditor ~~intends to rely on~~ ***plans to test*** the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures) or

b. substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level. (Ref: par. .A21–.A26)

[No amendment to paragraph .09.]

.10 In designing and performing tests of controls, the auditor should

a. perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including

i. how the controls were applied at relevant times during the period under audit;

ii. the consistency with which they were applied; and

iii. by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively, and (Ref: par. .A28–.A32)

b. ***to the extent not already addressed,*** determine whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the operating effectiveness of those indirect controls. (Ref: par. .A33–.A34)

[No amendment to paragraphs .11–12.]

Commented [MM198]: This was deleted because magnitude takes materiality into account

.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 should consider

a. the effectiveness of other ~~elements~~ ***components*** of ***the entity's system of*** internal control, including the control environment, the entity's ***process to*** monitor~~ing~~ ~~of~~ ***the system of internal*** controls~~,~~ and the entity's risk assessment process;

b. the risks arising from the characteristics of the control, including whether the control is manual or automated;

c. the effectiveness of general IT controls;

d. the effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits and whether there have been personnel changes that significantly affect the application of the control;

e. whether the lack of a change in a particular control poses a risk due to changing circumstances; and

f. the risks of material misstatement and the extent of reliance on the control. (Ref: par. .A38)

[No amendment to paragraph .14.]

Controls Over Significant Risks

.15 If the auditor ~~plans~~ ***intends*** to rely on controls over a risk the auditor has determined to be a significant risk, [fn 1] the auditor should test the operating effectiveness of those controls in the current period.

[fn 1] [Footnote omitted for purposes of this proposed SAS.]

Evaluating the Operating Effectiveness of Controls

.16 When evaluating the operating effectiveness of ~~relevant~~ controls ***upon which the auditor intends to rely***, the auditor should evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the relevant assertion being tested are effective. (Ref: par. .A43)

.17 If deviations from controls upon which the auditor intends to rely are detected, the auditor should make specific inquiries to understand these matters and their potential consequences and should determine whether

a. the tests of controls that have been performed provide an appropriate basis for reliance on the controls,

b. additional tests of controls are necessary, or

c. the ~~potential~~ risks of ***material*** misstatement need to be addressed using substantive procedures. (Ref: par. .A44)

.18 ~~Irrespective of the assessed risks of material misstatement,~~ ***T***~~t~~he auditor should ~~design and perform~~ perform substantive procedures for ***each*** ~~all~~ relevant assertions ~~related~~ ***of*** ~~to~~ each ~~material~~ ***significant*** class of transactions, account balance, and disclosure***, regardless of the assessed level of control risk.*** (Ref: par. .A45–.A50)

[No amendment to paragraphs .19–.28.]

.29 If the auditor has not obtained sufficient appropriate audit evidence ~~about~~ ***related to*** a relevant assertion ***about a significant class of transactions, account balance, or disclosure***, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or disclaim an opinion on the financial statements. [fn 4]

[fn 4] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .30–.33.]

Application and Other Explanatory Material

Overall Responses (Ref: par. .05)

.A1 Overall responses to address the assessed risks of material misstatement at the financial statement level may include [fn 6]

- emphasizing to the audit team the need to maintain professional skepticism.
- assigning more experienced staff or those with specialized skills or using specialists.
- providing ~~more supervision~~ ***changes to the nature, timing, and extent of direction and supervision of members of the engagement team and the review of the work performed***.
- incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.

- ***changes to the overall audit strategy as required by AU-C section 300,*** **Planning an Audit*****, or planned audit procedures, and may include changes to the following:***
  - ***The auditor's determination of performance materiality in accordance with AU-C section 320.***
  - ***The auditor's plans to test the operating effectiveness of controls, and the persuasiveness of audit evidence needed to support the planned reliance on the operating effectiveness of the controls, particularly when control deficiencies in the control environment or the entity's monitoring activities are identified.***
  - ***The nature, timing, and extent of substantive procedures. For example, it may be appropriate to perform substantive procedures at or near the date of the financial statements when the risk of material misstatement is assessed as higher.***
- ~~making general changes to the nature, timing, or extent of audit procedures (for~~ ***example,*** ~~performing substantive procedures at period-end instead of at an interim date or modifying the nature of audit procedures to obtain more persuasive audit evidence).~~

Commented [MM199]: Modified for consistency

fn 6 [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A2–.A3.]

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

The Nature, Timing, and Extent of Further Audit Procedures (Ref: par. .06)

.A4 The auditor's assessment of the identified risks ***of material misstatement*** at the relevant assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that

a. in addition to the substantive procedures that are required for all relevant assertions, in accordance with paragraph .18, an effective response to the assessed risk of material misstatement for a particular assertion can be achieved only by also performing tests of controls.

b. performing only substantive procedures is appropriate for particular assertions, and therefore, the auditor excludes the effect of controls from the ~~relevant risk~~ assessment ***of the risk of material misstatement***. This may be because the ~~auditor's risk assessment procedures have not identified any effective controls relevant to the assertion or because~~ ***auditor has not identified a risk for which***

substantive procedures alone cannot provide sufficient appropriate audit evidence and, as a result, is not required to test the operating effectiveness of controls. ~~testing controls would be inefficient, and t~~***T***herefor***e***, the auditor ~~does not intend to rely on~~ ***may not plan to test*** the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures.

c. a combined approach using both tests of controls and substantive procedures is an effective approach.

[No amendment to paragraphs .A5–.A6.]

.A7 Extent of an audit procedure refers to the quantity to be performed (for example, a sample size or the number of observations of a control ~~activity~~).

[No amendment to paragraphs .A8–.A9.]

Responding to the Assessed Risks at the Assertion Level (Ref: par. .07a)

.A10 ***AU-C section 315 requires that the auditor's assessment of the risks of material misstatement at the assertion level is performed by assessing inherent risk and control risk. The auditor assesses inherent risk by assessing the likelihood and magnitude of a*** ~~material~~ ***misstatement, taking into account how and the degree to which the inherent risk factors affect the susceptibility to misstatement of relevant assertions.*** ~~***, identified events or conditions relating to significant classes of transactions, account balances or disclosures are subject to, or affected by, the inherent risk factors.***~~[fn 9] The auditor's assessed risks***, including the reasons for those assessed risks,*** may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is higher, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, regarding revenue, tests of controls may be most responsive to the assessed risk of ***material*** misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of ***material*** misstatement of the occurrence assertion.

[fn 9] Paragraph .48 of AU-C section 315.

[Subsequent footnotes renumbered.]

.A11 The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because ~~of internal~~ ***the auditor plans to test the operating effectiveness of*** controls ***that are appropriately designed and implemented*** and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those

controls, as required by paragraph .08*a*. This may be the case, for example, for a class of transactions of reasonably uniform, noncomplex characteristics that are routinely processed and controlled by the entity's information system.

[No amendment to paragraphs .A12–.A18.]

.A19 *Considerations specific to smaller, less complex entities*. In the case of smaller entities, the auditor may not identify control***s*** ~~activities~~, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of control***s*** ~~activities~~ or ~~other~~ components of ***the system of internal*** control may make it impossible to obtain sufficient appropriate audit evidence.

[No amendment to paragraph .A20.]

Tests of Controls

Designing and Performing Tests of Controls (Ref: par. .08)

.A21 Tests of controls are performed only on those controls that the auditor ***plans to test and*** has determined are suitably designed to prevent, or detect and correct, a material misstatement in a relevant assertion***.*** If substantially different controls were used at different times during the period under audit, each is considered separately.

[No amendment to paragraphs .A22–.A24.]

.A25 In some cases, the auditor may find it impossible to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence at the relevant assertion level. [fn 9] This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph .08 requires the auditor to perform tests of ~~relevant~~ controls ***that address the risk for which substantive procedures alone cannot provide sufficient appropriate audit evidence***.

[fn 9] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A26–.A28.]

.A29 The nature of the particular control influences the type of audit procedure necessary to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect such documentation to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control***s*** ~~activities~~, such as ***automated*** control***s*** ~~activities performed by a~~

~~computer~~. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures, such as observation or the use of CAATs.

[No amendment to paragraphs .A30–.A31.]

.A32 Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the ~~program~~ ***IT application*** (including the tables, files, or other permanent data used by the ~~program~~ ***IT application***) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests ~~might~~ ***may*** include ***testing the general IT controls related to the IT application.*** ~~determining that~~

- ~~changes to the program are not made without being subject to the appropriate program change controls,~~
- ~~the authorized version of the program is used for processing transactions, and~~
- ~~other relevant general controls are effective.~~

~~Such tests also might include determining that changes to the programs have not been made, which may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.~~

.A33 Similarly, the auditor may perform tests of controls that address risks of material misstatement related to the integrity of the entity's data, or the completeness and accuracy of the entity's system-generated reports, or may determine they are necessary to address risks of material misstatement because substantive procedures alone cannot provide sufficient appropriate audit evidence. These tests of controls may include tests of general IT controls that address the matters in paragraph .10*a*. When this is the case, the auditor may not need to perform any further testing to obtain audit evidence about the matters in paragraph .10*a*.

.A34 When the auditor determines that a general IT control is deficient, the auditor may consider the nature of the related risks arising from the use of IT that were identified in accordance with the proposed SAS[fn 12] to provide the basis for the design of the auditor's additional procedures to address the assessed risk of material misstatement. Such procedures may address determining the following:

- ***Whether the related risks arising from the use of IT have occurred. For example, if users have unauthorized access to an IT application (but cannot access or modify the system logs that track access), the auditor may decide to inspect the***

system logs to obtain audit evidence that those users did not access the IT application during the period.

- ***Whether there are any alternate or redundant general IT controls, or any other controls, that address the related risks arising from the use of IT. If so, the auditor may identify such controls (if not already identified) and, therefore, evaluate their design, determine that they have been implemented, and perform tests of their operating effectiveness. For example, if a general IT control related to user access is deficient, the entity may have an alternate control whereby IT management reviews end-user access reports on a timely basis. Circumstances in which an application control may address a risk arising from the use of IT may include when the information that may be affected by the general IT control deficiency can be reconciled to external sources (for example, a bank statement) or internal sources not affected by the general IT control deficiency (for example, a separate IT application or data source).***

[fn 12] Paragraph .41 of AU-C section 315.

[Paragraphs .A33–.A77 renumbered as paragraphs .A35 to .A79. Subsequent footnotes renumbered.]

.A35.~~A33~~ *Testing of indirect controls (Ref: par. .10b)*. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls ***(for example, general IT controls)***. ***As explained in paragraphs .A33–.A34, general IT controls may have been identified in accordance with the proposed SAS because of their support of the operating effectiveness of automated controls or due to their support in maintaining the integrity of information used in the entity's financial reporting, including system-generated reports. The requirement in paragraph .10*b *acknowledges that the auditor may have already tested certain indirect controls to address the matters in paragraph .10*a. ~~For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is of direct relevance to the auditor. Controls over the accuracy of the information in the reports (for example, the general IT controls) are described as indirect controls.~~

~~**.A34** Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general IT controls (in particular, change controls), also may provide substantial audit evidence about its operating effectiveness.~~

Timing of Tests of Controls

.A36.~~A35~~ *Intended period of reliance (Ref: par. .11)*. Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose (for example, when testing controls over the entity's physical inventory counting at the period-end). If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of

providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of ***controls in*** the entity's ***process to*** monitor~~ing~~ ***the system of internal*** ~~of~~ control~~s~~.

[No amendment to paragraphs .A36–.A37.]

.A38 *Using audit evidence obtained in previous audits (Ref: par. .13)*. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence, provided that the auditor has determined whether changes have occurred since the previous audit that may affect its relevance ***to the current audit and its reliability***. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

.A39 *Controls that have changed from previous audits (Ref: par. .14a)*. Changes may affect the relevance ***and reliability*** of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

[No amendment to paragraph .A40.]

.A41 In general, the higher the risk of material misstatement or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control or result in not relying on audit evidence obtained in previous audits at all include the following:

- A deficient control environment
- ***A*** control ***d***~~D~~eficiency~~t~~ ***in the entity's process to*** monitor~~ing~~ ***the system of internal*** controls
- A significant manual element to the relevant controls
- Personnel changes that significantly affect the application of the control
- Changing circumstances that indicate the need for changes in the control
- Deficient general IT controls

[No amendment to paragraphs .A42–.A44.]

Commented [HH200]: Modified for consistency

Substantive Procedures (Ref: par. .06 and .18)

.A45 Paragraph .18 requires the auditor to design and perform substantive procedures for all relevant assertions related to each ~~material~~ ***significant*** class of transactions, account balance, and disclosure~~, irrespective of the assessed risks of material misstatement~~. ***For such classes of transactions, account balances, and disclosures, substantive procedures may have already been performed because paragraph .06 requires the auditor to design and perform further audit procedures that are responsive to the assessed risks of material misstatement at the assertion level. Accordingly, substantive procedures are required to be designed and performed in accordance with paragraph .18 w***hen the further audit procedures designed and performed in accordance with paragraph .06 for significant classes of transactions, account balances, or disclosures, designed and performed in accordance with paragraph ***.0***6, did not include substantive procedures***.***

This requirement reflects the facts that (i) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (ii) inherent limitations to internal controls exist, including management override.

[No amendment to paragraphs .A46–.A47.]

.A48 The ~~nature~~ ***assessment*** of the risk ~~and~~ ***or the nature of the*** assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included. For example, the auditor might inspect subsequent cash disbursements and compare them with the recorded accounts payable to determine whether any purchases had been omitted from accounts payable.

.A49 Because the assessment of the risks of material misstatement takes account of ~~internal~~ control***s which the auditor plans to test***, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

[No amendment to paragraphs .A50–.~~A60~~A61.]

.~~A61~~A62 Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period-end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The effectiveness of the control environment and other ~~relevant~~ controls

- The availability at a later date of information necessary for the auditor's procedures
- The purpose of the substantive procedure
- The assessed risk of material misstatement
- The nature of the class of transactions or account balance and relevant assertions
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period-end will not be detected

[No amendment to paragraph .~~A62~~A63]

.~~A63~~A64 Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period-end:

- Whether the period-end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition
- Whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and establishing proper accounting cutoffs are appropriate
- Whether the information system ~~relevant to financial reporting~~ will provide information concerning the balances at the period-end and the transactions in the remaining period that is sufficient to permit investigation of the following:
  - Significant unusual transactions or entries (including those at or near the period-end)
  - Other causes of significant fluctuations or expected fluctuations that did not occur
  - Changes in the composition of the classes of transactions or account balances

[No amendment to paragraphs .~~A64~~A65–.~~A72~~A73.]

.~~A73~~A74 An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures.

Information may come to the auditor's attention that differs significantly from the information on which the risk assessments were based. For example

- the extent of misstatements that the auditor detects by performing substantive procedures may ***alter the auditor's professional judgment about the risk assessments and indicate a significant deficiency or material weakness in internal control.***

- ***the auditor may become aware of discrepancies in accounting records or conflicting or missing evidence.***

- ***analytical*** procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement.

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks ***of material misstatement*** ~~for all or some~~***and the effect on the*** ~~of~~ ***significant*** classes of transactions, account balances, or disclosures and ~~related~~ ***their relevant*** assertions. Section 315 contains further guidance on revising the auditor's risk assessment. [fn 13]

[fn 13] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraph .~~A74~~A76]

.~~A75~~A77 The auditor's conclusion of whether sufficient appropriate audit evidence has been obtained is both at the relevant assertion level as well as the financial statement level. Section 500 enables the auditor to evaluate the results of audit procedures to inform the auditor's overall conclusion about whether sufficient appropriate audit evidence has been obtained as required by paragraph .28. The auditor's professional judgment about what constitutes sufficient appropriate audit evidence is influenced by ~~such~~ the following additional factors: ~~as the~~

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- significance of the potential misstatement in the relevant assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements (see section 450, *Evaluation of Misstatements Identified During the Audit*).

- effectiveness of management's responses and controls to address the risks.

- experience gained during previous audits with respect to similar potential misstatements.

- results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.

- source and reliability of the available information.

- persuasiveness of the audit evidence.
- understanding of the entity and its environment, ***the applicable financial reporting framework, and*** ~~including~~ ~~it's~~ the ***entity's system of*** internal control.

Documentation (Ref: par. .30)

.~~A76~~A78 The form and extent of audit documentation is a matter of professional judgment and is influenced by the nature, size, and complexity of the entity; ***system of*** internal control of the entity; availability of information from the entity; and the audit methodology and technology used in the audit.

[No further amendment to AU-C section 330.]

AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization*

.01 This section addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. Specifically, it expands on how the user auditor applies section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, in obtaining an understanding of the user entity, including ***the entity's system of*** internal control relevant to ***the preparation of the financial statements***~~the audit~~, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

[No amendment to paragraph .02.]

.03 Services provided by a service organization are relevant to the audit of a user entity's financial statements when those services and the controls over them affect the user entity's information system~~, including related business processes,~~ relevant to ~~financial reporting~~ ***the preparation of the financial statements***. ~~Although m~~***M***ost controls at the service organization are likely to ~~relate to financial reporting~~ ***be part of the user entity's information system relevant to the preparation of the financial statements or*** other ***related*** controls ~~also may be relevant to the audit~~, such as controls over the safeguarding of assets. A service organization's services are part of a user entity's information system~~,~~ ~~including related business processes, relevant to financial reporting~~ if these services affect any of the following:

a. ***How information relating to significant classes of transactions, account balances, and disclosures flows through the user entity's information system, whether manually or using IT, and whether obtained from within or outside the general ledger and subsidiary ledgers.*** ~~The classes of transactions in the user~~

~~entity's operations that are significant to the user entity's financial statements;~~ ***This includes when the service organization affects the following:***

~~*b.*~~***i.*** ~~The procedures within both IT and manual systems by which the user entity's transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements;~~ ***How transactions of the user entity are initiated and how information about them is recorded, processed, corrected as necessary, and incorporated in the general ledger and reported in the financial statements***

ii. How information about events or conditions, other than transactions, is captured, processed, and disclosed by the user entity in the financial statements

~~*c.*~~ ***b.*** The ~~related~~ accounting records, ~~supporting information, and~~ specific accounts in the user entity's financial statements~~.~~***, and other supporting records relating to the flows of information in paragraph 3a.*** ~~that are used to initiate, authorize, record, process, and report the user entity's transactions. This includes the correction of incorrect information and how information is transferred to the general ledger; the records may be in either manual or electronic form;~~

~~*d.* How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;~~

~~*e*~~ ***c.*** The financial reporting process used to prepare the user entity's financial statements ***from the records described in paragraph .03b, including as it relates to disclosures and accounting estimates relating to significant classes of transactions, account balances, and disclosures*** ~~accounting estimates and disclosures; and~~

d. The entity's IT environment relevant to preceding subparagraphs (a)–(c)

~~*f.* Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.~~

[No amendment to paragraph .04–.06.]

.07 The objectives of the user auditor, when the user entity uses the services of a service organization, are to

a. obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's ***system of*** internal control ~~relevant to the audit~~, sufficient to ***provide an appropriate basis for the identification and assessment of*** ~~identify and assess~~ the risks of material misstatement.

b. design and perform audit procedures responsive to those risks.

[No amendment to paragraph .08–.09.]

.10 When obtaining an understanding of ***the entity's system of*** internal control ~~relevant to the audit~~ in accordance with section 315,[fn 1] the user auditor ***should identify controls in the control activities component*** ~~evaluate the design and implementation of relevant controls~~ at the user entity ***from those*** that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization***, and evaluate their design and determine whether they have been implemented.*** [fn 2]

[fn 1] Paragraph .~~26a~~ .27 of AU-C section 315.

[fn 2] Paragraph .~~26b~~ .29 of AU-C section 315.

[Subsequent footnotes renumbered.]

.11 The user auditor should determine whether a sufficient understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's ***system of*** internal control ~~relevant to the audit~~ has been obtained to provide an ***appropriate*** basis for the identification and assessment of ***the*** risks of material misstatement.

.12 If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor should obtain that understanding from one or more of the following procedures:

a. Obtaining and reading a type 1 or type 2 report, if available

b. Contacting the service organization, through the user entity, to obtain specific information

c. Visiting the service organization and performing procedures that will provide the necessary information about the ~~***relevant***~~ controls at the service organization that address risks of material misstatement at the assertion level in accordance with section 315

d. Using another auditor to perform procedures that will provide the necessary information about the ~~relevant~~ controls at the service organization that address risks of material misstatement at the assertion level in accordance with section 315 (Ref: par. .A15–.A20)

[No amendment to paragraph .13.]

.14 If the user auditor plans to use a type 1 or type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of identified controls at the service organization, the user auditor should

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a. evaluate whether the type 1 report is as of a date, or in the case of a type 2 report, is for a period that is appropriate for the user auditor's purposes;

b. evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of ~~the user entity's internal~~ the identified ***controls at the service organization*** ~~relevant to the audit~~; and

c. determine whether complementary user entity controls identified by the service organization ~~are relevant in addressing~~address the risks of material misstatement relating to the relevant assertions in the user entity's financial statements and, if so, obtain an understanding of whether the user entity has designed and implemented such controls. (Ref: par. .A23–.A24)

[No amendment to paragraphs .15–.~~A18~~16.]

.17 If, in accordance with paragraph .16a, the user auditor plans to use a type 2 report as audit evidence that identified controls at the service organization are operating effectively, the user auditor should determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by

a. evaluating whether the type 2 report is for a period that is appropriate for the user auditor's purposes;

b. determining whether complementary user entity controls identified by the service organization ~~are relevant in addressing~~address the risks of material misstatement relating to the relevant assertions in the user entity's financial statements and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;

c. evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and

d. evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment. (Ref: par. .A32–.A40)

[No amendment to paragraphs .18–.A13.]

.A14 As noted in section 315, for some risks the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.5 Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions and account balances that may involve highly automated processing with little or no manual intervention. Risks related to such automated processing may be particularly present when the user entity uses a service organization. In such cases, the user auditor is required to identify ~~entity's~~ controls over

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such risks ~~are relevant to the audit and the user auditor is required to obtain an understanding of~~ and to evaluate the design of such controls and determine whether they have been implemented in accordance with paragraph~~s~~ ~~.09–.~~10 of this section.

[No amendment to paragraph .A15–.A18.]

.A19 Another auditor may be used to perform procedures that will provide the necessary information about the ~~relevant~~ controls at the service organization ***related to services provided to the user entity***. If a type 1 or type 2 report has been issued, the user auditor may use the service auditor to perform these procedures as the service auditor has an existing relationship with the service organization. The user auditor using the work of another auditor may find the guidance in section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*, useful as it relates to understanding another auditor (including that auditor's independence and professional competence); involvement in the work of another auditor in planning the nature, extent, and timing of such work; and in evaluating the sufficiency and appropriateness of the audit evidence obtained. [fn 6]

[fn 6] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A20–.A23.]

.A24 A type 1 or type 2 report, along with information about the user entity, may assist the user auditor in obtaining an understanding of the following:

a. The controls at the service organization that may affect the processing of the user entity's transactions, including the use of subservice organizations

b. The flow of significant transactions through the service organization's system to determine the points in the transaction flow where material misstatements in the user entity's financial statements could occur

c. The control objectives stated in the description of the service organization's system that are relevant to the user entity's financial statement assertions

d. Whether controls at the service organization are suitably designed and implemented to prevent, or detect and correct, processing errors that could result in material misstatements in the user entity's financial statements

A type 1 or type 2 report may assist the user auditor in obtaining a sufficient understanding to identify and assess the risks of material misstatement of the user entity's financial statements. A type 1 report, however, does not provide any evidence of the operating effectiveness of the ~~relevant~~ controls.

[No amendment to paragraphs .A25–.A30.]

.A31 The user auditor is required by section 330 to design and perform tests of controls to obtain sufficient appropriate audit evidence concerning the operating effectiveness of ~~relevant~~ controls in certain circumstances. [fn 8] In the context of a service organization, this requirement applies when

a. the user auditor's assessment of risks of material misstatement includes an expectation that the controls at the service organization are operating effectively (that is, the user auditor intends to rely on the operating effectiveness of controls at the service organization in determining the nature, timing, and extent of substantive procedures); or

b. substantive procedures alone, or in combination with tests of the operating effectiveness of controls at the user entity, cannot provide sufficient appropriate audit evidence at the assertion level.

[fn 8] [Footnote omitted for purposes of this proposed SAS.]

.A32 If a type 2 report is not available, a user auditor may contact the service organization through the user entity to request that a service auditor be engaged to perform a type 2 engagement that includes tests of the operating effectiveness of the ~~relevant~~ controls or the user auditor may use another auditor to perform agreed-upon procedures at the service organization that test the operating effectiveness of those controls. A user auditor may also visit the service organization and perform tests of ~~relevant~~ controls if the service organization agrees to it. The user auditor's risk assessments are based on the combined evidence provided by the service auditor's report and the user auditor's own procedures.

[No amendment to paragraphs .A33–.A34.]

.A35 It may also be necessary for the user auditor to obtain additional evidence about significant changes in the ~~relevant~~ controls at the service organization during a period outside the period covered by the type 2 report, or to determine what additional audit procedures need to be performed (for example, when little or no overlap exists between the period covered by the type 2 report and the period covered by the user entity's financial statements). Relevant factors in determining what additional audit evidence to obtain about controls at the service organization that were operating outside the period covered by the service auditor's report may include the following:

- The significance of the assessed risks of material misstatement at the assertion level
- The specific controls that were tested during the interim period and significant changes to them since they were tested including changes in the information systems, processes, and personnel
- The degree to which audit evidence about the operating effectiveness of those controls was obtained

- The length of the remaining period
- The extent to which the user auditor intends to reduce further substantive procedures based on the reliance on controls
- The effectiveness of the control environment and ***the user entity's process to*** monitor~~ing~~ ***the system of internal*** control~~s. at the user entity~~

.A36 Additional audit evidence may be obtained, for example, by performing tests of controls that operated during the remaining period or testing the user entity's ***process to*** monitor~~ing~~ ***the system of internal*** control~~s~~.

[No amendment to paragraphs .A37–.A40.]

.A41 *Communication of significant deficiencies and material weaknesses in internal control identified during the audit*. The user auditor is required by section 265, *Communicating Internal Control Related Matters Identified in an Audit*, to communicate in writing to management and those charged with governance significant deficiencies and material weaknesses identified during the audit. [fn 9] Matters related to the use of a service organization that the user auditor may identify during the audit and may communicate to management and those charged with governance of the user entity include the following:

- Any ***controls within the entity's process to monitor the system of internal control*** ~~needed monitoring controls~~ that could be implemented by the user entity, including those identified as a result of obtaining a type 1 or type 2 report
- Instances when complementary user entity controls identified in the type 1 or type 2 report are not implemented at the user entity
- Controls that may be needed at the service organization that do not appear to have been implemented or that were implemented, but are not operating effectively

[fn 9] [Footnote omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 402.]

AU-C section 501, *Audit Evidence — Specific Considerations for Selected Items*

[No amendment to paragraphs .01–.A22.]

.A23 Matters relevant in evaluating management's instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example, the following:

- The application of appropriate control***s*** ~~activities~~ (for example, the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and recount procedures)

- The accurate identification of the stage of completion of work in progress; slow moving, obsolete, or damaged items; and inventory owned by a third party (for example, on consignment)

- The procedures used to estimate physical quantities, when applicable, such as may be needed in estimating the physical quantity of a coal pile

- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date

[No further amendment to AU-C section 501.]

AU-C section 530, *Audit Sampling*

[No amendment to paragraphs .01–.A9.]

.A10 In considering the test objective and characteristics of a population for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the ~~relevant~~ controls. This assessment is made in order to design an audit sample and determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100 percent examination or increasing the sample size may be appropriate when performing tests of details.

[No further amendment to AU-C section 530.]

AU-C section 550, *Related Parties*

[No amendment to paragraphs .01–.A6.]

.A7 Matters that may be addressed in the discussion among the engagement team include the following:

- The nature and extent of the entity's relationships and transactions with related parties (using, for example, the auditor's record of identified related parties updated after each audit)

- An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions

- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (for example, a complex organizational structure, use of entities formed to accomplish specific purposes, [fn 22] or an inadequate information system)

- The records or documents that may indicate the existence of related party relationships or transactions

- The importance that management and those charged with governance attach to the identification of, appropriate accounting for, and disclosure of related party relationships and transactions and the related risk of management override of ~~relevant~~ controls

[fn 22] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A8–.A9.]

.A10 However, if the entity does not have such information systems in place, management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by paragraph .14 still applies because management may be aware of parties that meet the related party definition set out in GAAP. In such a case, however, the auditor's inquiries regarding the identity of the entity's related parties are likely to form part of the auditor's risk assessment procedures and related activities performed in accordance with section 315 to obtain information regarding ***the entity's organizational structure, ownership, governance, and business model.***[23] ~~the following:~~

- ~~The entity's ownership and governance structures~~

- ~~The types of investments that the entity is making and plans to make~~

- ~~The way the entity is structured and how it is financed~~

In the particular case of common control relationships, because management is more likely to be aware of such relationships if they have economic significance to the entity, the auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions or shares resources to a significant degree are related parties.

[fn 23] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A11–.A20.]

.A21 *Considerations specific to smaller entities.* Control***s*** ~~activities~~ in smaller entities are likely to be less formal, and smaller entities may have no documented processes for dealing with related party relationships and transactions. An owner-manager may mitigate some of the risks arising from related party transactions or potentially increase those risks through active involvement in all the main aspects of the transactions. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities and inspection of available relevant documentation.

[No amendment to paragraphs .A22–.A29.]

.A30 Relevant related party information shared with the engagement team members may include the following:

- The nature of the related party relationships and transactions
- Significant or complex related party relationships or transactions that may ***be associated with significant risks***~~require special audit consideration~~, particularly transactions in which management or those charged with governance are financially involved

The exchange of information is most useful if made at an early stage of the audit.

[No amendment to paragraphs .A31–.A37.]

.A38 Depending upon the results of the auditor's risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone, regarding the risks of material misstatement associated with related party relationships and transactions. For example, when intragroup transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, authorized, recorded, processed, or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the requirement of section 330 to obtain sufficient appropriate audit evidence about the operating effectiveness of ~~relevant~~ controls, the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.

[No further amendment to AU-C section 550.]

AU-C section 600*, Special Considerations — Audits of Group Financial Statements (Including the Work of Component* Auditors)

[No amendment to paragraphs .01–.19.]

.20 The auditor is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment, ***the applicable reporting framework, and the system of internal control***.[fn 7] The group engagement team should

a. enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage.

b. obtain an understanding of the consolidation process, including the instructions issued by group management to components. (Ref: par. .A31–.A37)

[fn 7] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .21–.A6.]

.A7 The group engagement team also may identify a component as likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances~~(that is, risks that require special audit consideration fn14)~~. For example, a component could be responsible for foreign exchange trading and, thus, expose the group to a significant risk of material misstatement, even though the component is not otherwise of individual financial significance to the group.

[fn 14] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A7–.A93.]

.A94 The examples provided cover a broad range of matters; however, not all matters are relevant to every group audit engagement, and the list of examples is not necessarily complete.

Group-Wide Controls

Group-wide controls may include a combination of the following:

- Regular meetings between group and component management to discuss business developments and review performance
- Monitoring of components' operations and their financial results, including regular reporting routines, which enables group management to monitor components' performance against budgets and take appropriate action
- Group management's risk assessment process (that is, the process for identifying,

analyzing, and managing business risks, including the risk of fraud, that may result in material misstatement of the group financial statements)

- Monitoring, controlling, reconciling, and eliminating intragroup account balances, transactions, and unrealized profits or losses at group level

- A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components

- A central IT system controlled by the same general IT controls for all or part of the group

- Control***s*** ~~activities~~ within an IT system that are common for all or some components

- ***Controls within the group's process to*** ~~M~~***m***onitor~~ing~~ ***the system of internal*** control~~s~~, including activities of the internal audit function and self-assessment programs

- Consistent policies and procedures, including a group financial reporting procedures manual

- Group-wide programs, such as codes of conduct and fraud prevention programs

- Arrangements for assigning authority and responsibility to component management

- The internal audit function may be regarded as part of group-wide controls, for example, when the function is centralized. Section 610, *Using the Work of Internal Auditors*, addresses the group engagement team's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of internal auditors, the level of competence of the internal audit function, and whether the function applies a systematic and disciplined approach when the group engagement team expects to use the function's work. [fn1]

[fn 1] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraph .A95.]

.A96 The following matters are relevant to the planning of the work of a component auditor:

[*Required matters are italicized.*]

- *A request for the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, to confirm that the component auditor will cooperate with the group engagement team*

- The timetable for completing the audit
- Dates of planned visits by group management and the group engagement team and dates of planned meetings with component management and the component auditor
- A list of key contacts
- *The work to be performed by the component auditor, the use to be made of that work,* and arrangements for coordinating efforts at the initial stage of and during the audit, including the group engagement team's planned involvement in the work of the component auditor
- *The ethical requirements that are relevant to the group audit and, in particular, the independence requirements*
- *In the case of an audit or review of the financial information of the component, component materiality*
- *In the case of an audit or review of, or specified audit procedures performed on, the financial information of the component, the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements*
- *A list of related parties prepared by group management and any other related parties of which the group engagement team is aware and a request that the component auditor communicates on a timely basis to the group engagement team related parties not previously identified by group management or the group engagement team*
- Work to be performed on intragroup account balances, transactions, and unrealized profits or losses
- Guidance on other statutory reporting responsibilities (for example, reporting on group management's assertion on the effectiveness of internal control)
- When a time lag between completion of the work on the financial information of the components and the group engagement team's conclusion on the group financial statements is likely, specific instructions for a subsequent events review

The following matters are relevant to the conduct of the work of the component auditor:

- The findings of the group engagement team's tests of control*s* ~~activities~~ of a processing system that is common for all or some components and tests of controls to be performed by the component auditor

…

[No further amendment to section 600.]

AU-C section 620, *Using the Work of an Auditor's Specialist*

[No amendment to paragraphs .01–.A4.]

.A5 An auditor's specialist may be needed to assist the auditor in one or more of the following:

- Obtaining an understanding of the entity and its environment, ***the applicable financial reporting framework, and*** ~~including~~ ***the entity's system of*** internal control
- Identifying and assessing the risks of material misstatement
- Determining and implementing overall responses to assessed risks at the financial statement level
- Designing and performing additional audit procedures to respond to assessed risks at the relevant assertion level, which may comprise tests of controls or substantive procedures
- Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements

[No further amendment to section 620.]

AU-C section 805, *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*

Commented [MM209]: New conforming amendment for consistency

[No amendment to paragraphs .01–.A6.]

.A7 Compliance with the requirements of AU-C sections relevant to the audit of a single financial statement or a specific element of a financial statement may not be practicable when the auditor is not also engaged to audit the entity's complete set of financial statements. In such cases, the auditor often does not have the same understanding of the entity and its environment, ***the applicable financial reporting framework, and*** ~~including~~ its internal control, as an auditor who also audits the entity's complete set of financial statements. The auditor also does not have the audit evidence about the general quality of the accounting records or other accounting information that would be acquired in an audit of the entity's complete set of financial statements. Accordingly, the auditor may need further evidence to corroborate audit evidence acquired from the accounting records. Also see paragraph .A18.

[No further amendments to AU-C section 805.]

AU-C section 930, *Interim Financial Information*

[No amendment to paragraphs .01–.10.]

Procedures for a Review of Interim Financial Information

Understanding the Entity and Its Environment, ***the Applicable Financial Reporting Framework, and*** ~~Including Its~~ ***the Entity's System of*** Internal Control

.11 To plan and conduct the engagement, the auditor should have an understanding of the entity and its environment, ***the applicable financial reporting framework, and*** ~~including its~~ ***the entity's system of*** internal control as it relates to the preparation and fair presentation of both annual and interim financial information, sufficient to be able to

a. identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence.

b. select the inquiries and analytical procedures that will provide the auditor with a basis for reporting whether the auditor is aware of any material modifications that should be made to the interim financial information for it to be in accordance with the applicable financial reporting framework.

[No amendment to paragraphs .12–.A6.]

Procedures for a Review of Interim Financial Information

Understanding the Entity and Its Environment, ***the Applicable Financial Reporting Framework,*** ~~Including It's the~~ ***and the Entity's System of*** Internal Control ***(Ref: par. .11–.12)***

.A7 As required by section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, the auditor who has audited the entity's financial statements for one or more annual periods would have obtained an understanding of the entity and its environment, ***the applicable financial reporting framework***, ~~including its~~ ***and the entity's system of*** internal control as it relates to the preparation and fair presentation of annual financial information, that was sufficient to conduct the audit. Internal control over the preparation and fair presentation of interim financial information may differ from internal control over the preparation and fair presentation of annual financial statements because certain accounting principles and practices used for interim financial information may differ from those used for the preparation of annual financial statements (for example, the use of estimated effective income tax rates for the preparation of interim financial information).

[No amendment to paragraphs .A8–.A10.]

Analytical Procedures, Inquiries, and Other Review Procedures

Analytical Procedures (Ref: par. .13)

.A11 Procedures for conducting a review of interim financial information generally are limited to analytical procedures, inquiries, and other procedures that address significant accounting and disclosure matters relating to the interim financial information. The auditor's understanding of the entity and its environment, ***the applicable financial reporting framework***, ***and*** ~~including its~~ ***the entity's*** ~~including its~~ ***system of*** internal control, the results of the risk assessments relating to the preceding audit, and the auditor's consideration of materiality as it relates to the interim financial information, influences the nature and extent of the inquiries made and analytical procedures performed. For example, if the auditor becomes aware of a significant change in the entity's ~~control activities~~controls at a particular location, the auditor may consider the following procedures:

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- Making additional inquiries, such as whether management monitored the changes and considered whether they were operating as intended
- Employing analytical procedures with a more precise expectation

[No further amendments to AU-C section 930.]

Amendment to SAS No. 128, *Using the Work of Internal Auditors* (AICPA, *Professional Standards*, AU-C sec. 610)

3. The amendment to AU-C section 610 is effective for audits of financial statements for periods ending on or after December 15, 2023.

AU-C section 610, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*

[No amendment to paragraphs .01–.04.]

.05 Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities, and its organizational status, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and those charged with governance. Section 315 addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment***, the applicable financial reporting framework, and the entity's system of internal control*** and identification and assessment of risks of material misstatement. Section 315[fn1] also explains how effective communication between the internal and external auditors creates an environment in which the external auditor can be informed by the internal auditor of significant matters that may affect the external auditor's work.

[fn1] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .06–.A2.]

.A3 However, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this section, although they may perform control***s*** ~~activities~~ that can be tested in accordance with section 330.[fn7] For this reason, monitoring controls performed by an owner-manager would not be considered equivalent to an internal audit function.

[fn 7] [Footnote omitted for purposes of the proposed SAS.]

[No amendment to paragraphs .A4–.A11.]

.A12 The application of a systematic and disciplined approach to planning, performing, supervising, reviewing, and documenting its activities distinguishes the activities of the internal audit function from other monitoring control***s*** ~~activities~~ that may be performed within the entity.

[No amendment to paragraphs .A13–.A25.]

.A26 As explained in section 315, [fn 11] significant risks ~~require special audit consideration~~ ***are risks assessed close to the upper end of the spectrum of inherent risk*** and, therefore, the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, when the risks of material misstatement is other than low, the use of the work of the internal audit function in obtaining audit evidence alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.

[fn 11] [Footnote omitted for purposes of this SAS.]

[No further amendment to section 610.]

Amendment to SAS No. 130, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, as Amended (AICPA, *Professional Standards*, AU-C sec. 940)

4. The amendment to AU-C section 940 is effective for audits of financial statements for periods ending on or after December 15, 2023.

AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*

[No amendment to paragraphs .01–.25.]

.26 The auditor should identify significant classes of transactions, account balances, and disclosures, and their relevant assertions. To identify significant classes of transactions, account balances, and disclosures, and their relevant assertions, the auditor should evaluate the ~~qualitative and quantitative~~ ***inherent*** risk factors[fn 6] related to the financial statement line items and disclosures. (Ref: par. .A50–.A52)

fn 6 See paragraph 12 of the proposed SAS **Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.***

[No amendment to paragraphs .27–.30. Subsequent footnotes renumbered.]

.31 The auditor should understand how IT affects the entity's flow of transactions and, as required by the proposed SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, ~~how the entity has responded to~~ ***the entity's general information technology (IT) controls that address the*** risks arising from ***the use of*** IT. [fn 6] (Ref: par. .A58)

[fn 6] Paragraph ~~22~~ ***26c*** of ~~section 315~~ ***the proposed SAS*** *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

[No amendment to paragraphs .32–.56.]

.57 In an audit of ICFR, the auditor should obtain written representations from management

a. acknowledging management's responsibility for ~~establishing~~ ***designing, implementing,*** and maintaining effective ICFR;

b. stating that management has performed an assessment of the effectiveness of the entity's ICFR and specifying the criteria;

c. stating that management did not use the auditor's procedures performed during the integrated audit as part of the basis for management's assessment about ICFR;

d. stating management's assessment about the effectiveness of the entity's ICFR based on the criteria as of a specified date;

e. stating that management has disclosed to the auditor all deficiencies in the design or operation of ICFR, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses;

f. describing any fraud resulting in a material misstatement to the entity's financial statements and any other fraud that does not result in a material misstatement to the entity's financial statements, but involves senior management or management or other employees who have a significant role in the entity's ICFR;

g. stating whether the significant deficiencies and material weaknesses identified and communicated to management and those charged with governance during

previous engagements pursuant to paragraph .59 have been resolved and specifically identifying any that have not; and

h. stating whether there were, subsequent to the date being reported on, any changes in ICFR or other conditions that might significantly affect ICFR, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses (Ref: par. .A103)

[No amendment to paragraphs .58–.A6.]

.A6 For purposes of a financial statement audit, the proposed SAS **Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement** ***defines the term*** **system of internal control** ***and recognizes that internal control frameworks may use different terms that are similar to the concept of the system of internal control. This section defines the term*** **internal control over financial reporting,** ***which is a system of internal control that supports the preparation of reliable financial statements, to more clearly define ICFR for purposes of expressing an opinion on the effectiveness of ICFR, based on suitable and available criteria.***

Commented [RMM211]: Modified to include additional language with respect to financial reporting objectives, which is consistent with COSO.

[Former paragraphs .A6–.A158 are renumbered as paragraphs .A7–.A159.]

[No amendment to paragraphs .07–.A20.]

.A21 Evaluating whether the following matters are important to the entity's financial statements and ICFR and, if so, how they may affect the auditor's procedures may assist the auditor in planning the audit of ICFR:

- Knowledge of the entity's ICFR obtained during other engagements performed by the auditor or, if applicable, during a review of a predecessor auditor's working papers
- Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes
- Matters relating to the entity's business, including its organization, operating characteristics, and capital structure
- The extent of recent changes, if any, in the entity, its operations, or its ICFR
- The auditor's preliminary judgments about financial statement materiality, risk, and other factors relating to the determination of material weaknesses
- Deficiencies previously communicated to those charged with governance or management
- Legal or regulatory matters of which the entity is aware

- The type and extent of available evidence related to the effectiveness of the entity's ICFR
- Preliminary judgments about the effectiveness of ICFR
- Public information about the entity relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the entity's ICFR
- Knowledge about risks related to the entity evaluated as part of the auditor's ***procedures regarding acceptance or continuance of the*** client ***relationship or the integrated audit engagement*** ~~acceptance and retention evaluation.~~
- The relative complexity of the entity's operations

[No amendment to paragraphs .A22–.A24.]

.A25 Section 240 addresses the auditor's identification and assessment of the risks of material misstatement due to fraud. [fn14] Controls that might address these risks include

- controls over significant unusual transactions, particularly those that result in late or unusual journal entries;
- controls over journal entries and adjustments made in the period-end financial reporting process;
- controls over related party transactions;
- controls related to significant ~~management~~ ***accounting*** estimates; and
- controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

[fn 14] [Footnote omitted for purposes of this proposed SAS.]

.A26 The extent of the procedures necessary to obtain the understanding required by paragraph .18 will vary, depending on the nature of those activities. In performing risk assessment procedures, the auditor is required to inquire of appropriate individuals within the internal audit function (if such function exists). [fn 15] Section 315 provides guidance with respect to such inquiries and certain additional procedures based on the responses to such inquiries. [fn 16]

[fn 15] Paragraph ~~.06*a*~~ ***.14*** of section 315. [Footnote renumbered by the issuance of SAS No. 140, April 2020.]

[fn 16] Paragraph ~~.A9–.A13~~***.A25 and appendix D*** of the proposed SAS. [Footnote renumbered by the issuance of SAS No. 140, April 2020.]

[No amendment to paragraphs .A26–.A32.]

.A33 A top-down approach involves

- beginning at the financial statement level;
- using the auditor's understanding of the overall risks to ICFR;
- focusing on entity-level controls***, which may be indirect or direct controls as described in the proposed SAS***;
- working down to significant classes of transactions, account balances, and disclosures, and their relevant assertions***, which directs attention to classes of transactions, accounts, disclosures, and assertions that present a reasonable possibility of material misstatement of the financial statements***;
- ~~directing attention to classes of transactions, accounts, disclosures, and assertions that present a reasonable possibility of material misstatement of the financial statements;~~
- verifying the auditor's understanding of the risks in the entity's processes; and
- selecting controls for testing that sufficiently address the assessed risk of material misstatement to each relevant assertion.

[No amendment to paragraphs .A34–.A49.]

.A50 ***Inherent*** risk factors ***are*** relevant to the identification of significant classes of transactions, account balances, and disclosures, and their relevant assertions ~~include~~***. Inherent risk factors may be qualitative or quantitative and affect the susceptibility of assertions to misstatement. Inherent risk factors are described in section 315***.

- ~~size and composition of the account;~~
- ~~susceptibility to misstatement due to errors or fraud;~~
- ~~volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;~~
- ~~nature of the account, class of transactions, or disclosure;~~
- ~~accounting and reporting complexities associated with the account, class of transactions, or disclosure;~~
- ~~exposure to losses in the account;~~

Commented [HH212]: Added to bridge the use of the terms indirect and direct controls in the proposed SAS, without using "entity-level controls" in the proposed SAS. The examples in paragraph A36 of AU-C 940 illustrate this and may not need further revision.

Commented [MM213]: Can you add the paragraph-level reference

- ~~possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;~~
- ~~existence of related party transactions in the account; and~~
- ~~changes from the prior period in the account, class of transactions, or disclosure characteristics.~~

.A51 The ***inherent*** ~~R~~*r*isk factors ~~in paragraph .26~~ that the auditor is required to evaluate in the identification of significant classes of transactions, account balances, and disclosures, and their relevant assertions, are the same in the audit of ICFR as in the audit of the financial statements; accordingly, significant classes of transactions, account balances, and disclosures, and their relevant assertions, are the same in an integrated audit.

Amendment to SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, as Amended, and Section 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (AICPA, Professional Standards, AU-C sec. 701)

5. The amendment to AU-C section 701 is effective for audits of financial statements for periods ending on or after December 15, 2023.

AU-C section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

[No amendment to paragraphs .01 –.A17]

.A18 Section 315 defines a *significant risk* as an identified ~~and assessed~~ risk of material misstatement ***for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which the inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur*** ~~that, in the auditor's judgment, requires special audit consideration.~~[fn 13]Areas of significant management judgment and significant unusual transactions may often be identified as significant risks. Significant risks are therefore often areas that require significant auditor attention.

[fn 13] ***See paragraph .13 of AU-C section 315,*** **Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.**

[Subsequent footnotes renumbered.]

[No further amendment to section 701.]

Amendment to SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, as Amended (AICPA, *Professional Standards*, AU-C sec. 720)

6. The amendment to AU-C section 720 is effective for audits of financial statements for periods ending on or after December 15, 2023.

AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*

[No amendment to paragraphs .01–.A33.]

.A34 The auditor's knowledge obtained in the audit includes the auditor's understanding of the entity and its environment, ***the applicable financial reporting framework, and*** ~~including~~ the entity's ***system of*** internal control, obtained in accordance with section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.*[fn 9] Section 315 sets out the auditor's required understanding, which includes such matters as obtaining an understanding of the following:

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***

~~a.~~***b.*** The relevant industry, regulatory, and other external factors

~~*b.* The nature of the entity~~

~~*c.* The entity's selection and application of accounting policies~~

~~*d.* The entity's objectives and strategies~~

~~*e.*~~***c.*** The ***relevant measures used, internally and externally, to assess*** ~~measurement and review of~~ the entity's financial performance

~~*f.*~~***d.*** The entity's internal control

[fn 9] [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A35–.A54.]

.A55 In reading the other information, the auditor may become aware of new information that has implications for the following:

- The auditor's understanding of the entity and its environment, ***the financial reporting framework, and the entity's system of internal control,*** which may indicate the need to revise the auditor's risk assessment [fn 12]

- The auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements [fn 13]

- The auditor's responsibilities relating to subsequent events

[fn 12 and fn 13] [Footnotes omitted for purposes of this proposed SAS.]

[No further amendment to section 720.]

Amendment to SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AICPA, *Professional Standards*, AU-C sec. 540)

7. The amendment to AU-C section 540 is effective for audits of financial statements for periods ending on or after December 15, 2023.

AU-C section 540, *Auditing Accounting Estimates and Related Disclosures*

[No amendment to paragraphs .01–.03.]

Key Concepts of This Section

.04 AU-C section 315 requires ***inherent risk and control risk to be assessed separately for identified risks of material misstatement*** ~~the auditor to assess the risk of material misstatement~~ at the relevant assertion level. ~~For this purpose, this SAS requires inherent risk and control risk to be assessed separately for accounting estimates.~~ ***In the context of this section and depending*** on the nature of a particular accounting estimate, the susceptibility of an assertion to a misstatement that could be material may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors, and the interrelationship among them. As explained in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*,[fn 2] inherent risk is ***influenced by inherent risk factors.*** ~~higher for some assertions and related classes of transactions, account balances, and disclosures than for others.~~ Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the ***susceptibility to misstatement of an assertion, and the level of inherent risk*** ~~likelihood or magnitude of misstatement and~~ varies on a scale that is referred to ~~in this SAS~~ as the *spectrum of inherent risk*. In assessing control risk, the auditor takes into account whether the auditor's further audit procedures contemplate planned

reliance on the operating effectiveness of controls. If the auditor does not ***intend to test and rely on the operating effectiveness of controls,*** ~~perform tests of controls,~~ the auditor's assessment of ***control risk is such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.*** ~~the risk of material misstatement at the relevant assertion level cannot be reduced for the effective operation of controls with respect to the particular assertion~~. (Ref: par. .A8–.A10, .A65–.A66, and app. A)

[fn 2] [Footnote omitted for purposes of this proposed SAS.]

.05 This section refers to relevant requirements in AU-C sections 315 and 330 and provides related guidance to emphasize the importance of the auditor's decisions about controls relating to accounting estimates, including decisions about whether

- there are controls ***required to be identified in accordance with*** ~~***paragraph .27 of***~~ ***AU-C section 315***~~relevant to the audit~~, for which the auditor is required to evaluate their design and determine whether they have been implemented.

- to test the operating effectiveness of ~~relevant~~ controls.

Commented [MM214]: Do we need to add the reference in a footnote

[No amendment to paragraph .06.]

.07 The exercise of professional skepticism in relation to accounting estimates is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity, or other inherent risk factors. Similarly, the exercise of professional skepticism is important when there is greater susceptibility to misstatement due to management bias or ***other*** fraud ***risk factors insofar as they affect inherent risk***. (Ref: par. .A11)

.08 This section requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable [fn 3] in the context of the applicable financial reporting framework or are misstated. For purposes of this section, *reasonable*, in the context of the applicable financial reporting framework, means that the relevant requirements of the applicable financial reporting framework have been applied appropriately, including those that address the following: (Ref: par. .A12–.A13 and .A139–.A144)

- The development of the accounting estimate, including the selection of the method, assumptions, and data in view of the nature of the accounting estimate and the facts and circumstances of the entity

- The selection of management's point estimate

- The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty

[fn 3] [Footnote omitted for purposes of this proposed SAS.]

[No proposed amendment to paragraphs .09–.11.]

Requirements

Risk Assessment Procedures and Related Activities

.12 When obtaining an understanding of the entity and its environment, ***the applicable financial reporting framework, and*** ~~including~~ the entity's ***system of*** internal control, as required by AU-C section 315, the auditor should obtain an understanding of the following matters related to the entity's accounting estimates. The auditor's procedures to obtain the understanding should be performed to the extent necessary to ***obtain audit evidence that*** provide***s*** an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels [fn 4] (Ref: par. .A19–.A23)

[fn 4] [Footnote omitted for purposes of this proposed SAS.]

Obtaining an Understanding of the ~~The~~ Entity and Its Environment ***and the Applicable Financial Reporting Framework***

a. The entity's transactions and other events ***or*** ~~and~~ conditions that may give rise to the need for or changes in accounting estimates to be recognized or disclosed in the financial statements (Ref: par. .A24)

b. The requirements of the applicable financial reporting framework related to accounting estimates (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements) and how they apply in the context of the nature and circumstances of the entity and its environment, including how ~~transactions and other events or conditions are subject to or affected by~~ ***the*** inherent risk factors ***affect susceptibility to misstatement of assertions***. (Ref: par. .A25–.A26)

c. Regulatory factors relevant to the entity's accounting estimates, including, when applicable, regulatory frameworks (Ref: par. .A27)

d. The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements, based on the auditor's understanding of the matters in paragraph .12*a–c* of this section (Ref: par. .A28)

Obtaining an Understanding of the ~~The~~ Entity's ***System of*** Internal Control

e. The nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates (Ref: par. .A29–.A31)

f. How management identifies the need for and applies specialized skills or knowledge related to accounting estimates, including with respect to the use of a management's specialist (Ref: par. .A32)

g. How the entity's risk assessment process identifies and addresses risks relating to accounting estimates (Ref: par. .A33–.A34)

h. The entity's information system as it relates to accounting estimates, including the following:

i. ***How information relating to accounting estimates and related disclosures for significant classes of transactions, account balances, or disclosures flows through the entity's information system***~~The classes of transactions, events, and conditions that are significant to the financial statements and that give rise to the need for or changes in accounting estimates and related disclosures~~ (Ref: par. .A20 and .A35)

ii. For such accounting estimates and related disclosures, how management

(1) identifies the relevant methods, assumptions, or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework, including how management (Ref: par. .A36– .A37)

(a) selects or designs, and applies, the methods used, including the use of models (Ref: par. .A38–.A39)

(b) selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions (Ref: par. .A40–.A43)

(c) selects the data to be used (Ref: par. .A44)

(2) understands the degree of estimation uncertainty, including by considering the range of possible measurement outcomes (Ref: par. .A45)

(3) addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements (Ref: par. .A46–.A49)

i. ***Identified controls in the control activities component*** [fn 5] ~~Control activities relevant to the audit~~ over management's process for making accounting estimates as described in paragraph .12*h*(ii) of this section (Ref: par. .A50–.A54)

j. How management reviews the outcomes of previous accounting estimates and responds to the results of that review

fn 5 Paragraph ~~26a~~27~~26A~~(~~ia~~)–(~~iv~~d) of proposed SAS Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.

[No proposed amendment to paragraphs .13–.14. Subsequent footnotes renumbered.]

Identifying and Assessing the Risks of Material Misstatement

.15 In identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the relevant assertion level, ***including separately assessing inherent risk and control risk at the relevant assertion level,*** as required by AU-C section 315, [fn 6] the auditor should ~~separately assess inherent risk and control risk. The auditor should~~ take the following into account in identifying the risks of material misstatement and assessing inherent risk: (Ref: par. .A64–.A71)

a. The degree to which the accounting estimate is subject to estimation uncertainty (Ref: par. .A72–.A75)

b. The degree to which one or both of the following are affected by complexity, subjectivity, or other inherent risk factors: (Ref: par. .A76–.A79)

i. The selection and application of the method, assumptions, and data in making the accounting estimate

ii. The selection of management's point estimate and related disclosures for inclusion in the financial statements

***fn 6 Paragraphs .31–.34 of proposed SAS* Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment.**

.16 The auditor should determine whether any of the risks of material misstatement identified and assessed in accordance with paragraph .15 are, in the auditor's judgment, a significant risk. [fn 6] If the auditor has determined that a significant risk exists, the auditor should ***identify controls that address*** ~~obtain an understanding of the entity's controls, including control activities, relevant to~~ that risk [fn 7] and ~~, based on that understanding,~~ evaluate whether such controls have been suitably designed and implemented to mitigate such risks. [fn 8] (Ref: par. .A80)

fn 6 Paragraph ***.32~~28~~*** of AU-C section 315.

fn 7 Paragraph .26a(i) of AU-C section 315.

fn 8 Paragraph ***.26a.~~30~~*** of AU-C section 315.

[Subsequent footnotes renumbered]

Responses to the Assessed Risks of Material Misstatement

[No proposed amendment to paragraphs .17]

.18 As required by AU-C section 330, [fn 11] the auditor should design and perform tests to obtain sufficient appropriate audit evidence about the operating effectiveness of ~~relevant~~ controls, if

a. the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively, or

b. substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level.

In relation to accounting estimates, the auditor's tests of such controls should be responsive to the reasons for the assessment given to the risks of material misstatement. In designing and performing tests of controls, the auditor should obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. [fn 12] (Ref: par. .A85–.A89)

[fn 11 and 12] [Footnotes omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .19–.A7.]

Application and Other Explanatory Material

…

Key Concepts of This Section

***Inherent Risk Factors* (Ref: par. .00)**

.A8 *Inherent risk factors* are characteristics of ~~conditions and~~ events ***or conditions*** that ~~may~~ affect ~~the~~ susceptibility ~~of an assertion~~ to misstatement***, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure,*** before consideration of controls. [***fn 25***] Appendix A, "Inherent Risk Factors," further explains the nature of these inherent risk factors, and their interrelationships, in the context of making accounting estimates and their presentation in the financial statements.

[**fn 25**] ***Paragraph .12 of AU-C section 315. [Subsequent footnotes renumbered.]***

.A9 ~~In addition to the inherent risk factors of estimation uncertainty, complexity, or subjectivity, other inherent risk factors that the auditor may consider in identifying and~~ ***When*** assessing the risks of material misstatement ***at the assertion level*** [***fn26***] ***in addition to estimation uncertainty, complexity, and subjectivity, the auditor also takes into account the degree*** ~~may include the extent~~ to which ***other inherent risk factors included in AU-C section 315 affect susceptibility of assertions to misstatement about*** the accounting estimate. ***Such additional inherent risk factors include the following:***

~~is subject to or affected by~~

- ***A*** change in the nature or circumstances of the relevant financial statement items, or requirements of the applicable financial reporting framework, which may give rise to the need for changes in the method, assumptions, or data used to make the accounting estimate~~.~~

- ***S***usceptibility to misstatement due to management bias or ***other*** fraud ***risk factors insofar as they affect inherent risk,*** in making the accounting estimate~~.~~

- ***Uncertainty, other than estimation uncertainty***

fn 26 Paragraph .31 of AU-C section 315.

Control Risk

.A10 ~~An important consideration for the auditor in~~ ***In*** assessing control risk at the relevant assertion level ***in accordance with AU-C section 315, the auditor takes into account*** ~~is the effectiveness of the design of the controls that~~ ***whether*** the auditor ~~intends~~ ***plans*** to ~~rely on~~ ***test the operating effectiveness of controls.*** ~~and the extent to which the controls address the assessed inherent risks at the relevant assertion level.~~ ***When the auditor is considering whether to test the operating effectiveness of controls, the*** ~~The~~ auditor's evaluation that controls are effectively designed and have been implemented supports an expectation***, by the auditor,*** about the operating effectiveness of the controls in ~~determining whether~~ ***establishing the plan*** to test them.

[No amendment to paragraphs .A11–.A18. Paragraph .A20, .A22–.A23, .A26–.A27, and .A30–.A33 have been included for contextual purposes.]

Risk Assessment Procedures and Related Activities

***Obtaining an Understanding of the Entity and Its Environment*, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control (Ref: par. .12)**

.A19 AU-C section 315 [24] requires the auditor to obtain an understanding of certain matters about the entity and its environment, ***the applicable financial reporting framework, and*** ~~including~~ the entity's ***system of*** internal control. The requirements in paragraph .12 of this section relate more specifically to accounting estimates and build on the broader requirements in AU-C section 315.

fn 24 [Footnote omitted for purposes of this proposed SAS.]

.A20 The classes of transactions, events, and conditions within the scope of paragraph .12*h* of this section are the same as the classes of transactions, events, and conditions relating to accounting estimates and related disclosures that are subject to AU-C section 315. [25] In obtaining the understanding of the entity's information system as it relates to accounting

estimates, the auditor may consider

- whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from nonrecurring or unusual transactions.
- how the information system addresses the completeness of accounting estimates and related disclosures, in particular, for accounting estimates related to liabilities.

[fn 25] [Footnote omitted for purposes of this proposed SAS.]

Scalability

.A21 The nature, timing, and extent of the auditor's procedures to obtain the understanding of the entity and its environment, ~~including~~ ***the applicable financial reporting framework, and*** the entity's ***system of*** internal control, related to the entity's accounting estimates, may depend, to a greater or lesser degree, on the extent to which the individual matters apply in the circumstances. For example, the entity may have few transactions or other events ***or***~~and~~ conditions that give rise to the need for accounting estimates; the applicable financial reporting requirements may be simple to apply; and there may be no relevant regulatory factors. Further, the accounting estimates may not require significant judgments, and the process for making the accounting estimates may be less complex. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree, and there may be fewer ***identified*** controls ***in the control activities component.*** ~~relevant to the audit.~~ If so, the auditor's risk assessment procedures are likely to be less extensive and may be performed primarily through inquiries of management with appropriate responsibilities for the financial statements***, such as*** ~~and~~ observation of management's process for making the accounting estimate ***(including when evaluating whether identified controls in that process are designed effectively and when determining whether the control has been implemented)***.

[No proposed amendment to paragraphs .A22–.A23.]

The Entity and Its Environment

The Entity's Transactions and Other Events ***or***~~and~~ Conditions (Ref: par. .12*a*)

.A24 Changes in circumstances that may give rise to the need for or changes in accounting estimates may include, for example, whether

- the entity has engaged in new types of transactions,
- terms of transactions have changed, or
- new events or conditions have occurred.

The Requirements of the Applicable Financial Reporting Framework (Ref: par. .12*b*)

.A25 Obtaining an understanding of the requirements of the applicable financial reporting framework provides the auditor with a basis for discussion with management and, where applicable, those charged with governance about how management has applied ***the*** ~~those~~ requirements ***of the applicable financial reporting framework*** relevant to the accounting estimates, and about the auditor's determination of whether they have been applied appropriately. This understanding also may assist the auditor in communicating with those charged with governance when the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework to not be the most appropriate in the circumstances of the entity. [fn 26]

[fn 26] [Footnote omitted for purposes of this proposed SAS.]

[No proposed amendment to paragraphs .A26–.A28.]

The Entity's ***System of*** *Internal Control* ~~*Relevant to the Audit*~~

The Nature and Extent of Oversight and Governance (Ref: par. .12*e*)

.A29 In applying AU-C section 315[fn 27] the auditor's understanding of the nature and extent of oversight and governance that the entity has in place over management's process for making accounting estimates may be important to the auditor's required evaluation ***about*** ~~as it relates to~~ whether

- management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior, and
- the ~~strengths in the~~ control environment ~~elements collectively provide~~ ***provides*** an appropriate foundation for the other components of ***the system of*** internal control ***considering the nature and size of the entity,*** and
- ~~whether those other components are undermined by~~ ***control*** deficiencies ***identified*** in the control environment ***undermine the other components of the system of internal control***.

[27] Paragraph .***21a***~~15~~ of AU-C section 315.

[No proposed amendment to paragraphs .A30–.A34.]

The Entity's Information System Relating to Accounting Estimates (Ref: par. .12*h*(i))

.A35 During the audit, the auditor may identify classes of transactions, events, ***or***~~and~~ conditions that give rise to the need for accounting estimates and related disclosures that management failed to identify. AU-C section 315 addresses circumstances in which the auditor identifies risks of material misstatement that management failed to identify,

including ***considering the implications for the auditor's evaluation of*** ~~determining whether there is a significant deficiency or material weakness in internal control with regard to~~ the entity's risk assessment process. [fn 30]

[fn 30] [Footnote omitted for purposes of this proposed SAS.]

[No proposed amendment to paragraphs .A36–.A38.]

Models

.A39 Management may design and implement specific controls around models used for making accounting estimates, whether it's management's own model or an external model. When the model itself has an increased level of complexity or subjectivity, such as an expected credit loss model or a fair value model using level 3 inputs, controls that address such complexity or subjectivity may be more likely to be identified ~~as relevant to the audit~~ ***in accordance with AU-C section 315***. When complexity in relation to models is present, controls over data integrity are also more likely to be ***identified controls in accordance with*** ~~***paragraph .27 of***~~ ***AU-C section 315***~~relevant to the audit~~. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and ***related identified controls*** ~~control activities relevant to the audit~~ include the following:

- How management determines the relevance and accuracy of the model.
  - The validation or back-testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model may include evaluation of
    - the model's theoretical soundness,
    - the model's mathematical integrity, and
    - the accuracy and completeness of the data and the appropriateness of data and assumptions used in the model.
- How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model.
- Whether adjustments, also referred to as *overlays* in certain industries, are made to the output of the model and whether such adjustments are appropriate in the circumstances in accordance with the requirements of the applicable financial reporting framework. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias.

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- Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, and the results of any validation performed on it and the nature of and basis for any adjustments made to its output.

Examples of valuation models may include the present value of expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

[No amendment to paragraphs .A40–.A43.]

Data (Ref: par. .12*h*(ii)(1)(c))

.A44 Matters that the auditor may consider in obtaining an understanding of how management selects the data on which the accounting estimates are based include the following:

- The nature and source of the data, including information obtained from an external information source
- How management evaluates whether the data is appropriate
- The accuracy and completeness of the data
- The consistency of the data used with data used in previous periods
- The complexity of the IT ***applications or other aspects of the entity's IT environment*** ~~systems~~ used to obtain and process the data, including when this involves handling large volumes of data
- How the data is obtained, transmitted, and processed and how its integrity is maintained

[No amendments to paragraphs .A45–.A49.]

Identified Controls ~~Control Activities Relevant to the Audit~~ Over Management's Process for Making Accounting Estimates (Ref: par. .12*i*)

.A50 The auditor's judgment in identifying controls ~~relevant to the audit~~ ***in the control activities component*** and, therefore, the need to evaluate the design of those controls and determine whether they have been implemented, relates to management's process described in paragraph .12*h*(ii). The auditor may not identify ***controls***~~relevant control activities~~ in relation to all ~~the elements~~ ***aspects*** of paragraph .12*h*(ii)**.** ~~, depending on the complexity associated with the accounting estimate.~~

.A51 As part of ~~obtaining an understanding of~~ ***identifying*** ~~the~~ ***controls*** ***evaluating the design and determining whether the identified controls have implemented,*** ~~control~~

Commented [MM217]: Hiram – I'm not sure this edit is right considering the bullets. But, I guess we leave it and bring it back to TF after board meeting. Can you make a note.

~~activities relevant to the audit~~, the auditor may consider the following:

- How management determines the appropriateness of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers.

- The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.

- The segregation of duties between those responsible for making the accounting estimates and those committing the entity to the related transactions, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity's financial products staffed by individuals whose remuneration is not tied to such products.

- The effectiveness of the design of the ***controls*** ~~control activities~~. Generally, it may be more difficult for management to design controls that address subjectivity and estimation uncertainty in a manner that effectively prevents, or detects and corrects, material misstatements than it is to design controls that address complexity. Controls that address subjectivity and estimation uncertainty may need to include more manual elements, which may be less reliable than automated controls as they can be more easily bypassed, ignored, or overridden by management. The design effectiveness of controls addressing complexity may vary depending on the reason for and the nature of the complexity. For example, it may be easier to design more effective controls related to a method that is routinely used or over the integrity of data.

.A52 When management makes extensive use of IT in making an accounting estimate, ***identified*** controls ~~relevant to the audit~~ ***in the control activities component*** are likely to include general IT controls and ~~application~~ ***information-processing*** controls. Such controls may address risks related to the following:

- Whether the IT ***application or other aspects of the IT environment*** ~~system~~ have the capability and is appropriately configured to process large volumes of data.

- Complex calculations in applying a method. When diverse ***IT applications*** ~~systems~~ are required to process complex transactions, regular reconciliations between the ***IT applications*** ~~systems~~ are made, in particular, when the ***IT applications*** ~~systems~~ do not have automated interfaces or may be subject to manual intervention.

- Whether the design and calibration of models is periodically evaluated.

- The complete and accurate extraction of data regarding accounting estimates from the entity's records or from external information sources.

- Data, including the complete and accurate flow of data through the entity's information system, the appropriateness of any modification to the data used in making accounting estimates, and the maintenance of the integrity and security of the data***; w***hen using external information sources, risks related to processing or recording the data.

- Whether management has controls around access, change, and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models.

- Whether there are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over journal entries.

.A53 In some entities, the term *governance* may be used to describe activities within the control environment, ***the entity's process to monitor the system of internal control,*** ~~monitoring of controls,~~ and other components of ***the system of*** internal control, as described in AU-C section 315. [fn 33]

[fn 33] [Footnote omitted for purposes of this proposed SAS.]

.A54 For entities with an internal audit function, its work may be particularly helpful to the auditor in obtaining an understanding of the following:

- The nature and extent of management's use of accounting estimates

- The design and implementation of ***controls*** ~~control activities~~ that address the risks related to the data, assumptions, and models used to make the accounting estimates

- The aspects of the entity's information system that generate the data on which the accounting estimates are based

- How new risks relating to accounting estimates are identified, assessed, and managed

Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates (Ref: par. .13)

.A55 A review of the outcome or re-estimation of previous accounting estimates (retrospective review) assists in identifying and assessing the risks of material misstatement when previous accounting estimates have an outcome through transfer or realization of the asset or liability in the current period or are re-estimated for the purpose of the current period. Through performing a retrospective review, the auditor may obtain the following:

- Information regarding the effectiveness of management's previous estimation process, from which the auditor can obtain audit evidence about the likely effectiveness of management's current process.

- Audit evidence of matters, such as the reasons for changes that may be required to be disclosed in the financial statements.

- Information regarding the complexity, subjectivity, or estimation uncertainty pertaining to the accounting estimates.

- Information regarding the susceptibility of accounting estimates to, or that may be an indicator of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing, and extent of further audit procedures.

.A56 A retrospective review may provide audit evidence that supports the identification and assessment of the risks of material misstatement in the current period. Such a retrospective review may be performed for accounting estimates made for the prior period's financial statements or may be performed over several periods or a shorter period (such as half-yearly or quarterly). In some cases, a retrospective review over several periods may be appropriate when the outcome of an accounting estimate is resolved over a longer period, *or when a history of outcomes provides meaningful information or evidence of a trend*.

.A57 A retrospective review of management judgments and assumptions related to significant accounting estimates is required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*. [fn 34] As a practical matter, the auditor's review of previous accounting estimates as a risk assessment procedure in accordance with this section may be carried out in conjunction with the review required by AU-C section 240.

[fn 34] [Footnote omitted for purposes of this proposed SAS.]

.A58 Based on the auditor's previous assessment of the risks of material misstatement, for example, if inherent risk is assessed as higher for one or more risks of material misstatement, the auditor may judge that a more detailed retrospective review is required. As part of the detailed retrospective review, the auditor may pay particular attention, when practicable, to the effect of data and significant assumptions used in making the previous accounting estimates. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

.A59 The measurement objective for fair value accounting estimates and other accounting estimates, based on current conditions at the measurement date, deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may, therefore, focus the

review on obtaining information that may be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in market participant assumptions that affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant audit evidence. In this case, audit evidence may be obtained by understanding the outcomes of assumptions (such as a cash flow projection) and understanding the effectiveness of management's prior estimation process that supports the identification and assessment of the risk of material misstatement in the current period.

.A60 A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. For example, an entity assumed a forecasted unemployment rate in the development of a loan loss estimate, and the actual losses and unemployment rate differed from that assumed. A difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized or that could reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.[35] Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may need to reconsider their risk assessment or may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

[fn 35] [Footnote omitted for purposes of this proposed SAS.]

[No proposed amendment to paragraphs .A61–.A63. Paragraph .A67, .A69, and .A71 included for contextual purposes only.]

Identifying and Assessing the Risks of Material Misstatement (Ref: par. .04 and .15)

.A64 Identifying and assessing risks of material misstatement at the relevant assertion level relating to accounting estimates includes not only accounting estimates that are recognized in the financial statements but also those that are included in the notes to the financial statements.

.A65 ~~AU-C section 200[38] states that GAAS does not ordinarily refer to inherent risk and control risk separately. However, this SAS~~ ***AU-C section 315*** requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the risks of material misstatement ***at the assertion level***, ***[fn 39]*** including significant risks, ~~at the relevant assertion level for accounting estimates~~ in accordance with AU-C section 330. ~~[fn]~~ See paragraphs .A148–.A149 of this ***section***~~SAS~~ for discussion about documentation of inherent risk factors.

[fn 38] [Footnote omitted for purposes of this proposed SAS.]

fn 39 ~~fn 39 Paragraph .07*b* of AU-C section 330.~~ ***Paragraphs .31 and .34 of AU-C section 315. [Subsequent footnotes renumbered]***

.A66. As discussed in paragraph .04 of this ***section*** ~~SAS~~, AU-C section 200 [fn 40] explains that inherent risk is ***influenced by inherent risk factors.*** ~~higher for some assertions and related classes of transactions, account balances, and disclosures than for others.~~ In identifying the risks of material misstatement and in assessing inherent risk ***for accounting estimates in accordance with AU-C section 315***, the auditor is required to take into account ***the inherent risk factors that affect susceptibility to misstatement of assertions and how they do so.*** ~~the degree to which the accounting estimate is subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors.~~ The auditor's consideration of the inherent risk factors may also provide information to be used in ~~determining~~ the following:

- ***Assessing the likelihood and magnitude of misstatement (such as, where*** ~~Where~~ inherent risk is assessed on the spectrum of inherent risk***)***

- ***Determining the*** ~~The~~ reasons for the assessment given to the risks of material misstatement at the relevant assertion level, and that the auditor's further audit procedures in accordance with paragraph .18 of this section are responsive to those reasons

The interrelationships between the inherent risk factors are further explained in appendix A.

fn 40 [Footnote omitted for purposes of this proposed SAS.]

.A67 The reasons for the auditor's assessment of inherent risk at the relevant assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity, or other inherent risk factors. Examples follow:

- Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity-specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgments about future events or conditions. Similar considerations apply to insurance contract liabilities.

- An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes but may involve little subjectivity, and the degree of estimation uncertainty may be low, depending on the nature of the inventory.

- Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an

accounting estimate that requires a single critical judgment about a liability, the amount of which is contingent on the outcome of the litigation.

.A68 The relevance and significance of inherent risk factors may vary from one estimate to another. Accordingly, the inherent risk factors may, either individually or in combination, affect simple accounting estimates to a lesser degree, and the auditor may identify fewer risks or assess inherent risk ***close to*** ~~at~~ the lower end of the spectrum of inherent risk.

.A69 Conversely, the inherent risk factors may, either individually or in combination, affect complex accounting estimates to a greater degree and may lead the auditor to assess inherent risk at the higher end of the spectrum of inherent risk. For these accounting estimates, the auditor's consideration of the effects of the inherent risk factors is likely to directly affect the number and nature of identified risks of material misstatement, the assessment of such risks, and ultimately, the persuasiveness of the audit evidence needed in responding to the assessed risks. Also, for these accounting estimates, the auditor's application of professional skepticism may be particularly important.

.A70 Events occurring after the date of the financial statements may provide additional information relevant to the auditor's assessment of the risks of material misstatement at the relevant assertion level. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise the assessment of the risks of material misstatement at the relevant assertion level, [fn 41] regardless of ***how*** the ***inherent risk factors affect susceptibility of assertions to misstatement relating to*** ~~degree to which~~ the accounting estimate**.** ~~was subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors.~~ Events occurring after the date of the financial statements also may influence the auditor's selection of the approach to testing the accounting estimate in accordance with paragraph .18. For example, for a simple bonus accrual that is based on a straightforward percentage of compensation for selected employees, the auditor may conclude that there is relatively little complexity or subjectivity in making the accounting estimate and, therefore, may assess inherent risk at the relevant assertion level ***close to***~~at~~ the lower end of the spectrum of inherent risk. The payment of the bonuses subsequent to period-end may provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the relevant assertion level.

[fn 41] Paragraph ***.37***~~.32~~ of AU-C section 315.

.A71 The auditor's assessment of control risk may be ~~done~~ performed in different ways depending on preferred audit techniques or methodologies. For instance, ~~T~~the control risk assessment may be expressed using qualitative ~~categories~~ terms (~~for example,~~such as control risk assessed as maximum, moderate, or minimum) or in terms of the auditor's expectation of how effective the controls are in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.

Commented [RMM218]: Modified to use consistent terminology between the proposed SAS, AU-C section 200, and AU-C section 540

[No amendment to paragraphs .A72–.A78.]

Other Inherent Risk Factors **(Ref: par. .15*b*)**

.A79 The degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or ~~fraud~~ ***other fraud risk factors insofar as they affect inherent risk***. For example, when an accounting estimate is subject to a high degree of subjectivity, the accounting estimate is likely to be more susceptible to misstatement due to management bias or fraud, and this may result in a wide range of possible measurement outcomes. Management may select a point estimate from that range that is inappropriate in the circumstances, or that is inappropriately influenced by unintentional or intentional management bias, and that is, therefore, misstated. For continuing audits, indicators of possible management bias identified during the audit of preceding periods may influence the planning and risk assessment procedures in the current period.

[No amendment to paragraphs .A80–.A84.]

When the Auditor Intends to Rely on the Operating Effectiveness of ~~Relevant~~ Controls **(Ref: par. .18)**

.A85 Testing the operating effectiveness of ~~relevant~~ controls may be appropriate when inherent risk is assessed as higher on the spectrum of inherent risk, including for significant risks. This may be the case when the accounting estimate is subject to or affected by a high degree of complexity. When the accounting estimate is affected by a high degree of subjectivity and, therefore, requires significant judgment by management, inherent limitations in the effectiveness of the design of controls may lead the auditor to focus more on substantive procedures than on testing the operating effectiveness of controls.

[No further amendment to AU-C section 540.]

Agenda Item 2C

DRAFT

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Executive Summary

Introduction

This executive summary provides an overview of Statement on Auditing Standards (SAS) No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (SAS No. 145). While this document is an overview, it also aims to highlight changes that are viewed to be of most interest (but it is not inclusive of all changes). This SAS supersedes SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended, section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AU-C section 315).[1]

Background

SAS No. 122 was issued by the Auditing Standards Board (ASB) in October 2011 to apply the clarity drafting conventions to all outstanding SASs issued by the ASB through SAS No. 121, including AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

The AICPA's Enhancing Audit Quality Initiative identified the auditor's risk assessment as an area of focus in 2019. This was, in part, because deficiencies in the process of obtaining the required understanding of internal control is a common audit issue identified by practice monitoring programs not only in the US, but worldwide.

The ASB's project to enhance the auditing standards relating to the auditor's risk assessment through the issuance of SAS No. 145 is intended to enable auditors to appropriately address the following:

a. Understanding the entity's system of internal control, in particular, relating to the auditor's work effort to obtain the necessary understanding

b. Modernizing the standard in relation to IT considerations, including addressing risks arising from entity's use of IT

c. Determining risks of material misstatements, including significant risks

Convergence

The ASB has a strategy to converge its standards with those of the IAASB. In doing that, the ASB uses the corresponding ISA as the base in developing its standards. SAS No. 145 was developed using as the base International Standard on Auditing (ISA) 315, *Identifying and Assessing the Risks of Material Misstatement* (Revised 2019). ISA 315 (Revised 2019) is effective for audits of financial statements for periods beginning on or after December 15, 2021.

[1] All AU-C sections can be found in AICPA *Professional Standards*.

Each SAS differs from its corresponding ISA only where the ASB believes compelling reasons exist for the differences. AU-C Appendix B, *Substantive Differences Between the International Standards on Auditing and Generally Accepted Auditing Standards*, of AICPA *Professional Standards* includes an analysis prepared by the AICPA Audit and Attest Standards staff that highlights substantive differences between the SASs and ISAs, and the rationales therefore.

Effective Date

SAS No. 145 is effective for audits of financial statements for periods ending on or after December 15, 2023.

The ASB has endeavored to closely coordinate the work between the AU-C section 315 and AU-C section 540 task forces in the development of revisions to both standards. Some of the new concepts in SAS No. 145 have already been approved in SAS No. 143, which supersedes AU-C section 540, including inherent risk factors, the spectrum of inherent risk, and the separate assessments of inherent risk and control risk. The ASB believes these concepts are appropriate for SAS No. 145 because they are applicable to all types of classes of transactions, account balances, and disclosures, not just those involving accounting estimates. The ASB has also worked toward addressing the use of these concepts consistently between the standards, recognizing that references to these concepts in SAS No. 143 specifically relate to accounting estimates. Because of the close interaction between SAS No. 145 and SAS No. 143, the ASB is aligning the effective dates of the standards. Both standards will be effective for audits of financial statements for periods ending on or after December 15, 2023.

Fundamental Aspects of SAS No. 145

A proper identification and assessment of the risks of material misstatement drives the performance of a quality audit; a proper risk assessment is the basis on which the auditor plans and performs audit procedures and gathers audit evidence to support the audit opinion on the financial statements.

SAS No. 145 builds on the foundational concepts relating to an audit of financial statements in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, (such as audit risk, identifying risks at the financial statement and assertion levels, and the definitions of *inherent risk* and *control risk*). SAS No. 145 does not fundamentally change the key concepts underpinning audit risk. Rather, SAS No. 145 clarifies and enhances certain aspects of the identification and assessment of the risks of material misstatement to drive better risk assessments and, therefore, enhance audit quality.

Scalability of SAS No. 145

Although size of the entity matters, the level of complexity in the nature of an entity and its environment, including internal control, is the primary driver of scalability in the application of SAS No. 145. SAS No. 145 has removed the extant "Considerations Specific to Smaller Entities"

sections but has included most of these matters previously in the application material, as appropriate, together with further revisions to promote scalability. SAS No. 145 recognizes that although the size of an entity may be an indicator of its complexity, some smaller entities may be complex, and some larger entities may be less complex.

The Exercise of Professional Skepticism

SAS No. 145 contains several key provisions that are designed to enhance the auditor's exercise of professional skepticism, including the following:

- Emphasizing the importance of exercising professional skepticism
- Clarifying that an appropriate understanding of the entity and its environment, and the applicable financial reporting framework, provides a foundation for being able to exercise professional skepticism throughout the audit
- Highlighting the benefits of exercising professional skepticism during the required engagement team discussion

Highlighting that contradictory evidence may be obtained as part of the auditor's risk assessment procedures.

Modernization for an Evolving Business Environment

SAS No. 145 was enhanced with additional guidance that addresses significant changes in, and the evolution and increasingly complex nature of, the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate. It also recognizes the ability to use of automated tools and techniques (including audit data analytics) when performing risk assessment procedures.

Obtaining an Understanding of the Entity and Its Environment, and the Applicable Financial Reporting Framework

SAS No. 145 elevates the importance of understanding the applicable framework by restructuring the requirements and clarifying the context of the auditor's understanding. In addition, SAS No. 145 includes:

- A new explicit requirement to understand the use of IT in the entity's structure, ownership and governance, and its business model. SAS No. 145 defines the IT environment, which includes 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.
- A new requirement to obtain an understanding of how inherent risk factors affect susceptibility of assertions and the degree to which they do so, in the preparation of the

financial statements in accordance with the applicable financial reporting framework (the concept of inherent risk factors is described further below).

Obtaining an Understanding of the Entity's System of Internal Control

Understanding certain aspects of the entity's system of internal control is integral to the auditor's identification and assessment of the risks of material misstatement, regardless of the auditor's planned controls reliance strategy. As described in paragraph A112 of SAS 145, the auditor's understanding and evaluation of the components of the entity's system of internal control provides a preliminary understanding of how the entity identifies business risks relevant to financial reporting and how it responds to them. It may also influence the auditor's identification and assessment of the risks of material misstatement in different ways.

SAS No. 145 clarifies that the overall understanding of the entity's system of internal control is achieved through the requirements that address understanding each of the following components of the system of internal control:

1. the control environment,
2. the entity's risk assessment process,
3. the entity's process to monitor the system of internal control,
4. the information system and communication, and
5. control activities.

Each component comprises a collection of controls, which may be direct or indirect.[2] While differing requirements exist with respect to each component, SAS No. 145 clarifies the auditor's responsibilities, including the requirements to evaluate the design and determine whether certain controls within the control activities component have been implemented.

The nature, timing, and extent of risk assessment procedures that the auditor performs to obtain the required understanding are matters of the auditor's professional judgment and are based on the auditor's determination regarding the procedures that will provide sufficient appropriate audit

[2] *Direct controls* are controls that are precise enough to address risks of material misstatement at the assertion level. *Indirect controls* are controls that support direct controls. Although indirect controls are not sufficiently precise to prevent, or detect and correct, misstatements at the assertion level, they are foundational and may have an indirect effect on the likelihood that a misstatement will be prevented or detected on a timely basis.

evidence to serve as a basis for the identification and assessment of the risks of material misstatement.

Terms Used to Describe Aspects of the Entity's System of Internal Control

SAS No. 145 applies certain revised terms consistently. These changes, made throughout GAAS, include the following:

- The term *internal control* has been changed to *system of internal control*, and the definition has been updated to reflect that it comprises five interrelated components.
- The use of the term *controls* has been clarified by including the following definition in the standard: (see paragraph 12)

  "Policies or procedures that an entity establishes to achieve the control objectives of management or those charged with governance. In this context

  i. policies are statements of what should, or should not, be done within the entity to effect control. Such statements may be documented, explicitly stated in communications, or implied through actions and decisions.

  ii. procedures are actions to implement policies."

SAS No. 145 recognizes that some aspects of the entity's system of internal control may be less formalized but still functioning. When the entity's systems and processes lack formality, the auditor may still be able to perform risk assessment procedures through observation and inquiry.

Understanding the Components of Internal Control

When identifying controls that address the risk of material misstatement, SAS No. 145 clarifies the requirement providing a list of the types of control activities that the ASB believes are always relevant to the risks of material misstatement. These controls include:

- Controls that address risks determined to be significant risks;
- Controls over journal entries and other adjustments;
- Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures; and,
- Other controls that, based on professional judgement, the auditor considers appropriate to meet the objectives set forth in SAS No. 145.

The following table provides a high-level summary of the auditor's responsibilities or work effort related to understanding the components of internal control in accordance with SAS No. 145.

Components of Internal Control				
Primarily Indirect Controls			Primarily Direct Controls	
Control Environment	**Entity's Risk Assessment Process**	**Entity's Process to Monitor the System of Internal Control**	**Information System and Communication**	**Control Activities**
SAS No. 145 addresses the required understanding related to each of these components, which also includes a requirement to evaluate certain matters related to each of the components based on such understanding. Inquiry alone may not be sufficient to obtain the required understanding and to perform the required evaluation. Accordingly, audit evidence for the auditor's understanding and evaluation may be obtained through a combination of inquiries and other risk assessment procedures (for example, corroborating inquiries about the entity's processes through observation or inspection of documents). The auditor's required understanding includes the ongoing tasks and activities, or processes, geared to the achievement of the entity's financial reporting objectives. Accordingly, the required evaluation related to each of these components does not require evaluating the design or determining the implementation of individual controls. However, the auditor may identify controls within these components for which the auditor also evaluates design and determines implementation because such controls address a risk of material misstatement.			SAS No. 145 also includes a requirement to understand the information system and communication component, which includes a requirement to evaluate certain matters, similar to the control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control. For the information system and communication component, however, the auditor's understanding includes the flows of transactions and other aspects of the entity's information-processing activities as well as the entity's communication of significant matters. The required evaluation does not require evaluating the design or determining the implementation of individual controls.	SAS No. 145 includes specific requirements to understand certain controls within the control activities component that address risks of material misstatement at the assertion level. This includes certain general IT controls that address risks arising from the use of IT. For the identified controls that address such risks, the auditor is required to evaluate the design and determine whether the controls have been implemented. The identified controls include: • Controls that address a risk that is determined to be a significant risk • Controls over journal entries and other adjustments, including nonstandard journal entries used to record nonrecurring, unusual transactions, as required by AU-C section 240 • Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which should include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence other controls • Other controls that, based on the auditor's professional judgment, the auditor considers are appropriate to enable the auditor to meet the objectives of paragraph 13 with respect to risks at the assertion level. Identified controls also include those general IT controls that address risks arising from the use of IT, as described in the following section.

Risks Arising from the Use of IT and General IT Controls

SAS No. 145 defines the term "risks arising from the use of IT" as the susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes. General information technology (IT) controls are defined as 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 in the entity's information system. SAS No. 145 requires the auditor to identify general IT controls that address the risks arising from the use of IT and to evaluate their design and determine their implementation.

General IT controls need not be identified for every IT process. General IT controls are identified based on the risks arising from the use of IT. To identify the risks arising from the use of IT, the auditor identifies the IT applications and other aspects of the entity's IT environment that are subject to such risks. Such IT applications and other aspects are identified based on the identified controls that address the risks of material misstatement at the assertion level. Appendix E of SAS No. 145 includes example characteristics of IT applications and other aspects of the IT environment, and guidance related to those characteristics, that may be relevant in identifying IT applications and other aspects of the IT environment subject to risks arising from the use of IT.

Other Matters Relevant to Understanding the Entity's System of Internal Control

Consistent with AU-C section 265, SAS No. 145 includes an explicit requirement that, based on the auditor's evaluation of each of the components of the entity's system of internal control, the auditor should determine whether one or more control deficiencies have been identified. The auditor may determine that a significant deficiency or material weakness exists that impacts the auditor's risk assessments and related response.

Identifying and Assessing the Risks of Material Misstatement

The auditor's risk identification and assessment process is iterative and dynamic. The auditor's understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control are interdependent with concepts within the requirements to identify and assess the risks of material misstatement, whether due to fraud or error. In obtaining the understanding required by SAS No. 145, initial expectations of risks may be developed, which may be further refined as the auditor progresses through the risk identification and assessment process.

SAS No. 145 does not prescribe the order in which the requirements related to the identification of the risks of material misstatement are to be applied or how such risks are documented, which may vary depending on preferred audit techniques or methodologies. To assist auditors in understanding the requirements related to the identification and assessment of the risks of material misstatement, SAS No. 145 clarified various requirements and also introduced new concepts and definitions, as described in the following table.

Inherent risk factors and spectrum of inherent risk (new)	*Inherent risk factors* are characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, before consideration of controls. Such factors may be quantitative or qualitative and include complexity, subjectivity, change, uncertainty, and susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk. Depending on the degree to which the inherent risk factors affect the susceptibility to misstatement of an assertion, the level of inherent risk varies on a scale that is referred to as the *spectrum of inherent risk***.** The spectrum of inherent risk provides a frame of reference in determining the significance of the combination of the likelihood and magnitude of a misstatement. Inherent risk factors are intended to assist the auditor in focusing on those aspects of events or conditions that affect an assertion's susceptibility to misstatement, which in turn, facilitates a more focused identification of risks of material misstatement at the assertion level. Understanding the degree to which inherent risk factors affect susceptibility of assertions to misstatement assists the auditor in assessing inherent risk, which also informs the auditor's design of further audit procedures in accordance with AU-C section 330. It is the intersection of the magnitude and likelihood of the material misstatement on the spectrum of inherent risk that will determine whether the assessed inherent risk is higher or lower on the spectrum of inherent risk.
Relevant assertions (revised)	The definition of a relevant assertion was revised to clarify that an assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement, taking into account the likelihood and magnitude of a misstatement. A risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). SAS No. 145 also clarifies that a reasonable possibility that a risk of material misstatement exists when the likelihood of a material misstatement occurring is more than remote. This guidance is

	consistent with that provided in other AU-C sections (that is, AU-C section 265 and AU-C section 501). The determination of whether an assertion is a relevant assertion continues to be made before consideration of any related controls (that is, the determination is based on inherent risk).
Significant class of transactions, account balance, or disclosure (new)	While the term "significant class of transactions, account balance, or disclosure" is used within GAAS, particularly within AU-C section 940, it was not defined. A class of transactions, account balance, or disclosure is considered significant when it has an identified risk of material misstatement at the assertion level (that is, there is one or more relevant assertions). The determination of whether a class of transactions, account balance, or disclosure is significant is made before consideration of any related controls (that is, the determination is based on inherent risk). The definition and guidance in SAS No. 145 are consistent with how the term was interpreted by various auditors when applying AU-C section 940. The introduction of the concept of a significant class of transactions, account balance, or disclosure is intended to clarify the scope of the auditor's understanding of the entity's information-processing activities as well as the auditor's responsibilities related to the identification and assessment of, and responses to, assessed risks of material misstatement.

As a reminder, AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*, continues to address the auditor's responsibilities relating to fraud in an audit of financial statements and expands on how SAS No. 145 and AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, are to be applied regarding risks of material misstatement due to fraud.

Assessing Inherent Risk and Control Risk Separately

For risks of material misstatement at the assertion level, SAS No. 145 requires separate assessments of inherent risk and control risk, which is consistent with SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*.[3] SAS No. 145, however, does not prescribe a specific method for making such risk assessments nor require a combined assessment of inherent risk and control risk. The auditor's separate assessments of inherent risk and control risk may be

[3] Statement on Auditing Standards (SAS) No. 143, *Auditing Accounting Estimates and Related Disclosures*, was approved by the Auditing Standards Board in May 2020 and, when issued, will have an effective date of audits of financial statement for periods ending or after December 15, 2023.

performed in different ways, depending on preferred audit techniques or methodologies, and may be expressed in different ways.

Assessing Control Risk at the Maximum Level

If the auditor does not plan to test the operating effectiveness of controls, SAS No. 145 requires the auditor to assess control risk at the maximum level such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk. In other words, tests of the operating effectiveness of controls are required to support a control risk assessment below the maximum level.

When the auditor does not plan to test the operating effectiveness of identified controls, the auditor's evaluation of the design and determination of the implementation of controls may still assist in the design of substantive procedures. When identified controls are designed effectively and implemented, risk assessment procedures may generally influence the auditor's determination of the nature and timing of substantive procedures to be performed (for example, the auditor may determine to perform inspection rather than external confirmation or to perform procedures at an interim date rather than at period end).

Significant Risks

To promote a more consistent approach to determining significant risks, SAS No. 145 revised the definition of *significant risks* to focus not on the response (that is, whether a risk requires special audit consideration) but on the inherent risk assessment. Accordingly, the definition in SAS No. 145 focuses on those risks 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. Significant risks also include those that are to be treated as a significant risk in accordance with the requirements of other AU-C sections (that is, AU-C section 240 or AU-C section 550).

SAS No. 145 no longer requires the auditor to determine whether a financial statement level risk is a significant risk. However, identified risks of material misstatement at the financial statement level may affect the auditor's assessment of significant risks at the assertion level.

SAS No. 145 acknowledges that the determination of whether a risk is a significant risk requires the application of professional judgment. AU-C section 330 continues to include special audit considerations in the form of specific requirements related to significant risks because of the nature of the risk and the likelihood and potential magnitude of misstatement related to the risk.

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

SAS No. 145 includes a new "stand-back" requirement (paragraph 39) intended to drive an evaluation of the completeness of the identification of significant classes of transactions, account balances, and disclosures by the auditor. For material classes of transactions, account balances, or disclosures that have not been determined to be significant classes of transactions, account balances, or disclosures (that is, there are no relevant assertions identified), SAS No. 145 requires the auditor to evaluate whether the auditor's determination remains appropriate. Materiality is in the context of the financial statements. Accordingly, classes of transactions, account balances, or disclosures are material if there is a substantial likelihood that omitting, misstating, or obscuring information about them would influence the judgment made by a reasonable user based on the financial statements.

The stand-back differs from the requirement in paragraph .18 of AU-C section 330, which was revised to align with the definitions in SAS No. 145 and with PCAOB standard AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*. Paragraph .18 of AU-C section 330 now requires the auditor to perform substantive procedures for each relevant assertion of each significant class of transactions, account balance, and disclosure, regardless of the assessed level of control risk (rather than for all relevant assertions related to each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement, as previously required).

Audit Documentation

SAS No. 145 also revised the related audit documentation requirements to include the following new requirements:

- Documentation of the evaluation of the design of identified controls, and determination of whether such controls have been implemented

- The rationale for significant judgments made regarding the identified and assessed risks of material misstatement

More detailed documentation that is sufficient to enable an experienced auditor having no previous experience with the audit to understand the nature, timing, and extent of the audit procedures performed and a conclusion or the basis for a conclusion not otherwise readily determinable from the documentation of the work performed or audit evidence obtained may be required to support the rationale for difficult judgments made.

Agenda Item 3

Discussion Memorandum: Audits of LCEs

Objective of Agenda Item

To discuss issues associated with the International Auditing and Assurance Standards Board's (IAASB's) project to develop an audit standard for less complex entities (LCEs) and the ASB's Audits of LCEs Task Force's plan to obtain input for the ASB's comment letter on the IAASB's exposure draft.

Audits of LCEs Task Force

Horace Emery, Chair – Member of the ASB
Denny Ard – Chair of ARSC
Diane Hardesty – Member of the ASB
Kathleen Healy – Member of the ASB
Michael Manspeaker – Member of ARSC (and immediate former member of TIC)

The Task Force is staffed by Mike Glynn.

Status of IAASB's Project to Develop a Standard for Audits of LCEs

To address complexity and scalability in the International Standards on Auditing (ISAs) as well as the specific needs for audits of LCEs and users of their financial statements, the IAASB developed the proposed International Standard on Auditing for Financial Statements of Less Complex Entities (ISA for LCEs).[1] In the draft explanatory memorandum[2] intended to accompany the exposure draft of the proposed standard, the IAASB stated that it has concluded:

- That a global solution is preferred to increasingly fragmented solutions.
- That a standard that has been designed to be proportionate to the typical nature and circumstance of an audit of an LCE would be responsive to those stakeholders who have identified challenges with applying international standards in audits of LCEs.

[1] While the final exposure draft has not been made publicly available as of the preparation of this discussion memorandum, the draft presented to the IAASB at its June 14-23, 2021 meeting is available at https://www.ifac.org/system/files/meetings/files/20210614-IAASB-Agenda-Item-2-A-Updated-for-23-June-Draft-ISA-for-LCE-Full-FINAL.pdf.
[2] The draft explanatory memorandum has not been made public.

- There is an urgent need for action.

Recognizing that the proposed ISA for LCEs was developed on an accelerated basis, at its meeting in June 2021, the IAASB approved the draft for public exposure. In presenting the draft to the IAASB, the IAASB Task Force stated that it is at a point where it needs to receive input from comment letters to continue the process leading to the ultimate issuance of a high-quality standard. In addition, other stakeholders (CAG, PIOB, and SMP Advisory Group) expressed an urgency in exposing the draft for public comment. At the same time, IAASB acknowledged that because the draft standard includes certain items that have not been fully explored, the explanatory memorandum that accompanies the exposure draft is vital in obtaining the input that the IAASB Task Force needs to progress the proposed standard.

The approval of the proposed standard for public exposure was prior to the development of the explanatory memorandum. That explanatory memorandum was distributed on July 6, 2021. The IAASB Task Force requested *substantial comments* on the content of the explanatory memorandum by July 14, 2021. The ASB's Audits of LCEs Task Force met on July 13, 2021 and provided comments for the American IAASB representatives' consideration in responding to the IAASB Task Force.

The exposure draft is expected to be issued in July 2021 with a comment period end date of January 31, 2022.

ASB Audits of LCEs Task Force Issues with IAASB ED

The ASB Audits of LCEs Task Force believes that, in the United States, most concerns with respect to scalability relate to risk assessment, documentation, and quality management. Accordingly, during the exposure period the Task Force will engage with the ASB and other committees and task forces to evaluate the separate standard and its merits for use in the United States.

The ASB's Audits of LCEs Task Force identified the following overriding issues with the proposed standard. Each of the following are discussed in further detail in this discussion memorandum.

1) Standalone standard
2) Assurance obtained
3) Authority of the proposed ISA for LCEs/exclusion of group audits
4) Exclusion of requirements/guidance from the ISA 800 series

Issue #1 – Standalone Standard

The proposed ISA for LCEs has been developed as a separate, standalone "self-contained" standard, designed to be proportionate to the typical nature and circumstances of an audit of the financial statements of an LCE. The proposed standard is based on the core requirements of the ISAs but is separate from the ISAs and with no need to directly reference back to the ISAs in its application. This means that if there is a circumstance that has not been addressed within the proposed standard, relevant ISA requirements cannot be used to address the deficiency. Paragraph A.9 of the proposed ISA for LCEs states "notwithstanding that professional judgment is used in

determining whether the [draft] standard is appropriate to use, if there is uncertainty about whether an audit is an audit of the financial statements of an LCE, the use of the [draft] ISA for LCE is not appropriate."

The IAASB determined to expose the proposed standard as a standalone standard as it concluded that providing auditors the ability to refer back to the ISAs may create further challenges and issues, or other unintentional consequences, when determining whether the ISA for LCEs is appropriate to use. A particular concern was the potential for encouraging the inappropriate use of ISA for LCEs when the ISAs would have been appropriate given the nature and circumstances of the entity and the needs of the users of the entity's audited financial statements. There may also be issues related to reporting when explaining which standards have been complied with in the auditor's report.

The proposed explanatory memorandum includes the following specific request for comment:

Excerpt from IAASB Request for Comments – Specific Questions

1. Stakeholders are asked for their views on:

   (a) The standalone nature of the standard, including detailing any areas of concern in applying, or possible obstacles that may impair this approach? …

ASB Consideration
At this point, prior to the development of the draft ASB comment letter, what are the ASB's views with respect to the proposed standalone nature of the ISA for LCEs that the ASB Audits of LCEs Task Force should keep in mind as it obtains input?

Issue #2 – Assurance Obtained

The proposed standard is intended to provide reasonable assurance in the circumstances of an audit of the financial statements of an LCE as contemplated in the proposed standard. The proposed standard is not intended to be designed for obtaining sufficient appropriate audit evidence for, and therefore does not address, complex matters or circumstances.

The IAASB Task Force prepared mapping documents with significant detail (approximately 450 pages) that are intended to illustrate how the ISA requirements map to the proposed ISA for LCEs and to highlight those requirements that have been omitted.[3] The draft explanatory memorandum includes a URL linking to the mapping documents. Examples of omitted procedures include:

- ISA 530, *Audit Sampling,* paragraph 15 (coincides with paragraph 14 of AU-C section 530)

[3] While the final mapping documents have not been made publicly available as of the preparation of this discussion memorandum, the drafts presented to the IAASB at its June 14-23, 2021 meeting are available at https://www.ifac.org/system/files/meetings/files/20210614-IAASB-Agenda-Item-2-B1-Proportionality-Mapping-Draft-ISA-for-LCE-Document-1-Final.pdf (Parts 1 - 6 of the proposed ISA for LCEs) and https://www.ifac.org/system/files/meetings/files/20210614-IAASB-Agenda-Item-2-B2-Proportionality-Mapping-Draft-ISA-for-LCE-Document-2-Final.pdf (Parts 7-9 of the proposed ISA for LCEs).

15. The auditor shall evaluate:
    (a) The results of the sample; and (Ref: Para. A21–A22)

    (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

- ISA 300, *Planning an Audit,* paragraph 9 (coincides with paragraph 9 of AU-C section 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 315.4
        (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA 330.5
        (c) Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs. (Ref: Para. A12) 10. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.

The removal of certain requirements is the most important element to be considered in relation to the proposed ISA for LCEs and may challenge the implementation and acceptance of the proposed standard. The ASB Audits of LCEs Task Force believes that potential commenters/stakeholders may find it very difficult to discern why certain ISA requirements have been omitted from the proposed standard and recommended that the explanatory memorandum include a summary of the mapping documents that the IAASB prepared to illustrate the "full blown ISA" requirements that are omitted from the proposed ISA for LCEs. The summary need only list significant omitted requirements but should include an explanation as to why the IAASB believes that each omitted requirement is not necessary in an audit of an LCE. Without such a summary, it will be very difficult for respondents to consider and conclude whether the proposed ISA for LCEs results in the auditor having obtained reasonable assurance. The ASB Audits of LCEs Task Force recommended a specific request for comment such as:

> Given that an audit performed in accordance with the ISAs is intended to provide the auditor with reasonable assurance on which to base his or her opinion, stakeholders are asked for their views as to whether an audit performed in accordance with the proposed ISA for LCE results in the auditor obtaining reasonable assurance on which to base an audit opinion. If stakeholders believe that reasonable assurance would not be obtained in an audit performed in accordance with proposed ISA for LCE, what additional procedures should be required to be performed for the auditor to have obtained reasonable assurance?

ASB Consideration
At this point, prior to the development of the draft ASB comment letter, does the ASB have any views with respect to whether the proposed ISA for LCEs results in the auditor having obtained reasonable assurance?

<u>Issue #3 – Authority of the proposed ISA for LCEs/exclusion of group audits</u>
The proposed ISA for LCEs explicitly prohibits its application when:

a) Prohibited by law or regulation.
b) The entity is a listed entity**.**
c) An entity meets one of the following criteria:
    a. An entity one of whose main functions is to take deposits from the public;
    b. An entity one of whose main functions is to provide insurance to the public;
    c. An entity whose function is to provide post-employment benefits;
    d. An entity whose function is to act as a collective investment vehicle and which issues redeemable financial instruments to the public; or
    e. An entity in a class of entity where use of the ISA for LCE is prohibited for that specific class of entity by a legislative or regulatory authority or relevant local body with standard-setting authority in the jurisdiction.
d) The audit is an audit of group financial statements.

It is the understanding of the ASB's Audits of LCEs Task Force that group audits are excluded from the authority for the proposed ISA for LCEs because some IAASB members view group audits as a "gateway to complexity." The ASB's Audits of LCEs Task Force challenges this assertion as many group audits are less complex. In addition, at the March 2021 IAASB meeting, CAG representatives encouraged the IAASB to reconsider the need to exclude requirements relating to group audits.

In addition, the ASB's Audits of LCEs Task Force encourages the IAASB to address whether a component audit may be performed in accordance with the proposed ISA for LCEs and provide the basis for that conclusion in the explanatory material accompanying the exposure draft.

ASB Consideration
At this point, prior to the development of the draft ASB comment letter, does the ASB have any additional feedback for the Task Force's consideration with respect to the exclusion of group audits from the proposed ISA for LCEs?

Issue #4 – Exclusion of ISA 800 series

The ISA 800 series includes:

- ISA 800 (Revised), *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*;
- ISA 805 (Revised), *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*; and
- ISA 810 (Revised)*, Engagements to Report on Summary Financial Statements*.

AU-C sections 800, 805, and 810 correspond with the respective ISA sections.

Requirements relating to the ISA 800 series have not been included in proposed ISA for LCEs as the IAASB agreed to focus on developing an auditing standard for audits of financial statements of LCEs first (i.e., an audit of a complete set of general purpose financial statements for an LCE). It is the view of the IAASB that consideration will be given at a later time to adding part(s) to address special considerations for audits of financial statements prepared in accordance with

special purpose frameworks and audits of single financial statements and specific elements, accounts or items of a financial statement, as well as, if a need exists, to address summary financial statements.

As many less complex entities prepare their financial statements in accordance with a special purpose framework, and the fact that the IAASB has stated that if there is a circumstance that has not been addressed within the proposed standard, relevant ISA requirements cannot be used to address the deficiency, the proposed standard will be limited in its applicability upon issuance. The ASB's Audits of LCEs Task Force plans to emphasize the need for requirements and guidance with respect to audits of financial statements of LCEs prepared in accordance with a special purpose framework in the comment letter on the proposed ISA for LCEs.

ASB Consideration
At this point, prior to the development of the draft ASB comment letter, does the ASB have any additional feedback for the ASB Audits of LCEs Task Force to consider with respect to the omission of the ISA 800 series from the proposed ISA for LCEs?

Plan for the Development of the ASB's Comment Letter on the Proposed ISA for LCEs

The ASB Audits of LCEs Task Force will perform a thorough analysis of the IAASB mapping documents to determine which ISA requirements are omitted from the proposed ISA for LCEs. If the Task Force identifies any omitted requirements that it believes will result in less assurance being obtained in an audit performed in accordance with the proposed standard or that will negatively impact audit quality, such omitted requirements will be flagged for further consideration.

In addition, the Task Force will continue its discussions with representatives from the Canadian Auditing and Assurance Standards Board as well as the Institute of Chartered Accountants in England and Wales, and potentially others to share information and perspectives regarding the ED. The Task Force will also set up meetings with the AICPA's Technical Issues Committee and, perhaps, the Accounting and Review Services Committee to obtain additional feedback.

The Task Force plans to bring issues to the ASB at the ASB meetings in September and October 2021 for further discussion and a final draft comment letter at the ASB meeting in January 2022. The comment letter will be sent to the IAASB no later than the due date of January 31, 2022.

ASB Consideration
Does the ASB have any additional direction for the ASB's Audits of LCEs Task Force as it commences development of a draft comment letter on the proposed ISA for LCEs?

No Additional Agenda Materials Presented

Agenda Item 4

Discussion Memorandum: Group Audits

Objectives of Agenda Item 4
To determine the following:

- Whether the ASB wishes to retain the option in extant AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors*), for the group engagement partner to make reference to the audit of a component auditor in the auditor's report on group financial statements (making reference).

- Whether the ASB agrees with the conclusion by the Group Audits Task Force (Task Force) that the main paragraphs in extant AU-C 600 (paragraphs 24-31 and related application material) that address making reference do not need revision, and that other paragraphs in extant AU-C 600 that mention making reference do not need revision (other than conforming changes). (See Agenda Item 4A, which is extant AU-C 600 with the paragraphs that mention making reference shown in highlighting. These are the paragraphs to consider in determining whether revisions to extant AU-C 600 (other than conforming amendments) are necessary.

- Whether the ASB agrees with the Task Force's plan for converging AU-C 600 with proposed International Standard on Auditing (ISA) 600 (Revised) *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors*).

In addition, Dora Burzenski, Chair of the Task Force and a member of the International Auditing and Assurance Standards Board (IAASB)'s ISA 600 Task Force, will provide an update on the results of the IAASB's discussion of the draft of ISA 600 (Revised) presented at the June 2021 IAASB meeting (Agenda Item 4B).

Background
The IAASB is revising ISA 600 to strengthen the auditor's approach to planning and performing a group audit and to clarify the interaction of ISA 600 with the other ISAs, including ISA 220 (Revised) *Quality Management for an Audit of Financial Statements*, ISA 315, *Identifying and Assessing the Risks of Material Misstatement,* and ISA 330, *The Auditor's Responses to Assessed Risks.*

In April 2020, the IAASB issued an exposure draft, *Proposed International Standard on Auditing (ISA) 600 (Revised), Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors*) (ED). The ED, like extant ISA 600, does not include an option for the group engagement partner to make reference (as this is not allowed under the ISAs). In September 2020, the Task Force provided the IAASB with a comment letter on the ED, and in March and June 2021, provided input to the AICPA's IAASB representative on the March and June 2021 drafts, respectively.

Workplan and Approach for the Issuance of an ASB Exposure Draft
In accordance with the ASB's policy to converge its standards with those of the IAASB, at future ASB meetings, Ms. Burzenski will be leading the ASB in discussions of the IAASB's evolving drafts of the ED (i.e., the ED that is currently undergoing modifications based on the IAASB's deliberations) marked to show the following changes:

- Insertion of the paragraphs from extant AU-C 600 on making reference, if the ASB agrees with that option
- Conforming changes to the inserted paragraphs
- Additional changes for other differences that currently exist between extant AU-C 600 and extant ISA 600
- If needed, changes to the requirements in the draft ISA 600 (Revised) to reflect the uniqueness of the US environment
- If needed, application material in the draft ISA 600 (Revised) that needs to be added or deleted, as a result of the uniqueness of the US environment.

The objective of the Task Force is to develop an exposure draft of proposed AU-C 600 that will be issued in approximately the first quarter of 2022.

At the October 2021 ASB meeting, the Task Force plans to present a draft of proposed AU-C 600 that is marked from the draft of ISA 600 (Revised) presented at the September 2021 IAASB meeting.

IAASB's Workplan
The IAASB's workplan indicates that the IAASB will discuss a draft of ISA 600 (Revised) at its September 2021 meeting. Because the next draft of ISA 600 (Revised) will not be available until September, the ASB will be discussing the topic of making reference at its July 2021 meeting because that topic is not dependent on the IAASB's draft, as explained in the next section.

Making Reference
Paragraph .08 of extant AU-C 600 states the following:

> .08 The group engagement partner is responsible for deciding, individually for each component, to either assume responsibility for, and thus be required to be involved in, the work of a component auditor, insofar as that work relates to the expression of an opinion on the group financial statements, or not assume responsibility for, and accordingly make reference to, the audit of a component auditor in the auditor's report on the group financial statements. The requirements in paragraphs .51–.65 are applicable only when the auditor of the group financial statements is assuming responsibility for the work of component auditors. All other requirements in this section apply to all audits of group financial statements.

Extant ISA 600 as well as the ED [and the draft of ISA 600 (Revised)] do not include an option for the group engagement partner to make reference to the audit of a component auditor in the auditor's report on group financial statements, as this is not allowed by the ISAs.

On July 12, 2021 the Task Force discussed the paragraphs in extant AU-C 600 on making reference to determine if they should be revised in response to practice issues or the need for clarification. The Task Force concluded that changes are not needed to those paragraphs, which are shown in yellow highlighting in Agenda Item 4A.

Members of the Group Audits Task Force
Dora Burzenski, Chair; assisted by Lauren Kolarik
Mike Bingham
Monique Booker
Harry Cohen
Heather Funsch
Clay Huffman
Maria Manasses
Staffed by Judith Sherinsky

Agenda Materials

Agenda Item 4	Discussion Memorandum: Group Audits
Agenda Item 4A	AU-C section 600 with paragraphs on making reference highlighted
Agenda Item 4B	Draft of ISA 600 (Revised) presented at the June 2021 IAASB meeting

Agenda Item 4A

AU-C 600 *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)* With Paragraphs on Making Reference Highlighted

AU-C Section 600 — Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)

Introduction
Scope of This Section
.01 Generally accepted auditing standards (GAAS) apply to group audits. This section addresses special considerations that apply to group audits, in particular those that involve component auditors.
.02 An auditor may find this section, adapted as necessary in the circumstances, useful when that auditor involves other auditors in the audit of financial statements that are not group financial statements. For example, an auditor may involve another auditor to observe the inventory count or inspect physical fixed assets at a remote location.
.03 A component auditor may be required by law or regulation or may have been engaged by component management for another reason to express an audit opinion on the financial statements of a component. The requirements of this section apply, nonetheless, regardless of whether the group engagement partner decides to make reference to the component auditor in the auditor's report on the group financial statements or to assume responsibility for the work of component auditors.
.04 Governmental entities frequently prepare group financial statements. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance to assist auditors in auditing and reporting on those financial statements in accordance with GAAS, including the requirements of this section.
.05 In accordance with section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, the group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively possess the appropriate competence and capabilities.[fn 1] The group engagement partner also is responsible for the direction, supervision, and performance of the group audit engagement. In this section, requirements to be undertaken by the group engagement partner are addressed to the group engagement partner. When the group engagement team may assist the group engagement partner in fulfilling a requirement, the requirement is addressed to the group engagement team. When it may be appropriate in the circumstances for the firm to fulfill a requirement, the requirement is addressed to the auditor of the group financial statements.

.06 The requirements of section 220 apply regardless of whether the group engagement team or a component auditor performs the work on the financial information of a component. This section assists the group engagement partner to meet the requirements of section 220 when component auditors perform work on the financial information of components.

.07 Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatements.[fn 2] In a group audit, detection risk includes the risk that a component auditor may not detect a misstatement in the financial information of a component that could cause a material misstatement of the group financial statements and the risk that the group engagement team may not detect this misstatement. This section explains the matters that the group engagement team considers when determining the nature, timing, and extent of its involvement in the risk assessment procedures and further audit procedures performed by the component auditors on the financial information of the components. The purpose of this involvement is to obtain sufficient appropriate audit evidence on which to base the audit opinion on the group financial statements.

.08 The group engagement partner is responsible for deciding, individually for each component, to either

- assume responsibility for, and thus be required to be involved in, the work of a component auditor, insofar as that work relates to the expression of an opinion on the group financial statements, or
- not assume responsibility for, and accordingly make reference to, the audit of a component auditor in the auditor's report on the group financial statements.

The requirements in paragraphs .51–.65 are applicable only when the auditor of the group financial statements is assuming responsibility for the work of component auditors. All other requirements in this section apply to all audits of group financial statements.

Effective Date

.09 This section is effective for audits of group financial statements for periods ending on or after December 15, 2012.

Objectives

.10 The objectives of the auditor are to determine whether to act as the auditor of the group financial statements and, if so, to

a. determine whether to make reference to the audit of a component auditor in the auditor's report on the group financial statements;
b. communicate clearly with component auditors; and
c. obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion about whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Definitions

.11 For purposes of GAAS, the following terms have the meanings attributed as follows:

Component. An entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements. (Ref: par. .A1–.A5)

Component auditor. An auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit. A component auditor may be part of the group engagement partner's firm, a network firm of the group engagement partner's firm, or another firm. (Ref: par. .A9–.A11)
Component management. Management responsible for preparing the financial information of a component.
Component materiality. The materiality for a component determined by the group engagement team for the purposes of the group audit.
Group. All the components whose financial information is included in the group financial statements. A group always has more than one component.
Group audit. The audit of group financial statements.
Group audit opinion. The audit opinion on the group financial statements.
Group engagement partner. The partner or other person in the firm[fn 3] who is responsible for the group audit engagement and its performance and for the auditor's report on the group financial statements that is issued on behalf of the firm. When joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team. This section does not, however, address the relationship between joint auditors or the work that one joint auditor performs in relation to the work of the other joint auditor.
Group engagement team. Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.
Group financial statements. Financial statements that include the financial information of more than one component. The term *group financial statements* also refers to combined financial statements aggregating the financial information prepared by components that are under common control.
Group management. Management responsible for the preparation and fair presentation of the group financial statements.
Group-wide controls. Controls designed, implemented, and maintained by group management over group financial reporting.
Significant component. A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements. (Ref: par. .A6–.A8)
.12 Reference to *the applicable financial reporting framework* means the financial reporting framework that applies to the group financial statements. Reference to *the consolidation process* includes the following:

a. The recognition, measurement, presentation, and disclosure of the financial information of the components in the group financial statements by way of inclusion, consolidation, proportionate consolidation, or the equity or cost methods of accounting (Ref: par. .A12)
b. The aggregation in combined financial statements of the financial information of components that are under common control

Requirements
Responsibility

.13 In accordance with section 220, the group engagement partner is responsible for (1) the direction, supervision, and performance of the group audit engagement in compliance with professional standards, applicable regulatory and legal requirements, and the firm's policies and procedures; and (2) determining whether the auditor's report that is issued is appropriate in the circumstances.[fn 4] (Ref: par. .A13–.A14)

Acceptance and Continuance

.14 The group engagement partner should determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained regarding the consolidation process and the financial information of the components on which to base the group audit opinion. For this purpose, the group engagement team should obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components. (Ref: par. .A15–.A17)

.15 The group engagement partner should evaluate whether the group engagement team will be able to obtain sufficient appropriate audit evidence through the group engagement team's work or use of the work of component auditors (that is, through assuming responsibility for the work of component auditors or through making reference to the audit of a component auditor in the auditor's report), to act as the auditor of the group financial statements and report as such on the group financial statements. (Ref: par. .A18–.A21)

.16 In some circumstances, the group engagement partner may conclude that it will not be possible, due to restrictions imposed by group management, for the group engagement team to obtain sufficient appropriate audit evidence through the group engagement team's work or use of the work of component auditors, and the possible effect of this inability, will result in a disclaimer of opinion on the group financial statements.[fn 5] In such circumstances, the auditor of the group financial statements should

- in the case of a new engagement, not accept the engagement, or, in the case of a continuing engagement, withdraw from the engagement when withdrawal is possible under applicable law or regulation, or
- when the entity is required by law or regulation to have an audit, having performed the audit of the group financial statements to the extent possible, disclaim an opinion on the group financial statements. (Ref: par. .A22–.A27)

Terms of Engagement

.17 The auditor of the group financial statements is required, in accordance with section 210, *Terms of Engagement*, to agree upon the terms of the group audit engagement.[fn 6] (Ref: par. .A28–.A29)

Overall Audit Strategy and Audit Plan

.18 The group engagement team should establish an overall group audit strategy and should develop a group audit plan. In developing the group audit plan, the group engagement team should assess the extent to which the group engagement team will use the work of component auditors and whether the auditor's report on the group financial statements will make reference to the audit of a component auditor, as discussed in paragraphs .24–.30.

.19 The group engagement partner should review and approve the overall group audit strategy and group audit plan. (Ref: par. .A30)

Understanding the Group, Its Components, and Their Environments

.20 The auditor is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment.[fn 7] The group engagement team should

a. enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage.
b. obtain an understanding of the consolidation process, including the instructions issued by group management to components. (Ref: par. .A31–.A37)

.21 The group engagement team should obtain an understanding that is sufficient to

a. confirm or revise its initial identification of components that are likely to be significant.
b. assess the risks of material misstatement of the group financial statements, whether due to fraud or error.[fn 8] (Ref: par. .A38–.A39)

Understanding a Component Auditor

.22 Regardless of whether reference will be made in the auditor's report on the group financial statements to the audit of a component auditor, the group engagement team should obtain an understanding of the following: (Ref: par. .A40–.A44)

a. Whether a component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent (Ref: par. .A46)
b. A component auditor's professional competence (Ref: par. .A47–.A48)
c. The extent, if any, to which the group engagement team will be able to be involved in the work of the component auditor
d. Whether the group engagement team will be able to obtain information affecting the consolidation process from a component auditor
e. Whether a component auditor operates in a regulatory environment that actively oversees auditors (Ref: par. .A45)

.23 When a component auditor does not meet the independence requirements that are relevant to the group audit or the group engagement team has serious concerns about the other matters listed in paragraph .22*a–b*, the group engagement team should obtain sufficient appropriate audit evidence relating to the financial information of the component without making reference to the audit of that component auditor in the auditor's report on the group financial statements or otherwise using the work of that component auditor. (Ref: par. .A49–.A51)

Determining Whether to Make Reference to a Component Auditor in the Auditor's Report on the Group Financial Statements

.24 Having gained an understanding of each component auditor, the group engagement partner should decide whether to make reference to a component auditor in the auditor's report on the group financial statements. (Ref: par. .A52)

.25 Reference to the audit of a component auditor in the auditor's report on the group financial statements should not be made unless

a. the group engagement partner has determined that the component auditor has performed an audit of the financial statements of the component in accordance with the relevant requirements of GAAS (Ref: par. .A53), and
b. the component auditor has issued an auditor's report that is not restricted as to use.[fn 9]

.26 If the component's financial statements are prepared using a different financial reporting framework from that used for the group financial statements, reference to the audit of a component auditor in the auditor's report on the group financial statements should not be made unless

a. the measurement, recognition, presentation, and disclosure criteria that are applicable to all material items in the component's financial statements under the financial reporting framework used by the component are similar to the criteria that are applicable to all material items in the group's financial statements under the financial reporting framework used by the group, and

b. the group engagement team has obtained sufficient appropriate audit evidence for purposes of evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the group without the need to assume responsibility for, and, thus, be involved in, the work of the component auditor. (Ref: par. .A54–.A57)

.27 When the group engagement partner decides to make reference in the auditor's report on the group financial statements to the audit of a component auditor, the group engagement team should obtain sufficient appropriate audit evidence with regard to such components by performing the following procedures:

a. The procedures required by this section, except for those required by paragraphs .51–.65

b. Reading the component's financial statements and the component auditor's report thereon to identify significant findings and issues and, when considered necessary, communicating with the component auditor in this regard

Making Reference in the Auditor's Report

.28 When the group engagement partner decides to make reference to the audit of a component auditor in the auditor's report on the group financial statements, the report on the group financial statements should clearly indicate

a. that the component was not audited by the auditor of the group financial statements but was audited by the component auditor.

b. the magnitude of the portion of the financial statements audited by the component auditor.

c. when the component's financial statements are prepared using a different financial reporting framework from that used for the group financial statements

i. the financial reporting framework used by the component and

ii. that the auditor of the group financial statements is taking responsibility for evaluating the appropriateness of the adjustments to convert the component's fina*ncial statements to the financial reporting framework used by the group.*

d. when

i. the component auditor's report on the component's financial statements does not state that the audit of the component's financial statements was performed in accordance with GAAS or the standards promulgated by the PCAOB, and

ii. the group engagement partner has determined that the component auditor performed additional audit procedures in order to meet the relevant requirements of GAAS

(1) the set of auditing standards used by the component auditor and

(2) that additional audit procedures were performed by the component auditor to meet the relevant requirements of GAAS. (Ref: par. .A58–.A60)

.29 If the group engagement partner decides to name a component auditor in the auditor's report on the group financial statements

a. the component auditor's express permission should be obtained.

b. the component auditor's report should be presented together with that of the auditor's report on the group financial statements.

.30 If the opinion of a component auditor is modified or that report includes an emphasis-of-matter or other-matter paragraph, the auditor of the group financial statements should determine the effect that this may have on the auditor's report on the group financial statements. When deemed appropriate, the auditor of the group financial statements should modify the opinion on the group financial statements or include an emphasis-of-matter paragraph or an other-matter paragraph in the auditor's report on the group financial statements. (Ref: par. .A61)

.31 If the group engagement partner decides to assume responsibility for work of a component auditor, no reference should be made to the component auditor in the auditor's report on the group financial statements. (Ref: par. .A62)

Materiality

.32 The group engagement team should determine the following: (Ref: par. .A63)

a. Materiality, including performance materiality, for the group financial statements as a whole when establishing the overall group audit strategy.[fn 10]

b. Whether, in the specific circumstances of the group, particular classes of transactions, account balances, or disclosures in the group financial statements exist for which there is a substantial likelihood that misstatements of lesser amounts than materiality for the group financial statements as a whole would influence the judgment made by a reasonable user based on the group financial statements. In such circumstances, the group engagement team should determine materiality to be applied to those particular classes of transactions, account balances, or disclosures.

c. Component materiality for those components on which the group engagement team will perform, or for which the auditor of the group financial statements will assume responsibility for the work of a component auditor who performs, an audit or a review. Component materiality should be determined taking into account all components, regardless of whether reference is made in the auditor's report on the group financial statements to the audit of a component auditor. To reduce the risk that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds the materiality for the group financial statements as a whole, component materiality should be lower than the materiality for the group financial statements as a whole, and component performance materiality should be lower than performance materiality for the group financial statements as a whole. (Ref: par. .A64–.A66)

d. The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements. (Ref: par. .A67)

See paragraph .51 for additional requirements that apply when the auditor of the group financial statements is assuming responsibility for the work of a component auditor.

Responding to Assessed Risks

.33 The auditor is required to design and implement appropriate responses to address the assessed risks of material misstatement of the financial statements.[fn 11] If the nature, timing, and extent of the work to be performed on the consolidation process or the financial information of the components is based on an expectation that group-wide controls are operating effectively or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, the group engagement team should test, or have a component auditor test on the group engagement team's behalf, the operating effectiveness of those controls. See paragraphs

.52–.58 for additional requirements that apply when the auditor of the group financial statements is assuming responsibility for the work of a component auditor. (Ref: par. .A68)

Consolidation Process

.34 In accordance with paragraph .20, the group engagement team obtains an understanding of group-wide controls and the consolidation process, including the instructions issued by group management to components. In accordance with paragraph .33, the group engagement team, or component auditor at the request of the group engagement team, tests the operating effectiveness of group-wide controls if the nature, timing, and extent of the work to be performed on the consolidation process are based on an expectation that group-wide controls are operating effectively or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

.35 The group engagement team should design and perform further audit procedures on the consolidation process to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process. This should include evaluating whether all components have been included in the group financial statements.

.36 The group engagement team should evaluate the appropriateness, completeness, and accuracy of consolidation adjustments and reclassifications and should evaluate whether any fraud risk factors or indicators of possible management bias exist. (Ref: par. .A69)

.37 If the financial information of a component has not been prepared in accordance with the same accounting policies applied to the group financial statements, the group engagement team should evaluate whether the financial information of that component has been appropriately adjusted for purposes of the preparation and fair presentation of the group financial statements in accordance with the applicable financial reporting framework. (Ref: par. .A57)

.38 The group engagement team should determine whether the financial information identified in a component auditor's communication (see paragraph .42*b*) is the financial information that is incorporated in the group financial statements.

.39 If the group financial statements include the financial statements of a component with a financial reporting period-end that differs from that of the group, the group engagement team should evaluate whether appropriate adjustments have been made to those financial statements in accordance with the applicable financial reporting framework.

Subsequent Events

.40 When the group engagement team or component auditors perform audits on the financial information of components, the group engagement team or the component auditors should perform procedures designed to identify events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements and that may require adjustment to, or disclosure in, the group financial statements. See paragraph .59 for additional requirements that apply when the auditor of the group financial statements is assuming responsibility for the work of a component auditor. (Ref: par. .A70)

Communication With a Component Auditor

.41 The group engagement team should communicate its requirements to a component auditor on a timely basis. This communication should include the following:

a. A request that the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, confirm that the component auditor will cooperate with the group engagement team.

b. The ethical requirements that are relevant to the group audit and, in particular, the independence requirements.

c. A list of related parties prepared by group management and any other related parties of which the group engagement team is aware, including the nature of the entity's relationships and transactions with those related parties. The group engagement team should request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team. The group engagement team should identify such additional related parties to other component auditors.

d. Identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor.

.42 The group engagement team should request a component auditor to communicate matters relevant to the group engagement team's conclusion, with regard to the group audit. Such communication should include the following:

a. Whether the component auditor has complied with ethical requirements relevant to the group audit, including independence and professional competence

b. Identification of the financial information of the component on which the component auditor is reporting

c. The component auditor's overall findings, conclusions, or opinion

See paragraphs .60–.61 for additional requirements that apply when the auditor of the group financial statements is assuming responsibility for the work of a component auditor.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Evaluating a Component Auditor's Communication and Adequacy of Their Work

.43 The group engagement team should evaluate a component auditor's communication (see paragraph .42). The group engagement team should discuss significant findings and issues arising from that evaluation with the component auditor, component management, or group management, as appropriate. See paragraphs .60–.63 for additional requirements that apply when the auditor of the group financial statements is assuming responsibility for the work of a component auditor.

Sufficiency and Appropriateness of Audit Evidence

.44 The auditor is required to obtain sufficient appropriate audit evidence on which to base the audit opinion.[fn 12] The group engagement team should evaluate whether sufficient appropriate audit evidence on which to base the group audit opinion has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components. (Ref: par. .A71)

.45 The group engagement partner should evaluate the effect on the group audit opinion of any uncorrected misstatements (either identified by the group engagement team or communicated by component auditors) and any instances in which there has been an inability to obtain sufficient appropriate audit evidence. (Ref: par. .A72)

Communication With Group Management and Those Charged With Governance of the Group

Communication With Group Management and Those Charged With Governance

.46 The group engagement team should communicate to group management and those charged with governance of the group material weaknesses and significant deficiencies in internal control

that are relevant to the group (either identified by the group engagement team or brought to its attention by a component auditor during the audit), in accordance with section 265, *Communicating Internal Control Related Matters Identified in an Audit*.

.47 If fraud has been identified by the group engagement team or brought to its attention by a component auditor or information indicates that a fraud may exist, the group engagement team should communicate this on a timely basis to the appropriate level of group management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: par. .A73)

.48 When a component auditor has been engaged to express an audit opinion on the financial statements of a component, the group engagement team should request group management to inform component management of any matter of which the group engagement team becomes aware that may be significant to the financial statements of the component, but of which component management may be unaware. If group management refuses to communicate the matter to component management, the group engagement team should discuss the matter with those charged with governance of the group. If the matter remains unresolved, the group engagement team, subject to legal and professional confidentiality considerations, should consider whether to advise the component auditor not to issue the auditor's report on the financial statements of the component until the matter is resolved and whether to withdraw from the engagement. (Ref: par. .A74)

Communication With Those Charged With Governance of the Group

.49 The group engagement team should communicate the following matters with those charged with governance of the group, in addition to those required by section 260, *The Auditor's Communication With Those Charged With Governance*, and other AU-C sections: (Ref: par. .A75)

a. An overview of the type of work to be performed on the financial information of the components, including the basis for the decision to make reference to the audit of a component auditor in the auditor's report on the group financial statements

b. An overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components

c. Instances in which the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work

d. Any limitations on the group audit (for example, when the group engagement team's access to information may have been restricted)

e. Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls, or others in which a material misstatement of the group financial statements has or may have resulted from fraud

Documentation

.50 The group engagement team should include in the audit documentation the following:[fn 13]

a. An analysis of components indicating those that are significant and the type of work performed on the financial information of the components

b. Those components for which reference to the reports of component auditors is made in the auditor's report on the group financial statements

c. Written communications between the group engagement team and the component auditors about the group engagement team's requirements

d. For those components for which reference is made in the auditor's report on the group financial statements to the audit of a component auditor

i. the financial statements of the component and the report of the component auditor thereon

ii. when the component auditor's report on the component's financial statements does not state that the audit of the component's financial statements was performed in accordance with GAAS or the standards promulgated by the PCAOB, the basis for the group engagement partner's determination that the audit performed by the component auditor met the relevant requirements of GAAS

See paragraph .65 for additional requirements that apply when the auditor of the group financial statements is assuming responsibility for the work of a component auditor.

Additional Requirements Applicable When Assuming Responsibility for the Work of a Component Auditor

Materiality (See paragraph .32)

.51 In the case of an audit of the financial information of a component in which the auditor of the group financial statements is assuming responsibility for the component auditor's work, the group engagement team should evaluate the appropriateness of performance materiality at the component level. (Ref: par. .A76–.A77)

Determining the Type of Work to Be Performed on the Financial Information of Components (See paragraph .33)

.52 For components for which the auditor of the group financial statements is assuming responsibility for the work of component auditors, the group engagement team should determine the type of work to be performed by the group engagement team or by component auditors on its behalf on the financial information of the components (see paragraphs .53–.56). The group engagement team also should determine the nature, timing, and extent of its involvement in the work of component auditors.

Significant Components

.53 For a component that is significant due to its individual financial significance to the group, the group engagement team, or a component auditor on its behalf, should perform an audit of the financial information of the component, adapted as necessary to meet the needs of the group engagement team, using component materiality. (Ref: par. .A78)

.54 For a component that is significant not due to its individual financial significance but because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, the group engagement team, or a component auditor on its behalf, should perform one or more of the following: (Ref: par. .A79)

a. An audit, adapted as necessary to meet the needs of the group engagement team, of the financial information of the component, using component materiality

b. An audit, adapted as necessary to meet the needs of the group engagement team, of one or more account balances, classes of transactions, or disclosures relating to the likely significant risks of material misstatement of the group financial statements (Ref: par. .A80)

c. Specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements (Ref: par. .A81)

Components That Are Not Significant Components

.55 For components that are not significant components, the group engagement team should perform analytical procedures at the group level. (Ref: par. .A82)

.56 In some circumstances, the group engagement team may determine that sufficient appropriate audit evidence on which to base the group audit opinion will not be obtained from the following:

a. The work performed on the financial information of significant components
b. The work performed on group-wide controls and the consolidation process
c. The analytical procedures performed at group level

In such circumstances, the group engagement team should select additional components that are not significant components and should perform or request a component auditor to perform one or more of the following on the financial information of the individual components selected: (Ref: par. .A83–.A86)

- An audit, adapted as necessary to meet the needs of the group engagement team, of the financial information of the component, using component materiality
- An audit, adapted as necessary to meet the needs of the group engagement team, of one or more account balances, classes of transactions, or disclosures
- A review of the financial information of the component, adapted as necessary to meet the needs of the group engagement team, using component materiality
- Specified audit procedures

The group engagement team should vary the selection of such individual components over a period of time.

Involvement in the Work Performed by Component Auditors (Ref: par. .A87–.A88)

Significant Components — Risk Assessment

.57 When a component auditor performs an audit or other specified audit procedures of the financial information of a significant component for which the auditor of the group financial statements is assuming responsibility for the component auditor's work, the group engagement team should be involved in the risk assessment of the component to identify significant risks of material misstatement of the group financial statements. The nature, timing, and extent of this involvement are affected by the group engagement team's understanding of the component auditor but, at a minimum, should include the following:

a. Discussing with the component auditor or component management the component's business activities of significance to the group.
b. Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error.
c. Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum that reflects the component auditor's conclusion with regard to the identified significant risks.

Identified Significant Risks of Material Misstatement of the Group Financial Statements — Further Audit Procedures

.58 When significant risks of material misstatement of the group financial statements have been identified in a component for which the auditor of the group financial statements is assuming responsibility for the work of a component auditor, the group engagement team should evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the group financial statements. Based on its

understanding of the component auditor, the group engagement team should determine whether it is necessary to be involved in the further audit procedures.

Subsequent Events (See paragraph .40)

.59 When component auditors perform work other than audits of the financial information of components at the request of the group engagement team, the group engagement team should request the component auditors to notify the group engagement team if they become aware of events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements that may require an adjustment to, or disclosure in, the group financial statements.

Communication With a Component Auditor (See paragraph .42)

.60 When the auditor of the group financial statements is assuming responsibility for the work of a component auditor, the communication required in paragraph .41 should set out the work to be performed and the form and content of the component auditor's communication with the group engagement team. It also should include, in the case of an audit or review of the financial information of the component, component materiality (and the amount or amounts lower than the materiality for particular classes of transactions, account balances, or disclosures, if applicable) and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements. (Ref: par. .A89–.A92)

.61 When the auditor of the group financial statements is assuming responsibility for the work of a component auditor, the communication requested from the component auditor, as required in paragraph .42, also should include the following:

a. Whether the component auditor has complied with the group engagement team's requirements.

b. Information on instances of noncompliance with laws or regulations at the component or group level that could give rise to a material misstatement of the group financial statements.

c. Significant risks of material misstatement of the group financial statements, due to fraud or error, identified by the component auditor in the component and the component auditor's responses to such risks. The group engagement team should request the component auditor to communicate such significant risks on a timely basis.

d. A list of corrected and uncorrected misstatements of the financial information of the component (the list need not include misstatements that are below the threshold for clearly trivial misstatements communicated by the group engagement team).

e. Indicators of possible management bias regarding accounting estimates and the application of accounting principles.

f. Description of any identified material weaknesses and significant deficiencies in internal control at the component level.

g. Other significant findings and issues that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level, or others that resulted in a material misstatement of the financial information of the component.

h. Any other matters that may be relevant to the group audit or that the component auditor wishes to draw to the attention of the group engagement team, including exceptions noted

in the written representations that the component auditor requested from component management.

Evaluating a Component Auditor's Communication and Adequacy of Their Work (See paragraph .43)

.62 The group engagement team should determine, based on the evaluation required in paragraph .43, whether it is necessary to review other relevant parts of a component auditor's audit documentation. (Ref: par. .A93)

.63 If the group engagement team concludes that the work of a component auditor is insufficient, the group engagement team should determine additional procedures to be performed and whether they are to be performed by the component auditor or by the group engagement team.

Communication With Group Management and Those Charged With Governance of the Group (See paragraphs .46–.49)

.64 The group engagement team should determine which material weaknesses and significant deficiencies in internal control that component auditors have brought to the attention of the group engagement team should be communicated to group management and those charged with governance of the group.

Documentation (See paragraph .50)

.65 The group engagement team should include in the audit documentation the nature, timing, and extent of the group engagement team's involvement in the work performed by the component auditors on significant components, including, when applicable, the group engagement team's review of relevant parts of the component auditors' audit documentation and conclusions thereon.

Application and Other Explanatory Material

Definitions

Component (Ref: par. .11)

.A1

The structure of a group affects how components are identified. For example, the group financial reporting system may be based on an organizational structure that provides for financial information to be prepared by a parent and one or more subsidiaries, joint ventures, or investees accounted for by the equity or cost methods of accounting; by a head office and one or more divisions or branches; or by a combination of both. Some groups, however, may organize their financial reporting system by function, process, product or service (or by groups of products or services), or geographical locations. In these cases, the entity or business activity for which group or component management prepares financial information that is included in the group financial statements may be a function, process, product or service (or group of products or services), or geographical location.

.A2

An investment accounted for under the equity method constitutes a component for purposes of this section. Investments accounted for under the cost method may be analogous to a component for purposes of this section when the work and reports of other auditors constitute a major element of evidence for such investments.

.A3

Various levels of components may exist within the group financial reporting system, in which case it may be more appropriate to identify components at certain levels of aggregation rather than individually.

.A4
Components aggregated at a certain level may constitute a component for purposes of the group audit; however, such a component also may prepare group financial statements that incorporate the financial information of the components it encompasses (that is, a subgroup). This section may, therefore, be applied by different group engagement partners and teams for different subgroups within a larger group.
Considerations Specific to Audits of Governmental Entities
.A5
In audits of state and local governments, a component may be a separate legal entity reported as a component unit or part of the governmental entity, such as a business activity, department, or program.
Significant Component (Ref: par. .11)
.A6
As the individual financial significance of a component increases, the risks of material misstatement of the group financial statements ordinarily increase. The group engagement team may apply a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. Identifying a benchmark and determining a percentage to be applied to it involve the exercise of professional judgment. Depending on the nature and circumstances of the group, appropriate benchmarks might include group assets, liabilities, cash flows, revenues, expenditures, or net income. For example, the group engagement team may consider that components exceeding a specified percentage of the chosen benchmark are significant components.
.A7
The group engagement team also may identify a component as likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances (that is, risks that require special audit consideration[fn 14]). For example, a component could be responsible for foreign exchange trading and, thus, expose the group to a significant risk of material misstatement, even though the component is not otherwise of individual financial significance to the group.
Considerations Specific to Governmental Entities
.A8
In audits of governmental entities, appropriate quantitative benchmarks for identifying significant components might include net costs or total budget. Qualitative considerations in audits of governmental entities may involve matters of heightened public sensitivity, such as national security issues, donor funded projects, or reporting of tax revenue.
Component Auditor (Ref: par. .11)
.A9
For purposes of this section, auditors who do not meet the definition of a member of the group engagement team are considered to be component auditors. However, an auditor who performs work on a component when the group engagement team will not use that work to provide audit evidence for the group audit is not considered a component auditor.
.A10
When two or more component auditors exist, the provisions of this section are applicable to each component auditor.
.A11

A member of the group engagement team may perform work on the financial information of a component for the group audit at the request of the group engagement team. When this is the case, such a member of the group engagement team also is a component auditor.

Consolidation Process (Ref: par. .12)

Considerations Specific to Governmental Entities

.A12

In audits of state and local governments, the applicable financial reporting framework may be based on multiple reporting units. Therefore, the consolidation process may involve the inclusion, but separate presentation, of the financial statements of each reporting unit in the governmental entity.

Responsibility (Ref: par. .13)

.A13

Component auditors may perform work on the financial information of the components for the group audit and, as such, are responsible for their overall findings, conclusions, or opinions. However, regardless of whether reference is made in the auditor's report on the group financial statements to the report of a component auditor, the auditor of the group financial statements is responsible for the group audit opinion.

Considerations Specific to Governmental Entities

.A14

When the auditor of the group financial statements is engaged to express opinions on both the group financial statements and the separate financial statements of the components presented in the group financial statements, the auditor's reporting responsibilities with respect to the separate financial statements are the same as the auditor's responsibilities with respect to the group financial statements.

Acceptance and Continuance

Obtaining an Understanding at the Acceptance or Continuance Stage (Ref: par. .14)

.A15

In the case of a new engagement, the group engagement team's understanding of the group, its components, and their environments may be obtained from the following:

- Information provided by group management
- Communication with group management
- When applicable, communication with the previous group engagement team, component management, or component auditors

.A16

The group engagement team's understanding may include matters such as the following:

- The group structure, including both the legal and organizational structure (that is, how the group financial reporting system is organized)
- Components' business activities that are significant to the group, including the industry and regulatory, economic, and political environments in which those activities take place
- The use of service organizations, including shared service centers
- A description of group-wide controls
- The complexity of the consolidation process

- Whether component auditors that are not from the group engagement partner's firm or network will perform work on the financial information of any of the components and group management's rationale for engaging more than one auditor, if applicable
- Whether the group engagement team
- will have unrestricted access to those charged with governance of the group, group management, those charged with governance of the component, component management, component information, and the component auditors (including relevant audit documentation sought by the group engagement team)
- will be able to perform necessary work on the financial information of the components

.A17

In the case of a continuing engagement, the group engagement team's ability to obtain sufficient appropriate audit evidence may be affected by significant changes, such as the following:

- Changes in the group structure (for example, acquisitions, disposals, reorganizations, or changes in how the group financial reporting system is organized)
- Changes in components' business activities that are significant to the group
- Changes in the composition of those charged with governance of the group, group management, or key management of significant components
- Concerns the group engagement team has with regard to the integrity and competence of group or component management
- Changes in group-wide controls
- Changes in the applicable financial reporting framework

Expectation to Obtain Sufficient Appropriate Audit Evidence (Ref: par. .15)

.A18

Relevant factors in determining whether to act as the auditor of the group financial statements include, among other things, the following:

- The individual financial significance of the components, as determined in accordance with the guidance in paragraph .A6, for which the auditor of the group financial statements will be assuming responsibility
- The extent to which significant risks of material misstatement of the group financial statements are included in the components for which the auditor of the group financial statements will be assuming responsibility
- The extent of the group engagement team's knowledge of the overall financial statements

.A19

A group may consist only of components not considered significant components. In these circumstances, the group engagement partner can reasonably expect to obtain sufficient appropriate audit evidence on which to base the group audit opinion if the group engagement team will be able to

a. perform the work on the financial information of some of these components.

b. use the work performed by component auditors on the financial information of other components to the extent necessary to obtain sufficient appropriate audit evidence.

.A20

When the auditor of the group financial statements is assuming responsibility for the work performed by a component auditor, the group engagement team is required by the provisions of this section to be involved in the work of the component auditor. Paragraph .27 describes the procedures to be followed to obtain sufficient appropriate audit evidence when the group

engagement partner decides to make reference in the auditor's report on the group financial statements to the audit of a component auditor.

Considerations Specific to Governmental Entities

.A21

Additional factors in determining whether to act as the auditor of the group financial statements in audits of state and local governments include, the following:

- Engagement by the primary government as the auditor of the financial reporting entity
- Responsibility for auditing the primary government's general fund (or other primary operating fund)

Access to Information (Ref: par. .16)

.A22

The group engagement team's access to information may be restricted by group management, or it may be restricted by circumstances that cannot be overcome by group management (for example, laws relating to confidentiality and data privacy or denial by a component auditor of access to relevant audit documentation sought by the group engagement team).

.A23

When access to information is restricted by circumstances, the group engagement team may still be able to obtain sufficient appropriate audit evidence; however, this is less likely as the significance of the component increases. For example, the group engagement team may not have access to those charged with governance, management, or the auditor (including relevant audit documentation sought by the group engagement team) of a component that is accounted for by the equity method of accounting. If the component is not a significant component and the group engagement team has a complete set of financial statements of the component, including the auditor's report thereon, and has access to information kept by group management regarding that component, the group engagement team may conclude that this information constitutes sufficient appropriate audit evidence regarding that component. If the component is a significant component, however, and the auditor of the group financial statements is not making reference to the audit of a component auditor in the auditor's report on the group financial statements, then the group engagement team will not be able to comply with the requirements of this section that are relevant in the circumstances of the group audit. For example, the group engagement team will not be able to comply with the requirement in paragraphs .57–.58 to be involved in the work of a component auditor. Therefore, the group engagement team will not be able to obtain sufficient appropriate audit evidence regarding that component. The effect on the auditor's report of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of section 705, *Modifications to the Opinion in the Independent Auditor's Report*.

.A24

The group engagement team will not be able to obtain sufficient appropriate audit evidence if group management restricts the access of the group engagement team or a component auditor to the information of a significant component.

.A25

Although the group engagement team may be able to obtain sufficient appropriate audit evidence if such restriction relates to a component considered not a significant component, the reason for the restriction may affect the group audit opinion. For example, it may affect the reliability of

group management's responses to the group engagement team's inquiries and group management's representations to the group engagement team.

.A26

Section 210 addresses circumstances when an entity is required by law or regulation to have an audit.[fn 15] In these circumstances, this section still applies to the group audit, and the effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of section 705.

.A27

Exhibit A, "Illustrations of Auditor's Reports on Group Financial Statements," contains an example of an auditor's report containing a qualified opinion based on the group engagement team's inability to obtain sufficient appropriate audit evidence regarding a significant component accounted for by the equity method of accounting when, in the group engagement team's professional judgment, the effect is material but not pervasive.

Terms of Engagement (Ref: par. .17)

.A28

The terms of engagement identify the applicable financial reporting framework.[fn 16] Additional matters that may be included in the terms of a group audit engagement include whether reference will be made to the audit of a component auditor in the auditor's report on the group financial statements, when relevant, or arrangements to facilitate the following:

- Unrestricted communication between the group engagement team and component auditors to the extent permitted by law or regulation
- Communication to the group engagement team of important communications between
- the component auditors, those charged with governance of the component, and component management, including communications on significant deficiencies and material weaknesses in internal control
- regulatory authorities and components related to financial reporting matters
- To the extent the group engagement team considers necessary
- access to component information, those charged with governance of components, component management, and the component auditors (including relevant audit documentation sought by the group engagement team)
- permission to perform work, or request a component auditor to perform work, on the financial information of the components

.A29

Certain restrictions imposed after acceptance of the group audit engagement result in an inability to obtain sufficient appropriate audit evidence that may affect the group audit opinion including, specifically, restrictions imposed on the following:

- The group engagement team's access to component information, those charged with governance of components, component management, or the component auditors (including relevant audit documentation sought by the group engagement team)
- The work to be performed on the financial information of the components

These restrictions may even lead to withdrawal from the engagement unless that is not possible under law or regulation. Section 705 addresses the auditor's responsibilities when management has imposed a limitation on the scope of the audit after the auditor has accepted the engagement.[fn 17]

Overall Audit Strategy and Audit Plan (Ref: par. .19)

.A30

The group engagement partner's review of the overall group audit strategy and group audit plan is an important part of fulfilling the group engagement partner's responsibility for the direction of the group audit engagement.

Understanding the Group, Its Components, and Their Environments

Matters About Which the Group Engagement Team Obtains an Understanding (Ref: par. .20)

.A31

Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, contains guidance on matters the auditor may consider when obtaining an understanding of the industry, regulatory, and other external factors that affect the entity, including the applicable financial reporting framework; the nature of the entity; objectives and strategies and related business risks; and measurement and review of the entity's financial performance.[fn 18] Appendix A, "Understanding the Group, Its Components, and Their Environments — Examples of Matters About Which the Group Engagement Team Obtains an Understanding," of this section contains guidance on matters specific to a group, including the consolidation process.

Instructions Issued by Group Management to Components (Ref: par. .20)

.A32

To achieve uniformity and comparability of financial information, group management ordinarily issues instructions to components. Such instructions specify the requirements for financial information of the components to be included in the group financial statements and often include financial reporting procedures manuals and a reporting package. A reporting package ordinarily consists of standard formats for providing financial information for incorporation in the group financial statements. Reporting packages generally do not, however, take the form of complete financial statements prepared and presented in accordance with the applicable financial reporting framework.

.A33

The instructions ordinarily cover the following:

- The accounting policies to be applied
- Statutory and other disclosure requirements applicable to the group financial statements, including the following:
- The identification and reporting of segments
- Related party relationships and transactions
- Intragroup transactions and unrealized profits or losses
- Intragroup account balances
- A reporting timetable

.A34

The group engagement team's understanding of the instructions may include the following:

- The clarity and practicality of the instructions for completing the reporting package
- Whether the instructions
- adequately describe the characteristics of the applicable financial reporting framework

- provide for disclosures that are sufficient to comply with the requirements of the applicable financial reporting framework (for example, disclosure of related party relationships, related party transactions, and segment information)
- provide for the identification of consolidation adjustments (for example, intragroup account balances, transactions, and unrealized profits or losses)
- provide for the approval of the financial information by component management

Fraud (Ref: par. .20)

.A35

The auditor is required to identify and assess the risks of material misstatement of the financial statements due to fraud and to design and implement appropriate responses to the assessed risks.[fn 19] Information used to identify the risks of material misstatement of the group financial statements due to fraud may include the following:

- Group management's assessment of the risks that the group financial statements may be materially misstated as a result of fraud
- Group management's process for identifying and responding to the risks of fraud in the group, including any specific fraud risks identified by group management or account balances, classes of transactions, or disclosures for which a risk of fraud is likely
- Whether particular components exist for which a risk of fraud is likely
- How those charged with governance of the group monitor group management's processes for identifying and responding to the risks of fraud in the group and the controls group management has established to mitigate these risks
- Responses of those charged with governance of the group, group management, appropriate individuals within the internal audit function (and, if considered appropriate, component management, the component auditors, and others) to the group engagement team's inquiry whether they have knowledge of any actual, suspected, or alleged fraud affecting a component or the group

Discussion Among Group Engagement Team Members and Component Auditors Regarding the Risks of Material Misstatement of the Group Financial Statements, Including Risks of Fraud (Ref: par. .20)

.A36

The key members of the engagement team are required to discuss the susceptibility of an entity to material misstatement of the financial statements due to fraud or error, specifically emphasizing the risks due to fraud. In a group audit, these discussions also may include the component auditors.[fn 20] [fn 21] The group engagement partner's determination of who to include in the discussions, how and when they occur, and their extent is affected by factors, such as prior experience with the group.

.A37

The discussions provide an opportunity to

- share knowledge of the components and their environments, including group-wide controls.
- exchange information about the business risks of the components or the group.
- exchange ideas about how and where the group financial statements may be susceptible to material misstatement due to fraud or error; how group management and component

management could perpetrate and conceal fraudulent financial reporting; and how assets of the components could be misappropriated.
- identify practices followed by group or component management that may be biased or designed to manage earnings that could lead to fraudulent financial reporting (for example, revenue recognition practices that do not comply with the applicable financial reporting framework).
- consider known external and internal factors affecting the group that may create an incentive or pressure for group management, component management, or others to commit fraud; provide the opportunity for fraud to be perpetrated; or indicate a culture or environment that enables group management, component management, or others to rationalize committing fraud.
- consider the risk that group or component management may override controls.
- consider whether uniform accounting policies are used to prepare the financial information of the components for the group financial statements and, if not, how differences in accounting policies are identified and adjusted (when required by the applicable financial reporting framework).
- discuss fraud that has been identified in components or information that indicates the existence of a fraud in a component.
- share information that may indicate noncompliance with laws or regulations (for example, payments of bribes and improper transfer pricing practices).

Risk Factors (Ref: par. .21)

.A38

Appendix B, "Examples of Conditions or Events That May Indicate Risks of Material Misstatement of the Group Financial Statements," sets out examples of conditions or events that, individually or together, may indicate risks of material misstatement of the group financial statements, including risks due to fraud.

Risk Assessment (Ref: par. .21)

.A39

The group engagement team's assessment at group level of the risks of material misstatement of the group financial statements is based on information, such as the following:

- Information obtained from the understanding of the group, its components, and their environments and of the consolidation process, including audit evidence obtained in evaluating the design and implementation of group-wide controls and controls that are relevant to the consolidation
- Information obtained from the component auditors

Understanding a Component Auditor (Ref: par. .22)

Group Engagement Team's Procedures to Obtain an Understanding of a Component Auditor and Sources of Audit Evidence (Ref: par. .22)

.A40

Factors that may affect the group engagement partner's decisions whether to use the work of a component auditor to provide audit evidence for the group audit and whether to make reference to the audit of a component auditor in the auditor's report on the group financial statements include the following:

- Differences in the financial reporting framework applied in preparing the financial statements of the component and that applied in preparing the group financial statements
- Whether the audit of the financial statements of the component will be completed in time to meet the group reporting timetable
- Differences in the auditing and other standards applied by the component auditor and those applied in the audit of the group financial statements
- Whether it is impracticable for the group engagement team to be involved in the work of a component auditor

.A41
It will not be necessary to obtain an understanding of the auditors of those components for which the group engagement team plans to perform analytical procedures at group level only.
.A42
The nature, timing, and extent of the group engagement team's procedures to obtain an understanding of a component auditor are affected by factors, such as previous experience with, or knowledge of, the component auditor and the degree to which the group engagement team and the component auditor are subject to common policies and procedures, such as the following:

- Whether the group engagement team and a component auditor share the following:
- Common policies and procedures for performing the work (for example, audit methodologies)
- Common quality control policies and procedures
- Common monitoring policies and procedures
- The consistency or similarity of the following:
- Laws and regulations or legal system
- Professional oversight, discipline, and external quality assurance
- Education and training
- Professional organizations and standards
- Language and culture

.A43
These factors interact and are not mutually exclusive. For example, the extent of the group engagement team's procedures to obtain an understanding of component auditor A, who consistently applies common quality control and monitoring policies and procedures and a common audit methodology or operates in the same jurisdiction as the auditor of the group financial statements, may be less than the extent of the group engagement team's procedures to obtain an understanding of component auditor B, who does not consistently apply common quality control and monitoring policies and procedures and a common audit methodology or operates in a different jurisdiction. The nature of the procedures performed regarding component auditors A and B also may be different.
.A44
The group engagement team may obtain an understanding of a component auditor in a number of ways. In the first year of involving a component auditor, the group engagement team may, for example

- determine through communication with a component auditor that
- the component auditor is aware that

- the financial statements of the component are to be included in the group financial statements on which the auditor of the group financial statements will report.
- the component auditor's report thereon will be relied upon by the auditor of the group financial statements.
- either the auditor of the group financial statements will make reference to the component auditor's report in the opinion on the group financial statements or the group engagement team will be involved in the work of the component auditor.
- a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.
- evaluate the results of the quality control monitoring system when the group engagement team and component auditor are from a firm or network that operates under, and complies with, common monitoring policies and procedures.[fn 22]
- visit a component auditor to discuss the matters in paragraph .22*a–d*.
- request a component auditor to confirm the matters referred to in paragraph .22*a–d* in writing. Exhibit B, "Illustrative Component Auditor's Confirmation Letter," contains an example of written confirmations by a component auditor.
- request a component auditor to complete questionnaires about the matters in paragraph .22*a–d*.
- discuss a component auditor with colleagues in the group engagement partner's firm or with a reputable third party that has knowledge of the component auditor, such as other practitioners or bankers and other credit grantors.

In subsequent years, the understanding of a component auditor may be based on the group engagement team's previous experience with that component auditor. The group engagement team may request the component auditor to confirm whether anything regarding the matters listed in paragraph .22*a–d* has changed since the previous year.

.A45

Where independent oversight bodies have been established to oversee the auditing profession and monitor the quality of audits, awareness of the regulatory environment may assist the group engagement team in evaluating the independence and competence of a component auditor. Information about the regulatory environment and the public results of any inspections performed by oversight bodies may be obtained from the component auditor or information provided by the independent oversight bodies.

Ethical Requirements That Are Relevant to the Group Audit (Ref: par. .22a)

.A46

When performing work on the financial information of a component for a group audit, the component auditor is subject to ethical requirements that are relevant to the group audit. Such requirements may be different or in addition to those applying to the component auditor when performing an audit in the component auditor's jurisdiction. The group engagement team, therefore, obtains an understanding about the component auditor's understanding of, and compliance with, the ethical requirements that are relevant to the group audit and whether that is sufficient to fulfill the component auditor's responsibilities in the group audit. When the component auditor is not subject to the AICPA Code of Professional Conduct, compliance by the component auditor with the ethics and independence requirements set forth in the International

Federation of Accountants *Code of Ethics for Professional Accountants* is sufficient to fulfill the component auditor's ethical responsibilities in the group audit.[fn 23]

A Component Auditor's Professional Competence (Ref: par. .22b)

.A47

Inquiries about the professional reputation and standing of a component auditor may be made of the AICPA, the state board of accountancy by which the component auditor is licensed, the applicable state society of CPAs, or the local chapter, or, in the case of an auditor from a foreign jurisdiction, the corresponding professional organization, and if applicable, the PCAOB. The group engagement team may obtain the peer review report, if available, on the component auditor's firm. Exhibit C, "Sources of Information," provides information about specific inquires that may be directed to the AICPA.

.A48

The group engagement team's understanding of a component auditor's professional competence may include whether the component auditor

- possesses an understanding of the auditing and other standards applicable to the group audit, such as U.S. GAAS, that is sufficient to fulfill the component auditor's responsibilities.
- possesses the special skills (for example, industry-specific knowledge or knowledge of relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies) necessary to perform the work on the financial information of the particular component.
- when relevant, possesses an understanding of the applicable financial reporting framework that is sufficient to fulfill the component auditor's responsibilities in the group audit (instructions issued by group management to components often describe the characteristics of the applicable financial reporting framework).

Application of the Group Engagement Team's Understanding of a Component Auditor (Ref: par. .23)

.A49

The group engagement team cannot overcome the fact that a component auditor is not independent by being involved in the work of the component auditor or by performing additional risk assessment or further audit procedures on the financial information of the component or by making reference in the auditor's report on the group financial statements to the audit of the component auditor.

.A50

However, the group engagement team may be able to overcome less than serious concerns about a component auditor's professional competency (for example, lack of industry-specific knowledge) or the fact that a component auditor does not operate in an environment that actively oversees auditors by being involved in the work of that component auditor or by performing additional risk assessment or further audit procedures on the financial information of the component.

.A51

When law or regulation prohibits access to relevant parts of the audit documentation of a component auditor, the group engagement team may request the component auditor to overcome this by preparing a memorandum that covers the relevant information.

Determining Whether to Make Reference to a Component Auditor in the Auditor's Report on the Group Financial Statements (Ref: par. .24)

.A52

In group audits involving two or more component auditors, the decision to make reference to the audit of a component auditor is made individually for each component auditor, regardless of the decision whether to refer to any other component auditor. The auditor of the group financial statements may make reference to any, all, or none of the component auditors. For example, if significant components are audited by a component auditor from a network firm and one component is audited by another firm, the group engagement partner may decide to assume responsibility for the work of the component auditor from the network firm and to make reference to the work of the component auditor from the other firm.

Determining Whether the Audit Was Conducted in Accordance With GAAS (Ref: par. .25a)

.A53

A component auditor's report stating that the audit was conducted in accordance with GAAS or, if applicable, the auditing standards promulgated by the PCAOB is sufficient to make the determination required by paragraph .25*a*. When the component auditor has performed an audit of the component financial statements in accordance with auditing standards other than GAAS or, if applicable, the auditing standards promulgated by the PCAOB, the group engagement partner may evaluate, exercising professional judgment, whether the audit performed by the component auditor meets the relevant requirements of GAAS. For the purposes of complying with paragraph .25*a*, relevant requirements of GAAS are those that pertain to planning and performing the audit of the component financial statements and do not include those related to the form of the auditor's report. Audits performed in accordance with International Standards on Auditing (ISAs) promulgated by the International Auditing and Assurance Standards Board (IAASB) are more likely to meet the relevant requirements of GAAS than audits performed in accordance with auditing standards promulgated by bodies other than the IAASB. The group engagement team may provide the component auditor with appendix B, *Substantive Differences Between the International Standards on Auditing and Generally Accepted Auditing Standards*, that identifies substantive requirements of GAAS that are not requirements in the ISAs. The component auditor may perform additional procedures in order to meet the relevant requirements of GAAS. The communication requested of the component auditor required by paragraph .42 may address whether the audit of the component auditor met the relevant requirements of GAAS. The group engagement partner, having determined that all relevant requirements of GAAS have been met by the component auditor, may decide to make reference to the audit of that component auditor in the auditor's report on the group financial statements.

Determining Whether to Make Reference When the Financial Reporting Framework Is Not the Same (Ref: par. .26)

.A54

When the component's financial statements are prepared using a financial reporting framework that differs from the financial reporting framework used to prepare the group financial statements, the group engagement team is required by paragraph .37 to evaluate whether the financial information of the component has been appropriately adjusted for purposes of the preparation and fair presentation of the group financial statements in accordance with the applicable financial reporting framework. Evaluating whether the financial statements of the

component have been appropriately adjusted to conform with the financial reporting framework used by the group is based on a depth of understanding of the component's financial statements that ordinarily is not obtained unless the auditor of the group financial statements assumes responsibility for, and, thus, is involved in, the work of the component auditor. In rare circumstances, however, the group engagement partner may conclude that the group engagement team can reasonably expect to obtain sufficient appropriate audit evidence for purposes of evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the group without the need to assume responsibility for, and, thus, be involved in, the work of the component auditor.

.A55

The greater the number of differences or the greater the significance of the differences between the criteria used for measurement, recognition, presentation, and disclosure of all material items in the component's financial statements under the financial reporting framework used by the component and the financial reporting framework used by the group, the less similar they are. Financial statements prepared and presented in accordance with International Financial Reporting Standards (IFRSs) and *International Financial Reporting Standard for Small and Medium-sized Entities*, as issued by the International Accounting Standards Board, are generally viewed as more similar to financial statements prepared and presented in accordance with accounting principles generally accepted in the United States of America (GAAP) than financial statements prepared and presented in accordance with jurisdiction-specific reporting frameworks or adaptations of IFRSs. In most cases, special purpose frameworks set forth in section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, are not similar to GAAP.

.A56

Additional considerations in determining whether it may be appropriate to make reference to the audit of a component auditor in the auditor's report on the group financial statements when the component prepares financial statements using a different financial reporting framework than that used by the group include the

- effectiveness of groupwide controls and the adequacy of the consolidation process specifically related to the adjustments to convert the component's financial statements to the financial reporting framework used by the group, including the financial reporting competencies of personnel involved in the adjustments.
- depth of the group engagement team's understanding of the component and its environment, including the complexity of the events and transactions subject to the differing financial reporting requirements and the assessed risk of material misstatement related to the adjustments.
- extent of the group engagement team's knowledge of the financial reporting framework used to prepare the component financial statements.
- group engagement team's ability to obtain information from group or component management that is relevant to the adjustments.
- need and ability to seek, as necessary, the assistance of professionals possessing specialized skills or knowledge related to the adjustments.

Considerations for Governmental Entities

.A57

When the applicable financial reporting framework used by the group provides for the inclusion of component financial statements that are prepared in accordance with a different financial reporting framework, the component financial statements are deemed to be in accordance with the applicable financial reporting framework used for the group financial statements. For example, both the financial reporting framework established by the Governmental Accounting Standards Board and the financial reporting framework established by the Federal Accounting Standards Advisory Board have such provisions. Accordingly, when the provisions established by the applicable financial reporting framework for inclusion of those component financial statements have been followed, the requirements in paragraphs .26 and .28*c* are not relevant.

Making Reference in the Auditor's Report (Ref: par. .28–.31)

.A58

The disclosure of the magnitude of the portion of the financial statements audited by a component auditor may be achieved by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly describes the portion of the financial statements audited by a component auditor. When two or more component auditors participate in the audit, the dollar amounts or the percentages covered by the component auditors may be stated in the aggregate.

.A59

Reference in the auditor's report on the group financial statements to the fact that part of the audit was conducted by a component auditor is not to be construed as a qualification of the opinion, but rather is intended to communicate (1) that the auditor of the group financial statements is not assuming responsibility for the work of the component auditor, and (2) the source of the audit evidence with respect to those components for which reference to the audit of component auditors is made.

.A60

Exhibit A contains examples of appropriate reporting in the auditor's report on the group financial statements when reference is made to the audit of a component auditor.

.A61

If the modified opinion, emphasis-of-matter paragraph, or other-matter paragraph in the component auditor's report does not affect the report on the group financial statements and the component auditor's report is not presented, the auditor of the group financial statements need not make reference to those paragraphs in the auditor's report on the group financial statements. If the component auditor's report is presented, the auditor of the group financial statements may make reference to those paragraphs and their disposition.

.A62

When the auditor of the group financial statements is assuming responsibility for the work of a component auditor, no reference is made to the component auditor in the report on the group audit because to do so may cause a reader to misinterpret the degree of responsibility being assumed.

Materiality (Ref: par. .32)

.A63

The auditor is required[fn 24]

a. when establishing the overall audit strategy

i. to determine materiality for the financial statements as a whole.

ii. to consider whether, in the specific circumstances of the entity, particular classes of transactions, account balances, or disclosures exist for which there is a substantial likelihood that misstatements of lesser amounts than materiality for the financial statements as a whole would influence the judgment made by a reasonable user based on the financial statements. In such circumstances, the auditor determines materiality to be applied to those particular classes of transactions, account balances, or disclosures.

b. to determine performance materiality for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks.

In the context of a group audit, materiality is established for both the group financial statements as a whole and the financial information of those components on which the group engagement team will perform, or request a component auditor to perform, an audit or review. Materiality for the group financial statements as a whole is used when establishing the overall group audit strategy.

.A64

Different materiality may be established for different components. The aggregate of component materiality may exceed group materiality.

.A65

Consideration of all components, regardless of whether reference is made in the auditor's report on the group financial statements to the audit of a component auditor, is necessary when determining component materiality to reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole. Determining component materiality is necessary for the group engagement team to determine the overall group audit plan for the components for which the auditor of the group financial statements is not making reference to the component auditor.

.A66

When the component is subject to an audit required by law or regulation or performed for another reason, the materiality used by the component auditor for purposes of such audit ordinarily can be expected to be less than the group materiality and, accordingly, be acceptable for purposes of the group audit. In the case of an equity method investment, the investee may be larger than the investor, and the auditor's evidence to support the investor's share of earnings from the investment may consist largely of the audited financial statements of the investee. In such cases, the materiality used by the investee's auditor may be larger than the materiality used by the investor's auditor. When such circumstances exist, the group engagement team may take into consideration matters such as the group's ownership percentage and its share of the investee's profits and losses when determining whether the component materiality used by the investee's auditor is appropriate for purposes of the audit of the group financial statements.

.A67

A threshold for misstatements is determined in addition to component materiality. Misstatements identified in the financial information of the component that are above the threshold for misstatements of the group are communicated to the group engagement team. [

Responding to Assessed Risks (Ref: par. .33)

.A68

In an audit of group financial statements, appropriate responses to assessed risks of material misstatement for some or all classes of transactions or account balances may be implemented at the group level, without the involvement of component auditors.

Consolidation Process

Consolidation Adjustments and Reclassifications (Ref: par. .36)

.A69

The consolidation process may require adjustments to amounts reported in the group financial statements that do not pass through the usual transaction processing systems and may not be subject to the same internal controls to which other financial information is subject. The group engagement team's evaluation of the appropriateness, completeness, and accuracy of the adjustments may include the following:

- Evaluating whether significant adjustments appropriately reflect the events and transactions underlying them
- Determining whether significant adjustments have been correctly calculated, processed, and authorized by group management and, when applicable, by component management
- Determining whether significant adjustments are properly supported and sufficiently documented
- Checking the reconciliation and elimination of intragroup account balances, transactions, and unrealized profits or losses
- Communicating with the component auditor, regardless of whether reference is made in the auditor's report on the group financial statements to the audit of the component auditor.

Subsequent Events (Ref: par. .40)

.A70

When the auditor's report on the group financial statements will make reference to the audit of a component auditor, procedures designed to identify subsequent events between the date of the component auditor's report and the date of the auditor's report on the group financial statements may include

- obtaining an understanding of any procedures that group management has established to ensure that such subsequent events are identified.
- requesting the component auditor to update subsequent events procedures to the date of the auditor's report on the group financial statements.
- requesting written representation from component management regarding subsequent events.
- reading available interim financial information of the component and making inquiries of group management.
- reading minutes of meetings of the governing board, or any other administrative board with management oversight, held since the financial statement date.
- reading the subsequent year's capital and operating budgets.
- inquiring of group management regarding currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations for items that represent subsequent events.
- considering the implications for the auditor's report on the group financial statements if the group engagement team has been unable to obtain sufficient appropriate audit evidence regarding subsequent events.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Sufficiency and Appropriateness of Audit Evidence (Ref: par. .44–.45)

.A71

If the group engagement team concludes that sufficient appropriate audit evidence on which to base the group audit opinion has not been obtained, the group engagement team may request a component auditor to perform additional procedures. Alternatively, the group engagement team may perform its own procedures on the financial information of the component.

.A72

The group engagement partner's evaluation of the aggregate effect of any misstatements (either identified by the group engagement team or communicated by component auditors) allows the group engagement partner to determine whether the group financial statements as a whole are materially misstated.

Communication With Group Management and Those Charged With Governance of the Group

Communication With Group Management (Ref: par. .46–.48)

.A73

Section 240, *Consideration of Fraud in a Financial Statement Audit*, contains requirements and guidance on communication of fraud to management and, when management may be involved in the fraud, those charged with governance.[fn 25]

.A74

Group management may need to keep certain material sensitive information confidential. Examples of matters that may be significant to the financial statements of the component of which component management may be unaware include the following:

- Potential litigation
- Plans for abandonment of material operating assets
- Subsequent events
- Significant legal agreements

Communication With Those Charged With Governance of the Group (Ref: par. .49)

.A75

The matters the group engagement team communicates to those charged with governance of the group may include those brought to the attention of the group engagement team by component auditors that the group engagement team judges to be significant to the responsibilities of those charged with governance of the group. Communication with those charged with governance of the group takes place at various times during the group audit. For example, the matters referred to in paragraph .49*a–b* may be communicated after the group engagement team has determined the work to be performed on the financial information of the components. On the other hand, the matter referred to in paragraph .49*c* may be communicated at the end of the audit, and the matters referred to in paragraph .49*d–e* may be communicated when they occur.

Additional Requirements Applicable When Assuming Responsibility for the Work of a Component Auditor

Materiality (Ref: par. .51)

.A76

Component materiality for those components whose financial information will be audited or reviewed as part of the group audit in accordance with paragraphs .53, .54*a*, and .56, is communicated to the component auditor and is used by the component auditor to evaluate whether uncorrected detected misstatements are material, individually or in the aggregate.

.A77

In the case of an audit of the financial information of a component, section 320, *Materiality in Planning and Performing an Audit*, requires the component auditor (or group engagement team) to determine performance materiality for purposes of assessing the risks of material misstatement of the financial information of the component and to design further audit procedures in response to assessed risks.[fn 26] This is necessary to reduce the risk that the aggregate of detected and undetected misstatements in the financial information of the component exceeds component materiality. In practice, the group engagement team may set component materiality at the level of performance materiality for the component. When this is the case, the component auditor uses component materiality for purposes of assessing the risks of material misstatement of the financial information of the component and to design further audit procedures in response to assessed risks, as well as for evaluating whether detected misstatements are material individually or in the aggregate.

Determining the Type of Work to Be Performed on the Financial Information of Components

Significant Components (Ref: par. .53–.54)

.A78

Adapting an audit of the financial information of a significant component to meet the specific needs of the group engagement team may include requesting the component auditor to

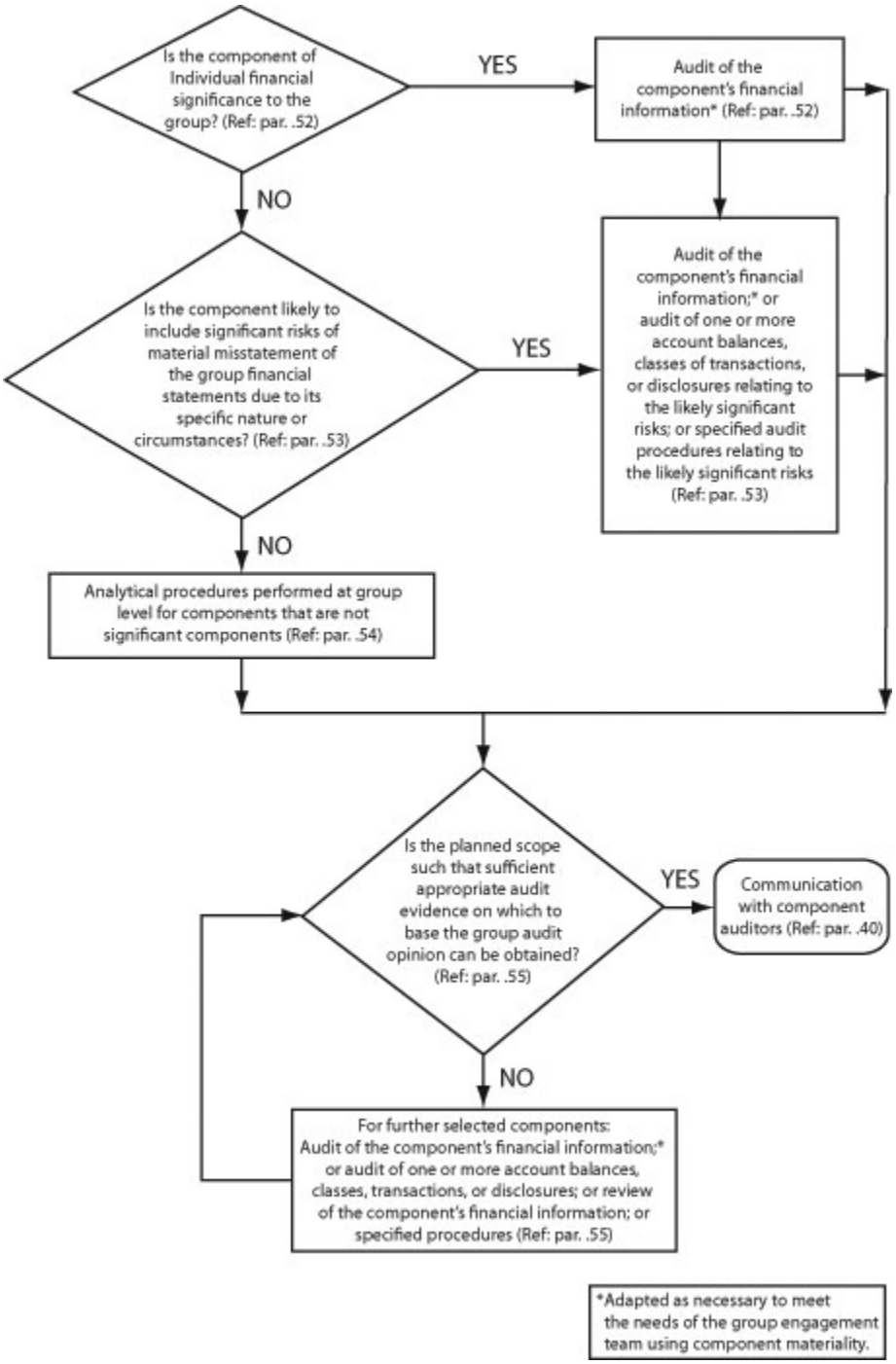
- perform an audit, using component materiality, in accordance with GAAS, with the exception of performing audit procedures on, for example, tax accounts or litigation, claims, and assessments because those procedures are performed at the group level.
- communicate the results of the audit in a form that is responsive to the needs of the group engagement team.

.A79

The group engagement team's determination of the type of work to be performed on the financial information of a component and its involvement in the work of the component auditor is affected by the following:

a. The significance of the component
b. The identified significant risks of material misstatement of the group financial statements
c. The group engagement team's evaluation of the design of group-wide controls and the determination of whether they have been implemented
d. The group engagement team's understanding of the component auditor

The following diagram shows how the significance of the component affects the group engagement team's determination of the type of work to be performed on the financial information of the component.



.A80

The group engagement team may identify a component as a significant component because that component is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances. In that case, the group engagement team may be able to identify the account balances, classes of transactions, or disclosures affected by the likely significant risks. When this is the case, the group engagement team may decide to perform or request a component auditor to perform an audit, adapted as necessary to meet the

needs of the group engagement team, of only those account balances, classes of transactions, or disclosures. For example, in the situation described in paragraph .A7, the work on the financial information of the component may be limited to an audit of the account balances, classes of transactions, and disclosures affected by the foreign exchange trading of that component. When the group engagement team requests a component auditor to perform an audit of one or more specific account balances, classes of transactions, or disclosures, the communication of the group engagement team (see paragraph .41) takes account of the fact that many financial statement items are interrelated.

.A81

The group engagement team may design audit procedures that respond to a likely significant risk of material misstatement of the group financial statements. For example, in the case of a likely significant risk of inventory obsolescence, the group engagement team may perform or request a component auditor to perform specified audit procedures on the valuation of inventory at a component that holds a large volume of potentially obsolete inventory but that is not otherwise significant.

Components That Are Not Significant Components (Ref: par. .55–.56)

.A82

Depending on the circumstances of the engagement, the financial information of the components may be aggregated at various levels for purposes of the analytical procedures. The results of the analytical procedures corroborate the group engagement team's conclusions that no significant risks of material misstatement exist of the aggregated financial information of components that are not significant components.

.A83

The group engagement team's decision about how many components to select in accordance with paragraph .56, which components to select, and the type of work to be performed on the financial information of the individual components selected may be affected by factors, such as the following:

- The extent of audit evidence expected to be obtained on the financial information of the significant components
- Whether the component has been newly formed or acquired
- Whether significant changes have taken place in the component
- Whether the internal audit function has performed work at the component and any effect of that work on the group audit
- Whether the components apply common systems and processes
- The operating effectiveness of group-wide controls
- Abnormal fluctuations identified by analytical procedures performed at group level
- The individual financial significance of, or the risk posed by, the component in comparison with other components within this category
- Whether the component is subject to an audit required by law or regulation or performed for another reason

Including an element of unpredictability in selecting components in this category may increase the likelihood of identifying material misstatement of the components' financial information. The selection of components is often varied on a cyclical basis.

.A84

An audit of a component that is not a significant component may have already been performed. Once the group engagement team decides to use that work to provide audit evidence for the group audit, the provisions of this section apply.

.A85

A review of the financial information of a component may be performed in accordance with Statements on Standards for Accounting and Review Services, adapted as necessary in the circumstances. A review is designed to obtain only limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. The group engagement team also may specify additional procedures to supplement this work.

.A86

As explained in paragraph .A19, a group may consist only of components that are not significant components. In these circumstances, the group engagement team can obtain sufficient appropriate audit evidence on which to base the group audit opinion by determining the type of work to be performed on the financial information of the components, in accordance with paragraph .56. It is unlikely that the group engagement team will obtain sufficient appropriate audit evidence on which to base the group audit opinion if the group engagement team or a component auditor only tests group-wide controls and performs analytical procedures on the financial information of the components.

Involvement in the Work Performed by Component Auditors (Ref: par. .57–.58)

.A87

Factors that may affect the group engagement team's involvement in the work of a component auditor include the following:

a. The significance of the component
b. The identified significant risks of material misstatement of the group financial statements
c. The group engagement team's understanding of the component auditor

In the case of a significant component or identified significant risks, the group engagement team performs the procedures described in paragraphs .57–.58. In the case of a component that is not a significant component, the nature, timing, and extent of the group engagement team's involvement in the work of the component auditor will vary based on the group engagement team's understanding of that component auditor. The fact that the component is not a significant component becomes secondary. For example, even though a component is not considered a significant component, the group engagement team, nevertheless, may decide to be involved in the component auditor's risk assessment because it has concerns (although less than serious concerns) about the component auditor's professional competency (for example, lack of industry-specific knowledge), or the component auditor does not operate in an environment that actively oversees auditors.

.A88

Forms of involvement in the work of a component auditor other than those described in paragraphs .43 and .57–.58 may, based on the group engagement team's understanding of the component auditor, include one or more of the following:

- Meeting with component management or the component auditor to obtain an understanding of the component and its environment.
- Reviewing the component auditor's overall audit strategy and audit plan.

- Performing risk assessment procedures to identify and assess the risks of material misstatement at the component level. These may be performed with the component auditor or by the group engagement team.
- Designing and performing further audit procedures. These may be designed and performed with the component auditor or by the group engagement team.
- Participating in the closing and other key meetings between the component auditor and component management.
- Reviewing other relevant parts of the component auditor's audit documentation.

Communication With a Component Auditor (Ref: par. .60)

.A89

If effective two-way communication does not exist between the group engagement team and component auditors, whose work the auditor of the group financial statements is assuming responsibility for, a risk exists that the group engagement team may not obtain sufficient appropriate audit evidence on which to base the group audit opinion. Clear and timely communication of the group engagement team's requirements forms the basis of effective two-way communication between the group engagement team and a component auditor. This two-way communication also may be initiated by the component auditor regarding matters that may be significant to the component audit such as

- transactions, adjustments, or other matters that have come to the group engagement team's attention that it believes require adjustment to or disclosure in the financial statements of the component being audited by the component auditor.
- any relevant limitation on the scope of the audit performed by the group engagement team.

.A90

The group engagement team's requirements often are communicated in a letter of instruction. Appendix C, "Required and Additional Matters Included in the Group Engagement Team's Letter of Instruction," contains guidance on required and additional matters that may be included in such a letter of instruction. A component auditor's communication with the group engagement team often takes the form of a memorandum or report of work performed. Communication between the group engagement team and a component auditor, however, may not necessarily be in writing. For example, the group engagement team may visit the component auditor to discuss identified significant risks or review relevant parts of the component auditor's audit documentation. Nevertheless, the documentation requirements of this section and other AU-C sections apply.

.A91

In cooperating with the group engagement team, a component auditor, for example, would provide the group engagement team with access to relevant audit documentation, if not prohibited by law or regulation.

.A92

When a member of the group engagement team is also a component auditor, the objective for the group engagement team to communicate clearly with the component auditor often can be achieved by means other than specific written communication. For example

- access by the component auditor to the overall audit strategy and audit plan may be sufficient to communicate the group engagement team's requirements set out in paragraph .41.
- a review of the component auditor's audit documentation by the group engagement team may be sufficient to communicate matters relevant to the group engagement team's conclusion set out in paragraph .42.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Reviewing a Component Auditor's Audit Documentation (Ref: par. .62)

.A93

The parts of the audit documentation of a component auditor that will be relevant to the group audit may vary depending on the circumstances. Often, the focus is on audit documentation that is relevant to the significant risks of material misstatement of the group financial statements. The extent of the review may be affected by the fact that a component auditor's audit documentation has been subjected to the review procedures of the component auditor's firm.

Appendix A — Understanding the Group, Its Components, and Their Environments — Examples of Matters About Which the Group Engagement Team Obtains an Understanding (Ref: par. .A31)

.A94

The examples provided cover a broad range of matters; however, not all matters are relevant to every group audit engagement, and the list of examples is not necessarily complete.

Group-Wide Controls

Group-wide controls may include a combination of the following:

- Regular meetings between group and component management to discuss business developments and review performance
- Monitoring of components' operations and their financial results, including regular reporting routines, which enables group management to monitor components' performance against budgets and take appropriate action
- Group management's risk assessment process (that is, the process for identifying, analyzing, and managing business risks, including the risk of fraud, that may result in material misstatement of the group financial statements)
- Monitoring, controlling, reconciling, and eliminating intragroup account balances, transactions, and unrealized profits or losses at group level
- A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components
- A central IT system controlled by the same general IT controls for all or part of the group
- Control activities within an IT system that are common for all or some components
- Monitoring of controls, including activities of the internal audit function and self-assessment programs
- Consistent policies and procedures, including a group financial reporting procedures manual
- Group-wide programs, such as codes of conduct and fraud prevention programs
- Arrangements for assigning authority and responsibility to component management

The internal audit function may be regarded as part of group-wide controls, for example, when the function is centralized. Section 610, *Using the Work of Internal Auditors*, addresses the group

engagement team's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of internal auditors, the level of competence of the internal audit function, and whether the function applies a systematic and disciplined approach when the group engagement team expects to use the function's work.[fn 1]

Consolidation Process

The group engagement team's understanding of the consolidation process may include matters such as the following:

- Matters relating to the applicable financial reporting framework, such as the following:
- The extent to which component management has an understanding of the applicable financial reporting framework
- The process for identifying and accounting for components, in accordance with the applicable financial reporting framework
- The process for identifying reportable segments for segment reporting, in accordance with the applicable financial reporting framework
- The process for identifying related party relationships and related party transactions for reporting, in accordance with the applicable financial reporting framework
- The accounting policies applied to the group financial statements, changes from those of the previous financial year, and changes resulting from new or revised standards under the applicable financial reporting framework
- The procedures for dealing with components with financial year-ends different from the group's year-end
- Matters relating to the consolidation process, such as the following:
- Group management's process for obtaining an understanding of the accounting policies used by components and, when applicable, ensuring that uniform accounting policies are used to prepare the financial information of the components for the group financial statements and that differences in accounting policies are identified and adjusted, when required, in terms of the applicable financial reporting framework. Uniform accounting policies are the specific principles, bases, conventions, rules, and practices adopted by the group, based on the applicable financial reporting framework, that the components use to report similar transactions consistently. These policies are ordinarily described in the financial reporting procedures manual and reporting package issued by group management.
- Group management's process for ensuring complete, accurate, and timely financial reporting by the components for the consolidation.
- The process for translating the financial information of foreign components into the currency of the group financial statements.
- How IT is organized for the consolidation, including the manual and automated stages of the process and the manual and programmed controls in place at various stages of the consolidation process.
- Group management's process for obtaining information on subsequent events.
- Matters relating to consolidation adjustments, such as the following:
- The process for recording consolidation adjustments, including the preparation, authorization, and processing of related journal entries and the experience of personnel responsible for the consolidation
- The consolidation adjustments required by the applicable financial reporting framework

- Business purpose for the events and transactions that gave rise to the consolidation adjustments
- Frequency, nature, and size of transactions between components
- Procedures for monitoring, controlling, reconciling, and eliminating intragroup account balances, transactions, and unrealized profits or losses
- Steps taken to arrive at the fair value of acquired assets and liabilities, procedures for amortizing goodwill (when applicable), and impairment testing of goodwill, in accordance with the applicable financial reporting framework
- Arrangements with a controlling interest or noncontrolling interest regarding losses incurred by a component (for example, an obligation of the noncontrolling interest to compensate such losses)

Appendix B — Examples of Conditions or Events That May Indicate Risks of Material Misstatement of the Group Financial Statements (Ref: par. .A38)

.A95

The examples provided cover a broad range of conditions or events; however, not all conditions or events are relevant to every group audit engagement, and the following list of examples is not necessarily complete:

- A complex group structure, especially when there are frequent acquisitions, disposals, or reorganizations
- Poor corporate governance structures, including decision-making processes, that are not transparent
- Nonexistent or ineffective group-wide controls, including inadequate group management information on monitoring of components' operations and their results
- Components operating in foreign jurisdictions that may be exposed to factors, such as unusual government intervention in areas such as trade and fiscal policy, restrictions on currency and dividend movements, and fluctuations in exchange rates
- Business activities of components that involve high risk, such as long-term contracts or trading in innovative or complex financial instruments
- Uncertainties regarding which components' financial information requires incorporation in the group financial statements, in accordance with the applicable financial reporting framework (for example, whether any special purpose entities or nontrading entities exist and require incorporation)
- Unusual related party relationships and transactions
- Prior occurrences of intragroup account balances that did not balance or reconcile on consolidation
- The existence of complex transactions that are accounted for in more than one component
- Components' application of accounting policies that differ from those applied to the group financial statements
- Components with different financial year-ends, which may be utilized to manipulate the timing of transactions
- Prior occurrences of unauthorized or incomplete consolidation adjustments
- Aggressive tax planning within the group or large cash transactions with entities in tax havens
- Frequent changes of auditors engaged to audit the financial statements of components

Appendix C — Required and Additional Matters Included in the Group Engagement Team's Letter of Instruction (Ref: par. .A90)

.A96

The following matters are relevant to the planning of the work of a component auditor: [*Required matters are italicized.*]

- *A request for the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, to confirm that the component auditor will cooperate with the group engagement team*
- The timetable for completing the audit
- Dates of planned visits by group management and the group engagement team and dates of planned meetings with component management and the component auditor
- A list of key contacts
- *The work to be performed by the component auditor, the use to be made of that work,* and arrangements for coordinating efforts at the initial stage of and during the audit, including the group engagement team's planned involvement in the work of the component auditor
- *The ethical requirements that are relevant to the group audit and, in particular, the independence requirements*
- *In the case of an audit or review of the financial information of the component, component materiality*
- *In the case of an audit or review of, or specified audit procedures performed on, the financial information of the component, the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements*
- *A list of related parties prepared by group management and any other related parties of which the group engagement team is aware and a request that the component auditor communicates on a timely basis to the group engagement team related parties not previously identified by group management or the group engagement team*
- Work to be performed on intragroup account balances, transactions, and unrealized profits or losses
- Guidance on other statutory reporting responsibilities (for example, reporting on group management's assertion on the effectiveness of internal control)
- When a time lag between completion of the work on the financial information of the components and the group engagement team's conclusion on the group financial statements is likely, specific instructions for a subsequent events review

The following matters are relevant to the conduct of the work of the component auditor:

- The findings of the group engagement team's tests of control activities of a processing system that is common for all or some components and tests of controls to be performed by the component auditor
- *Identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor and a request that the component auditor communicates on a timely basis any other significant risks of material misstatement of the group financial statements, due to fraud or error, identified in the component and the component auditor's response to such risks*
- The findings of the internal audit function, based on work performed on controls at or relevant to components

- A request for timely communication of audit evidence obtained from performing work on the financial information of the components that contradicts the audit evidence on which the group engagement team originally based the risk assessment performed at group level
- A request for a written representation on component management's compliance with the applicable financial reporting framework or a statement that differences between the accounting policies applied to the financial information of the component and those applied to the group financial statements have been disclosed
- Matters to be documented by the component auditor

Other information, such as the following:

- A request that the following be reported to the group engagement team on a timely basis:
- Significant accounting, financial reporting, and auditing matters, including accounting estimates and related judgments
- Matters relating to the going concern status of the component
- Matters relating to litigation and claims
- Material weaknesses in controls that have come to the attention of the component auditor during the performance of the work on the financial information of the component and information that indicates the existence of fraud
- A request that the group engagement team be notified of any significant or unusual events as early as possible
- A request that the matters listed in paragraph .49 be communicated to the group engagement team when the work on the financial information of the component is completed

Exhibit A — Illustrations of Auditor's Reports on Group Financial Statements

.A97

Illustration 1 — A Report With a Qualified Opinion When the Group Engagement Team Is Not Able to Obtain Sufficient Appropriate Audit Evidence on Which to Base the Group Audit Opinion (Ref: par. .A27)

Illustration 2 — A Report in Which the Auditor of the Group Financial Statements Is Making Reference to the Audit of the Financial Statements of a Component Prepared Using the Same Financial Reporting Framework as That Used for the Group Financial Statements and Performed by a Component Auditor in Accordance With Generally Accepted Auditing Standards (Ref: par. .A60)

Illustration 3 — A Report in Which the Auditor of the Group Financial Statements Is Making Reference to the Audit of the Financial Statements of a Component Prepared Using a Different Financial Reporting Framework Than That Used for the Group Financial Statements and Performed by a Component Auditor in Accordance With GAAS (Ref: par. .A60)

Illustration 4 — A Report in Which the Auditor of the Group Financial Statements Is Making Reference to the Audit of the Financial Statements of a Component Prepared Using the Same Financial Reporting Framework as That Used for the Group Financial Statements and Performed by a Component Auditor in Accordance With Auditing Standards Other Than GAAS (Ref: par. .A60)

Illustration 1 — A Report With a Qualified Opinion When the Group Engagement Team Is Not Able to Obtain Sufficient Appropriate Audit Evidence on Which to Base the Group Audit Opinion

Circumstances include the following:

- Audit of a complete set of consolidated general purpose financial statements (comparative).
- Management is responsible for the preparation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America as promulgated by the Financial Accounting Standards Board.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in section 210, *Terms of Engagement*.
- The group engagement team is unable to obtain sufficient appropriate audit evidence relating to a significant component accounted for by the equity method because the group engagement team was unable to obtain the audited financial statements of the component as of December 31, 20X1 and 20X0, including the auditor's report thereon. In this example, the auditor of the group financial statements is not making reference to the report of a component auditor. In the auditor's professional judgment, the effect on the group financial statements of this inability to obtain sufficient appropriate audit evidence is material but not pervasive. Accordingly, the auditor's report contains a qualified opinion.
- Based on the audit evidence obtained, the auditor has concluded that there are no conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in accordance with section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.
- The auditor has obtained all the other information prior to the date of the auditor's report, and the qualified opinion on the consolidated financial statements also affects the other information included in the annual report.
- The auditor has not been engaged to communicate key audit matters.

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Consolidated Financial Statements fn 1

Qualified Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 20X1 and 20X0, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of ABC Company and its subsidiaries as of December 31, 20X1 and 20X0, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Qualified Opinion

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_____ and $_____ at December 31, 20X1 and 20X0, respectively, or its equity in earnings of that affiliate of $_____ and $_____, which is

included in net income for the years then ended as described in Note X to the consolidated financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC Company and its subsidiaries and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for [*insert the time period set by the applicable financial reporting framework*].

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risk. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.[fn 2]
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the consolidated financial statements.

- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the audit.

***Other Information* [or another title, if appropriate, such as "Information Other Than the Financial Statements and Auditor's Report Thereon"]**

[*Reporting in accordance with the reporting requirements in section 720,* The Auditor's Responsibilities Relating to Other Information Included in Annual Reports.]

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Signature of auditor's firm*] [*City and state where the auditor's report is issued*] [*Date of the auditor's report*]

Illustration 2 — A Report in Which the Auditor of the Group Financial Statements Is Making Reference to the Audit of the Financial Statements of a Component Prepared Using the Same Financial Reporting Framework as That Used for the Group Financial Statements and Performed by a Component Auditor in Accordance With Generally Accepted Auditing Standards

Circumstances include the following:

- Audit of a complete set of consolidated general purpose financial statements (comparative).
- Management is responsible for the preparation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America as promulgated by the Financial Accounting Standards Board.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in section 210, *Terms of Engagement*.
- The auditor of the group financial statements is making reference to the audit of the financial statements of a component prepared using the same financial reporting framework as that used for the group financial statements and performed by a component auditor in accordance with generally accepted auditing standards (GAAS).
- The auditor has concluded that an unmodified (that is, "clean") opinion is appropriate based on the audit evidence obtained.
- Based on the audit evidence obtained, the auditor has concluded that there are no conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in accordance with section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.
- The auditor has obtained all the other information prior to the date of the auditor's report and has not identified an uncorrected material misstatement of the other information included in the annual report.
- The auditor has not been engaged to communicate key audit matters.

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Consolidated Financial Statements [fn 1]

Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 20X1 and 20X0, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, based on our audits and the report of the other auditors, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of ABC Company and its subsidiaries as of December 31, 20X1 and 20X0, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

We did not audit the financial statements of B Company, a wholly owned subsidiary, which statements reflect total assets constituting 20 percent and 22 percent, respectively, of consolidated total assets at December 31, 20X1 and 20X0, and total revenues constituting 18 percent and 20 percent, respectively, of consolidated total revenues for the years then ended. Those statements were audited by other auditors, whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for [*insert the time period set by the applicable financial reporting framework*].

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial

likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.
In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risk. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.[fn 2]
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the consolidated financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the audit.
***Other Information* [or another title, if appropriate, such as "Information Other Than the Financial Statements and Auditor's Report Thereon"]**
[*Reporting in accordance with the reporting requirements in section 720,* The Auditor's Responsibilities Relating to Other Information Included in Annual Reports.]
Report on Other Legal and Regulatory Requirements
[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities.*]
[*Signature of auditor's firm*] [*City and state where the auditor's report is issued*] [*Date of the auditor's report*]
Illustration 3— A Report in Which the Auditor of the Group Financial Statements Is Making Reference to the Audit of the Financial Statements of a Component Prepared Using a Different Financial Reporting Framework From That Used for the Group Financial Statements and Performed by a Component Auditor in Accordance With GAAS
Circumstances are the same as in illustration 2, except in this example, the auditor of the group financial statements is making reference to the audit of the financial statements of a component prepared using a different financial reporting framework than that used for the group financial statements and performed by a component auditor in accordance with GAAS.
Independent Auditor's Report
[*Appropriate Addressee*]
Report on the Consolidated Financial Statements [fn 1]
Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 20X1 and 20X0, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, based on our audits and the report of the other auditors, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of ABC Company and its subsidiaries as of December 31, 20X1 and 20X0, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

We did not audit the financial statements of B Company, a wholly owned subsidiary, which statements reflect total assets constituting 20 percent and 22 percent, respectively, of consolidated total assets at December 31, 20X1 and 20X0, and total revenues constituting 18 percent and 20 percent, respectively, of consolidated total revenues for the years then ended. Those statements, which were prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board, were audited by other auditors, whose report has been furnished to us. We have applied audit procedures on the conversion adjustments to the financial statements of B Company, which conform those financial statements to accounting principles generally accepted in the United States of America. Our opinion, insofar as it relates to the amounts included for B Company, prior to these conversion adjustments, is based solely on the report of the other auditors.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for [*insert the time period set by the applicable financial reporting framework*].

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the

override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.
In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risk. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.[fn 2]
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the consolidated financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the audit.
Report on Other Legal and Regulatory Requirements
[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities.*]
[*Signature of auditor's firm*] [*City and state where the auditor's report is issued*] [*Date of the auditor's report*]
Illustration 4 — A Report in Which the Auditor of the Group Financial Statements Is Making Reference to the Audit of the Financial Statements of a Component Prepared Using the Same Financial Reporting Framework as That Used for the Group Financial Statements and Performed by a Component Auditor in Accordance With Auditing Standards Other Than GAAS
Circumstances are the same as in illustration 2, except in this example, the auditor of the group financial statements is making reference to the audit of the financial statements of a component prepared using the same financial reporting framework as that used for the group financial statements and performed by a component auditor in accordance with auditing standards other than GAAS or standards promulgated by the Public Company Accounting Oversight Board. The group engagement partner has determined that the component auditor performed additional audit procedures to meet the relevant requirements of GAAS. If additional procedures were not necessary for the audit of the component auditor to meet the relevant requirements of GAAS, illustration 2 is applicable.
Independent Auditor's Report
[*Appropriate Addressee*]
Report on the Consolidated Financial Statements [fn 1]

Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 20X1 and 20X0, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, based on our audits and the report of, and additional audit procedures performed by, the other auditors, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of ABC Company and its subsidiaries as of December 31, 20X1 and 20X0, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

We did not audit the financial statements of B Company, a wholly owned subsidiary, which statements reflect total assets constituting 20 percent and 22 percent, respectively, of consolidated total assets at December 31, 20X1 and 20X0, and total revenues constituting 18 percent and 20 percent, respectively, of consolidated total revenues for the years then ended. Those statements were audited by other auditors in accordance with [describe the set of auditing standards], whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of, and additional audit procedures to meet the relevant requirements of auditing standards generally accepted in the United States of America performed by, the other auditors.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for [*insert the time period set by the applicable financial reporting framework*].

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the

override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.
In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risk. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.[fn 2]
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the consolidated financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the audit.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Signature of auditor's firm*] [*City and state where the auditor's report is issued*] [*Date of the auditor's report*]

Exhibit B — Illustrative Component Auditor's Confirmation Letter (Ref: par. .A44) .A98

The following is not intended to be a standard letter. Confirmations may vary from one component auditor to another and from one period to the next. In this example, confirmations expected only when the auditor of the group financial statements is assuming responsibility have been italicized.
Confirmations often are obtained before work on the financial information of the component commences.

[*Component Auditor Letterhead*]

[*Date*]

[*To Audit Firm*]

This letter is provided in connection with your audit of the group financial statements of [*name of parent*] as of and for the year ended [*date*] for the purpose of expressing an opinion on whether the group financial statements present fairly, in all material respects, the financial

position of the group as of [*date*] and of the results of its operations and its cash flows for the year then ended in accordance with [*indicate applicable financial reporting framework*].
We acknowledge receipt of your instructions dated [*date*], requesting us to perform the specified work on the financial information of [*name of component*] as of and for the year ended [*date*].
We confirm that:
1. *We will be able to comply with the instructions. / We advise you that we will not be able to comply with the following instructions [*specify instructions*] for the following reasons [*specify reasons*].*
2. *The instructions are clear, and we understand them. / We would appreciate it if you could clarify the following instructions [*specify instructions*].*
3. *We will cooperate with you and provide you with access to relevant audit documentation.*

We acknowledge that:
1. The financial information of [*name of component*] will be included in the group financial statements of [*name of parent*].
2. *You may consider it necessary to be further involved in the work you have requested us to perform on the financial information of [*name of component*] as of and for the year ended [*date*].*
3. *You intend to evaluate and, if considered appropriate, use our work for the audit of the group financial statements of [*name of parent*].*

In connection with the work that we will perform on the financial information of [*name of component*], a [*describe component, e.g., wholly-owned subsidiary, subsidiary, joint venture, investee accounted for by the equity or cost methods of accounting*] of [*name of parent*], we confirm the following:
1. We have an understanding of [*indicate relevant ethical requirements*] that is sufficient to fulfill our responsibilities in the audit of the group financial statements and will comply therewith. In particular, and with respect to [*name of parent*] and the other components in the group, we are independent within the meaning of [*indicate relevant ethical requirements*] and comply with the applicable requirements of [*refer to rules*] promulgated by [*name of regulatory agency*].
2. We have an understanding of auditing standards generally accepted in the United States of America and [*indicate other auditing standards applicable to the audit of the group financial statements, such as* Government Auditing Standards] that is sufficient to fulfill our responsibilities in the audit of the group financial statements and will conduct our work on the financial information of [*name of component*] as of and for the year ended [*date*] in accordance with those standards.
3. We possess the special skills (e.g., industry specific knowledge) necessary to perform the work on the financial information of the particular component.
4. We have an understanding of [*indicate applicable financial reporting framework or group financial reporting procedures manual*] that is sufficient to fulfill our responsibilities in the audit of the group financial statements.

We will inform you of any changes in the above representations during the course of our work on the financial information of [*name of component*].
[*Auditor's signature*]

Illustration of Potential Component Auditor Representations in Governmental Entities and Not-for-Profit Organizations

5. We have an understanding of relevant laws and regulations that may have a direct and material effect on the financial statements of [*name of component*]. In particular, we have an understanding of [*indicate relevant laws and regulations*].

Exhibit C — Sources of Information (Ref: par. .A47)

.A99

The AICPA Professional Ethics Team can respond to inquiries about whether individuals are members of the AICPA and whether complaints against members have been adjudicated by the Joint Trial Board. The team cannot respond to inquiries about public accounting firms or provide information about letters of required corrective action issued by the team or pending disciplinary proceedings or investigations. The AICPA Peer Review Program staff or the applicable state CPA society administering entity can respond to inquiries about whether specific public accounting firms are enrolled in the AICPA Peer Review Program and the date of acceptance and the period covered by the firm's most recently accepted peer review.

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fn 1 Paragraph .16 of section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.
fn 2 Paragraph .A36 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.
fn 3 *Group engagement partner* and *firm* refer to their governmental equivalents when relevant.
fn 4 Paragraph .17 of section 220.
fn 5 Paragraphs .11–.14 of section 705, *Modifications to the Opinion in the Independent Auditor's Report*.
fn 6 Paragraph .09 of section 210, *Terms of Engagement*.
fn 7 See section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.
fn 8 See section 315.
fn 9 See section 905, *Alert That Restricts the Use of the Auditor's Written Communication*.
fn 10 See section 320, *Materiality in Planning and Performing an Audit.*
fn 11 See section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.
fn 12 Paragraph .19 of section 200.
fn 13 Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*.
fn 14 Paragraphs .28–.30 of section 315.
fn 15 Paragraphs .07 and .A19 of section 210.
fn 16 Paragraph .10 of section 210.
fn 17 Paragraphs .11–.14 and .A15–.A16 of section 705.
fn 18 Paragraphs .A17–.A41 of section 315.
fn 19 See section 240, *Consideration of Fraud in a Financial Statement Audit*.
fn 20 Paragraph .15 of section 240.
fn 21 Paragraph .11 of section 315.
fn 22 Paragraph .57 of QC section 10, *A Firm's System of Quality Control*.
fn 23 ET section 0.200.020, *Application of the AICPA Code*, of the AICPA Code of Professional Conduct explains that an AICPA member who is the group engagement partner of a U.S. consolidated entity should be considered to have performed an audit in accordance with generally accepted auditing standards, and in compliance with the AICPA Code of Professional Conduct, provided that component auditors that are not subject to the AICPA Code are in compliance with the ethics and independence requirements set forth in the International Federation of Accountants Code of Ethics.
fn 24 Paragraphs .10–.11 of section 320.
fn 25 Paragraphs .39–.41 of section 240.
fn 26 Paragraph .11 of section 320.

fn 1 Paragraphs .14–.15 of section 610, *Using the Work of Internal Auditors*.
fn 1 The subtitle “Report on the Audit of Consolidated Financial Statements” is unnecessary in circumstances in which the second subtitle, “Report on Other Legal and Regulatory Requirements,” is not applicable.
fn 2 In circumstances in which the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of ABC Company’s internal control. Accordingly, no such opinion is expressed."

fn 1 The subtitle “Report on the Consolidated Financial Statements” is unnecessary in circumstances in which the second subtitle, “Report on Other Legal and Regulatory Requirements,” is not applicable.
fn 2 In circumstances in which the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of ABC Company’s internal control. Accordingly, no such opinion is expressed."

fn 1 The subtitle “Report on the Consolidated Financial Statements” is unnecessary in circumstances in which the second subtitle, “Report on Other Legal and Regulatory Requirements,” is not applicable.
fn 2 In circumstances in which the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of ABC Company’s internal control. Accordingly, no such opinion is expressed."

fn 1 The subtitle “Report on the Consolidated Financial Statements” is unnecessary in circumstances in which the second subtitle, “Report on Other Legal and Regulatory Requirements,” is not applicable.
fn 2 In circumstances in which the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of ABC Company’s internal control. Accordingly, no such opinion is expressed."

ASB
Agenda Item 4B

PROPOSED INTERNATIONAL STANDARD ON AUDITING 600 (REVISED)

SPECIAL CONSIDERATIONS—AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS)

Introduction

Scope of this ISA

1. The International Standards on Auditing (ISAs) apply to an audit of group financial statements (a group audit). This ISA deals with special considerations that apply to a group audit, including in those circumstances when component auditors are involved. The requirements and guidance in this ISA refer to, or expand on, the application of other relevant ISAs to a group audit, in particular ISA 220 (Revised),[1] ISA 230,[2] ISA 300,[3] ISA 315 (Revised 2019),[4] and ISA 330.[5] (Ref: Para. A1–A2)

1A. Group financial statements include the financial information of more than one entity or business unit through a consolidation process, as described in paragraph 9(k). The term consolidation process as used in this ISA refers not only to the preparation of consolidated financial statements in accordance with the applicable financial reporting framework, but also to the presentation of combined financial statements, and to the aggregation of the financial information of entities or business units such as branches or divisions. (Ref: Para. A2A–A2C, A15B.

1B. As explained in ISA 220 (Revised),[6] this ISA, adapted as necessary in the circumstances, may also be useful in an audit of financial statements other than a group audit when the engagement team includes individuals from another firm. For example, this ISA may be useful when involving such an individual to attend a physical inventory count, inspect property, plant and equipment, or perform audit procedures at a shared service center at a remote location4. This ISA highlights the responsibility of the group engagement team to obtain sufficient appropriate audit evidence to provide a basis for forming an opinion on the group financial statements. This ISA also recognizes that component auditors can be, and often are, involved in all phases of the group audit, and in particular to assist the group engagement team in identifying, assessing and responding to the risks of material misstatement of the group financial statements. Accordingly, this ISA requires sufficient and appropriate involvement by the group engagement team in the work of component auditors and emphasizes the importance of two-way communication between the group engagement team and component auditors. In addition, this ISA explains the matters that the group engagement team takes into account when determining the nature, timing and extent of the direction and supervision of component auditors and the review of their work. (Ref: Para. A7–A8, Appendix 1)

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[1] ISA 220 (Revised), *Quality Management for an Audit of Financial Statements*

[2] ISA 230, *Audit Documentation*

[3] ISA 300, *Planning an Audit of Financial Statements*

[4] ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*

[5] ISA 330, *The Auditor's Responses to Assessed Risks*

[6] ISA 220 (Revised), paragraph A1

Groups and Components

3. A group may be organized in various ways. For example, a group may be organized by legal or other entities (e.g., a parent and one or more subsidiaries, joint ventures, or investments accounted for by the equity method). Alternatively, the group may be organized by geography, by other economic units (including branches or divisions), or by functions or business activities. In this ISA, these different forms of organization are collectively referred to as "entities or business units." (Ref: Para. A3A)

3A. The group auditor determines an appropriate approach to planning and performing audit procedures to respond to the assessed risks of material misstatement of the group financial statements. For this purpose, the group auditor uses professional judgment in determining the components at which audit work will be performed (see paragraph 17A(a)). This determination is based on the group auditor's understanding of the group and its environment, and other factors such as the ability to perform audit procedures centrally, the presence of shared service centers, or common information systems and internal control. (Ref: Para. A5–A6A)

Involvement of Component Auditors

3B. ISA 220 (Revised) requires the engagement partner to determine that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner.[7] In a group audit, such resources may include component auditors. Therefore, this ISA requires the group auditor to determine the nature, timing and extent of involvement of component auditors (see paragraph 17A(b)). Component auditors may have greater experience and a more in-depth knowledge of the components and their environments (including local laws and regulations, business practices, language, and culture) than the group auditor. Accordingly, component auditors can be, and often are, involved in all phases of the group audit. (Ref: Para. A7–A8, Appendix 1)

4. Audit risk is a function of the risks of material misstatement and detection risk.[8] In a group audit, this includes the risk that the component auditor may not detect a misstatement in the financial information of the component that could cause a material misstatement of the group financial statements, and the risk that the group auditor may not detect this misstatement. Accordingly, this ISA requires sufficient and appropriate involvement by the group auditor in the work of component auditors and emphasizes the importance of two-way communication between the group auditor and component auditors. In addition, this ISA explains the matters that the group auditor takes into account when determining the nature, timing and extent of the direction and supervision of component auditors and the review of their work. (Ref: Para. A8A–A8B)

Professional Skepticism

5. In accordance with ISA 200,[9] the engagement team is required to plan and perform the group audit with professional skepticism and to exercise professional judgment. The appropriate exercise of professional skepticism may be demonstrated through the actions and communications of the

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[7] ISA 220 (Revised), paragraph 25

[8] ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A34

[9] ISA 200, paragraphs 15–16 and A20–A24

engagement team, including emphasizing the importance of each engagement team member exercising professional skepticism throughout the group audit engagement. Such actions and communications may include specific steps to mitigate impediments that may impair the appropriate exercise of professional skepticism. (Ref: Para. A9–A10)

Scalability

5A. This ISA is intended for all group audits, regardless of size or complexity. However, the requirements of this ISA are intended to be applied in the context of the nature and circumstances of each group audit. For example, when a group audit is carried out entirely by the group auditor, some requirements in this ISA are not relevant because they are conditional on the involvement of component auditors. This may be the case when the group auditor is able to perform audit procedures centrally or is able to perform procedures at the components without involving component auditors. The guidance in paragraphs A75A and A76 also may be helpful in applying this ISA in these circumstances. [Previously paragraph A2C]

Responsibilities of the Group Engagement Partner and Group Auditor

6. The group engagement partner remains ultimately responsible, and therefore accountable, for compliance with the requirements of this ISA. The term "the group engagement partner shall take responsibility for…" or "the group auditor shall take responsibility for…" is used for those requirements when the group engagement partner or group auditor, respectively, is permitted to assign the design or performance of procedures, tasks or actions to other appropriately skilled or suitably experienced members of the engagement team, including component auditors. For other requirements, this ISA expressly intends that the requirement or responsibility be fulfilled by the group engagement partner or group auditor, as applicable, and the group engagement partner or group auditor may obtain information from the firm or other members of the engagement team. (Ref: Para. A19)

Effective Date

7. This ISA is effective for audits of group financial statements for periods beginning on or after December 15, 20XX.

Objectives

8. The objectives of the auditor are to:

   (a) With respect to the acceptance and continuance of the group audit engagement, determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained to provide a basis for forming an opinion on the group financial statements;

   (b) Identify and assess the risks of material misstatement of the group financial statements, and to plan and perform further audit procedures to appropriately respond to those assessed risks;

   (c) Be sufficiently and appropriately involved in the work of component auditors throughout the group audit engagement, including communicating clearly about the scope and timing of their work, and in evaluating the results of that work; and

(d) Evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed, including with respect to the work performed by component auditors, as a basis for forming an opinion on the group financial statements.

Definitions

9. For purposes of the ISAs, the following terms have the meanings attributed below:

(a) Aggregation risk – The probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. (Ref: Para. A11)

(b) Component – An entity or business unit or a function or activity, (or some combination thereof), determined by the group auditor for purposes of planning and performing audit procedures in a group audit. (Ref: Para. A12)

(c) Component auditor – An auditor who, at the request of the group auditor, performs audit work related to a component for purposes of the group audit. A component auditor is a part of the engagement team for a group audit.[10] (Ref: Para. A13–A14)

(d) Component management – Management responsible for a component. (Ref: Para. A15)

(e) Component performance materiality – An amount set by the group auditor to reduce aggregation risk to an appropriately low level for purposes of planning and performing audit procedures in relation to a component.

(f) Group – A reporting entity for which group financial statements are prepared.

(g) Group audit – The audit of group financial statements.

(h) Group auditor – The group engagement partner and members of the engagement team other than component auditors who are responsible for:

(i) Establishing the overall group audit strategy and group audit plan;

(ii) Directing and supervising component auditors and reviewing their work;

(iii) Evaluating the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the group financial statements.

(i) Group audit opinion – The audit opinion on the group financial statements.

(j) Group engagement partner – The engagement partner[11] who is responsible for the group audit. (Ref: Para. A15A)

(k) Group financial statements – Financial statements that include the financial information of more than one entity or business unit through a consolidation process. For purposes of this ISA, a consolidation process includes:

(i) Consolidation, proportionate consolidation, or an equity method of accounting;

(ii) The presentation in combined financial statements of the financial information of entities

[10] ISA 220 (Revised), paragraph 10(d)

[11] ISA 220 (Revised), paragraph 10(a)

or business units that have no parent but are under common control or common management; or

(iii) The aggregation of the financial information of entities or business units such as branches or divisions. (Ref: Para. A16–A16B)

(l) Group management – Management responsible for the preparation of the group financial statements.

(m) Group performance materiality – Performance materiality[12] in relation to the group financial statements as a whole, as determined by the group auditor.

10. Reference in this ISA to "the applicable financial reporting framework" means the financial reporting framework that applies to the group financial statements.

Requirements

Leadership Responsibilities for Managing and Achieving Quality on a Group Audit

12. In applying ISA 220 (Revised),[13] the group engagement partner shall take overall responsibility for managing and achieving quality on the group audit engagement, including taking responsibility for creating an environment for the engagement that emphasizes the expected behavior of engagement team members. In doing so, the group engagement partner shall be sufficiently and appropriately involved throughout the group audit engagement, including in the work of component auditors, such that the group engagement partner has the basis for determining whether the significant judgments made, and the conclusions reached, are appropriate given the nature and circumstances of the group audit engagement. (Ref: Para. A19–A20)

Acceptance and Continuance

13. The group engagement partner shall determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained to provide a basis for forming an opinion on the group financial statements. (Ref: Para. A21–A23)

14. If, after the acceptance or continuance of the group audit engagement, the group engagement partner concludes that sufficient appropriate audit evidence cannot be obtained, the group engagement partner shall consider the possible effects on the group audit. (Ref: Para. A25)

Terms of the Engagement

15. In applying ISA 210,[14] the group auditor shall obtain the agreement of group management that it acknowledges and understands its responsibility to provide the engagement team with: (Ref: Para. A26)

(a) Access to all information of which group management is aware that is relevant to the preparation of the group financial statements such as records, documentation and other

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[12] ISA 320, *Materiality in Planning and Performing an Audit*, paragraphs 9 and 11

[13] ISA 220 (Revised), paragraph 13

[14] ISA 210, *Agreeing the Terms of Audit Engagements*, paragraphs 6(b) and 8(b)

matters;

(b) Additional information that the engagement team may request from group management and component management for the purpose of the group audit; and

(c) Unrestricted access to persons within the group from whom the engagement team determines it necessary to obtain audit evidence.

Restrictions on Access Outside the Control of Group Management

16. If the group engagement partner concludes that group management cannot provide the engagement team with access to information or unrestricted access to persons within the group due to restrictions that are outside the control of group management, the group engagement partner shall consider the possible effects on the group audit. (Ref: Para. A27–A32)

Restrictions on Access Imposed by Group Management

17. If the group engagement partner concludes that:

(a) It will not be possible for the group auditor to obtain sufficient appropriate audit evidence due to restrictions imposed by group management; and

(b) The possible effect of this limitation will result in a disclaimer of opinion on the group financial statements,

the group engagement partner shall either:

(i) In the case of an initial engagement, not accept the engagement, or, in the case of a continuing engagement, withdraw from the engagement, where withdrawal is possible under applicable law or regulation; or

(ii) Where law or regulation prohibit an auditor from declining an engagement or where withdrawal from an engagement is not otherwise possible, having performed the audit of the group financial statements to the extent possible, disclaim an opinion on the group financial statements. (Ref: Para. A31–A33)

Overall Group Audit Strategy and Group Audit Plan

17A. In applying ISA 300, the group auditor shall establish an overall group audit strategy and group audit plan that includes a determination of: (Ref: Para. A33A–A33E)

(a) The components at which audit work will be performed; and (Ref: Para. A33F)

(b) The resources needed to perform the group audit engagement, including the nature, timing and extent to which component auditors are to be involved. (Ref: Para. A33G–A33I)

Considerations When Component Auditors Are Involved

18. As part of the determination in paragraph 12, the group engagement partner shall evaluate whether the group auditor will be able to be sufficiently and appropriately involved in the work of the component auditor. (Ref: Para. A34)

19. As part of the evaluation in paragraph 18, the group auditor shall request the component auditor to confirm that the component auditor will cooperate with the group auditor, including whether the component auditor will perform the work requested by the group auditor. (Ref: Para. A35A)

Relevant Ethical Requirements, Including Those Related to Independence

20. In applying ISA 220 (Revised),[15] the group engagement partner shall take responsibility for: (Ref: Para. A36–A39A, A52J)
    (a) Component auditors having been made aware of relevant ethical requirements that are applicable given the nature and circumstances of the group audit engagement; and
    (b) Confirming whether the component auditors understand and will comply with the ethical requirements that are relevant to the group audit engagement, including with respect to independence.

Engagement Resources

21. In applying ISA 220 (Revised),[16] the group engagement partner shall: (Ref: Para. A40A–A40B)
    (a) Determine that component auditors have the appropriate competence and capabilities, including sufficient time, to perform the assigned audit procedures at the component; and (Ref: Para. A41–A45)
    (b) When information about the results of the monitoring and remediation process or external inspections with respect to the component auditor's firm has been provided by the firm or has otherwise been made available to the group engagement partner, determine the relevance of such information to the group auditor’s determination in paragraph 21(a)
22. The group auditor shall obtain sufficient appropriate audit evidence relating to the work to be performed at the component without involving that component auditor if:
    (a) A component auditor is not independent in accordance with ethical requirements that are relevant to the group audit; or (Ref: Para. A46A–A47)
    (b) The group engagement partner has serious concerns about the matters in paragraphs 18–21. (Ref: Para. A48)

Engagement Performance

23. In applying ISA 220 (Revised),[17] the group engagement partner shall take responsibility for the nature, timing and extent of direction and supervision of component auditors and the review of their work. In doing so, the group engagement partner takes into account: (Ref: Para. A48A–A52)
    (a) Areas of higher assessed risks of material misstatement of the group financial statements, or significant risks identified in accordance with ISA 315 (Revised 2019); and
    (b) Areas in the audit of the group financial statements that involve significant judgment.

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[15] ISA 220 (Revised), paragraphs 16–17 and 21

[16] ISA 220 (Revised), paragraphs 25

[17] ISA 220 (Revised), paragraph 29

Communications with Component Auditors

23A. The group auditor shall communicate with component auditors about their respective responsibilities and the group auditor's expectations, including about the nature, timing and extent of communications. These communications shall take place at appropriate points in time throughout the group audit and reflect the component auditor's involvement in various phases of the group audit. (Ref: Para. A52A–A52J)

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

24. In applying ISA 315 (Revised 2019),[18] the group auditor shall take responsibility for obtaining an understanding of the following: (Ref: Para. A53–A55A, A69–A70)

    (a) The group and its environment, including: (Ref: Para. A56–A58)

        (i) The group's organizational structure and its business model, including:

            a. The locations in which the group has its operations or activities;

            b. The nature of the group's activities and the extent to which they are similar; and

            c. The extent to which the group's business model integrates the use of IT;

        (ii) Regulatory factors impacting the entities and business units in a group; and

        (iii) The measures used internally and externally to assess the entities or business units' financial performance;

    (b) The applicable financial reporting framework and the consistency of accounting policies and practices across the group; and

    (c) The group's system of internal control, including:

        (i) The nature and extent of commonality of controls; (Ref: Para. A59–A63)

        (ii) Whether, and if so, how, the group centralizes activities relevant to financial reporting; (Ref: Para. A64–A65A)

        (iii) The consolidation process used by the group, including sub-consolidations, if any, and consolidation adjustments; and

        (iv) How the group management communicates significant matters that support the preparation of the group financial statements and related financial reporting responsibilities in the information system and other components of the group's system of internal control. (Ref: Para. A66–A68)

Considerations When Component Auditors Are Involved

Communications with Component Auditors

26. The group auditor shall communicate to component auditors on a timely basis:

[18] ISA 315 (Revised 2019), paragraph 19

(a) In applying ISA 550,[19] related party relationships or transactions identified by group management, and any other related parties of which the group auditor is aware, that are relevant to the work of the component auditor. (Ref: Para. A72)

(b) In applying ISA 570 (Revised)[20] any events or conditions identified by group management or the group auditor, that may cast significant doubt on the group's ability to continue as a going concern that are relevant to the work of the component auditor.27. In applying ISA 550,[21] the group engagement team shall communicate with the component auditor related party relationships or transactions identified by group management, and any other related parties of which the group engagement team is aware, that are relevant to the work of the component auditor. (Ref: Para. A72)

26A. The group auditor shall request component auditors to communicate on a timely basis: (Ref: Para. A72A)

(a) Matters related to the financial information of the component that may be relevant to the identification and assessment of the risks of material misstatement of the group financial statements, whether due to fraud or error(b) Related party relationships not previously identified by group management or the group auditor.

(c) Any events or conditions identified by the component auditor that may cast significant doubt on the group's ability to continue as a going concern. [Previously paragraph 41]

Identifying and Assessing the Risks of Material Misstatement

26B. In applying ISA 315 (Revised 2019),[22] based on the understanding obtained in paragraph 24, the group auditor shall take responsibility for the identification and the assessment of the risks of material misstatement of the group financial statements. (Ref: Para. A72B–A72G) [Previously paragraph 31]

Considerations When Component Auditors Are Involved

26C. In applying ISA 315 (Revised 2019),[23] the group auditor shall include the work of component auditors in the evaluation 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 of the group financial statements. (Ref: Para. A72H–A72I)

Materiality

29. In applying ISA 320[24] and ISA 450,[25] when classes of transactions, account balances or disclosures in the group financial statements are disaggregated across components, for purposes of planning and performing audit procedures, the group auditor shall determine:

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[19] ISA 550, *Related Parties,* paragraph 17

[20] ISA 570 (Revised), *Going Concern*

[21] ISA 550, *Related Parties,* paragraph 17

[22] ISA 315 (Revised 2019), paragraphs 28–34

[23] ISA 315 (Revised 2019), paragraph 35

[24] ISA 320, paragraph 11

[25] ISA 450, *Evaluation of Misstatements Identified during the Audit,* paragraph 5

(a) Component performance materiality. To address aggregation risk, such amount shall be lower than group performance materiality. (Ref: Para. A73–A76)

(b) The threshold above which misstatements identified in component financial information are to be communicated to the group auditor. Such threshold shall not exceed the amount regarded as clearly trivial to the group financial statements. (Ref: Para. A77)

Considerations When Component Auditors Are Involved

30. The group auditor shall communicate to the component auditor the amounts determined in accordance with paragraph 29. (Ref: Para: A77A–A77B)

Responding to the Assessed Risks of Material Misstatement

33. In applying ISA 330,[26] the group auditor shall take responsibility for the nature, timing and extent of further audit procedures to be performed, including determining the components at which to perform further audit

Consolidation Process

34. The group auditor shall take responsibility for designing and performing further audit procedures to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process. This shall include:

(a) Evaluating whether all entities and business units have been included in the group financial statements as required by the applicable financial reporting framework and, if applicable, for designing and performing further audit procedures on sub-consolidations; (Ref: Para. A94)

(b) Evaluating whether any fraud risk factors or indicators of possible management bias exist; and

(c) Evaluating the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications. (Ref: Para. A95)

35. If the financial information of an entity or business unit has not been prepared in accordance with the same accounting policies applied to the group financial statements, the group auditor shall evaluate whether the financial information has been appropriately adjusted for purposes of preparing and presenting the group financial statements.

36. If the group financial statements include the financial statements of an entity or business unit with a financial reporting period-end that differs from that of the group, the group auditor shall take responsibility for evaluating whether appropriate adjustments have been made to those financial statements in accordance with the applicable financial reporting framework.

Considerations When Component Auditors Are Involved

37. When the group auditor involves component auditors in the design or performance of further audit procedures, the group auditor shall communicate with component auditors matters that are relevant to the design of responses to the assessed risks of material misstatement of the group financial statements.

[26] ISA 330, paragraphs 6–7

38. For areas of higher assessed risks of material misstatement of the group financial statements, or significant risks identified in accordance with ISA 315 (Revised 2019), on which a component auditor is determining the further audit procedures to be performed, the group auditor shall evaluate the appropriateness of the design and performance of those further audit procedures.

39. In accordance with paragraph 23, the group auditor shall determine the nature and extent of direction and supervision of component auditors and the review of their work when component auditors perform further audit procedures on the consolidation process, including on sub-consolidations. (Ref: Para. A102)

40. The group auditor shall determine whether the financial information identified in the component auditor's communication (see paragraph 44(a)) is the financial information that is incorporated in the group financial statements.

Using Audit Evidence from an Audit Performed for Another Purpose

42. If an audit has been performed on the financial statements of an entity or business unit that is part of the group, and an auditor's report has been issued for statutory, regulatory or other reasons, and the group auditor plans to use such work as audit evidence for the group audit, the group auditor shall evaluate whether: (Ref: Para. A103–A104)

    (a) The audit procedures performed are an appropriate response to the assessed risks of material misstatement of the group financial statements;

    (b) Performance materiality used for that audit is appropriate for the purposes of the group audit; and

    (c) Other relevant requirements in this ISA have been met with respect to the use of the work of a component auditor, including the requirements in paragraphs 20–22. (Ref: Para. A105)

Communication about Matters Relevant to the Group Auditor's Conclusion

44. The group auditor shall request the component auditor to communicate matters relevant to the group auditor's conclusion with regard to the group audit. Such communication shall include: (Ref: Para. A111A)

    (a) Identification of the financial information on which the component auditor has been requested to perform audit procedures;

    (aa) Whether the component auditor has performed the work requested by the group auditor;

    (ab) Whether the component auditor has complied with the ethical requirements that are relevant to the group audit, including those relating to independence;

    (b) Information on instances of non-compliance with laws or regulations;

    (c) Corrected and uncorrected misstatements of the component financial information identified by the component auditor and that are above the threshold communicated by the group auditor in accordance with paragraph 30; (Ref: Para. A111B)

    (d) Indicators of possible management bias;

    (e) Description of any deficiencies in the system of internal control identified in connection with the

audit procedures performed;

(f) Fraud or suspected fraud involving component management, employees who have significant roles in the group's system of internal control at the component or others where the fraud resulted in a material misstatement of the financial information of the component; (Ref: Para. A112)

(fa) Other significant matters that the component auditor communicated or expects to communicate to component management or those charged with governance of the component;

(g) Any other matters that may be relevant to the group audit, or that the component auditor wishes to draw to the attention of the group auditor, including exceptions noted in the written representations that the component auditor requested from component management; and

(h) The component auditor's overall findings or conclusions. (Ref: Para. A112A)

45. The group auditor shall:

(a) Discuss significant matters arising from the communications with the component auditor, component management or group management, as appropriate; and

[Moved to paragraph 45A]

(b) Evaluate whether the communications with component auditors are adequate for the group auditor's purposes.

45A. The group auditor also shall determine whether, and the extent to which, it is necessary to review parts of the component auditor's audit documentation. In making this determination, the group auditor shall consider:

(a) The nature, timing and extent of the work performed by the component auditor; and

(b) The competence and capabilities of the component auditor. (Ref: Para. A112C–A113) [Previously paragraph 45(b)]

46. If the group auditor determines that the component auditors' communications are not adequate for the group auditor's purposes, the group auditor shall consider whether further information can be obtained from component auditors or other sources. If such information cannot be obtained through other sources, the group auditor shall consider the implications for the group audit, in accordance with paragraph 49.

Subsequent Events

47. In applying ISA 560,[27] the group auditor shall take responsibility for performing procedures, including, as appropriate, requesting component auditors to perform procedures, designed to identify events that may require adjustment to or disclosure in the group financial statements. (Ref: Para. A114)

Considerations When Component Auditors Are Involved

[27] ISA 560, *Subsequent Events*, paragraph 7

48. The group auditor shall request the component auditors to notify the group auditor if they become aware of subsequent events that may require an adjustment to or disclosure in the group financial statements. (Ref: Para. A114)

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

49. In applying ISA 330,[28] the group auditor shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed, including with respect to the work performed by component auditors, on which to base the group audit opinion. (Ref: Para. A114A–A115B)

Evaluating the Effect on the Group Audit Opinion

50. The group engagement partner shall evaluate the effect on the group audit opinion of any uncorrected misstatements (whether identified by the group auditor or communicated by component auditors) and any instances where there has been an inability to obtain sufficient appropriate audit evidence. (Ref: Para. A116)

Considerations When Component Auditors Are Involved

51. If the group auditor concludes that the work of the component auditor is insufficient, the group auditor shall determine what additional audit procedures are to be performed, and whether they are to be performed by a component auditor or by the group auditor.

Auditor's Report

52. The auditor's report on the group financial statements shall not refer to a component auditor, unless required by law or regulation to include such reference. If such reference is required by law or regulation, the auditor's report shall indicate that the reference does not diminish the group engagement partner's or the group engagement partner's firm's responsibility for the group audit opinion. (Ref: Para. A117–A118)

Communication with Group Management and Those Charged with Governance of the Group

Communication with Group Management

53A. The group auditor shall communicate with group management an overview of the group audit plan. (Ref: Para. A119A, A123)

54. If fraud has been identified by the group auditor or brought to its attention by a component auditor (see paragraph 44(f)), or information indicates that a fraud may exist, the group auditor shall communicate this on a timely basis to the appropriate level of group management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref. Para. A120)

55. A component auditor may be required by statute, regulation or for another reason, to express an audit opinion on the financial statements of an entity or business unit that forms part of the group. In that case, the group auditor shall request group management to inform management of the entity or business unit of any matter of which the group auditor becomes aware that may be significant to the

[28] ISA 330, paragraph 26

financial statements of the entity or business unit, but of which management of the entity or business unit may be unaware. If group management refuses to communicate the matter to management of the entity or business unit, the group auditor shall discuss the matter with those charged with governance of the group. If the matter remains unresolved, the group auditor, subject to legal and professional confidentiality considerations, shall consider whether to advise the component auditor not to issue the auditor's report on the financial statements of the entity or business unit until the matter is resolved. (Ref: Para. A121)

Communication with Those Charged with Governance of the Group

56. The group auditor shall communicate the following matters with those charged with governance of the group, in addition to those required by ISA 260 (Revised)[29] and other ISAs: (Ref: Para. A122)

    (a) An overview of the work to be performed at the components of the group and the nature of the group auditor's planned involvement in the work to be performed by component auditors. (Ref: Para. A123)

    (b) Instances where the group auditor's review of the work of a component auditor gave rise to a concern about the quality of that component auditor's work, and how the group auditor addressed the concern.

    (c) Any limitations on the scope of the group audit, for example, significant matters related to restrictions on access to people or information.

    (d) Fraud or suspected fraud involving group management, component management, employees who have significant roles in the group's system of internal control or others where the fraud resulted in a material misstatement of the group financial statements.

Communication of Identified Deficiencies in Internal Control

56A. In applying ISA 265,[30] the group auditor shall determine whether any identified deficiencies in the group's system of internal control are required to be communicated to those charged with governance of the group and group management. In making this determination, the group auditor shall consider deficiencies in internal control that have been identified by component auditors and communicated to the group auditor in accordance with paragraph 44(e). (Ref: Para. A123A) [Previously paragraph 53]

Documentation

57. In accordance with ISA 230, the audit documentation for a group audit engagement needs to be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing and extent of audit procedures performed, the evidence obtained, and the conclusions reached with respect to significant matters arising during the group audit. In applying ISA 230,[31] the group auditor shall include in the audit documentation: (Ref: Para. A123B–A124x, A129–A130A)

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[29] ISA 260 (Revised), *Communication with Those Charged with Governance*

[30] ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

[31] ISA 230, paragraphs 1–3, 8–11, A6–A7 and Appendix

(a) Significant matters related to restrictions on access to people or information within the group that were considered before deciding to accept or continue the engagement, or that arose subsequent to acceptance or continuance, and how such matters were addressed.

(b) The basis for the group auditor's determination of components for purposes of planning and performing the group audit. (Ref: Para; A124y)

(c) The basis for the determination of component performance materiality and the threshold for communicating misstatements in component financial information to the group auditor.

(ca) The basis for the group auditor's determination that component auditors have the appropriate competence and capabilities, including sufficient time, to perform the assigned audit procedures at the components. (Ref: Para. A124z)

(cb) Key elements of the understanding of the group's system of internal control in accordance with paragraph 24(c);

(d) The nature, timing and extent of the group auditor's direction and supervision of component auditors and the review of their work, including, as applicable, the group auditor's review of parts of the component auditor's audit documentation in accordance with paragraph 45A. (Ref: Para. A124D–A128)

(e) Matters related to communications with component auditors, including:

(i) Matters, if any, related to fraud, related parties or going concern communicated in accordance with paragraph 26A.

(ii) Matters relevant to the group auditor's conclusion with regard to the group audit, in accordance with paragraph 44, including how the group auditor has addressed significant matters discussed with component auditors, component management or group management.

(f) The group auditor's evaluation of, and response to, findings or conclusions of the component auditors with respect to matters that could have a material effect on the group financial statements.

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Application and Other Explanatory Material

Scope (Ref: Para. 1–1B)

A1. This ISA also deals with the special considerations for the group engagement partner or group auditor, as applicable, in applying the requirements and guidance in ISA 220 (Revised), including with respect to the direction and supervision of component auditors and the review of their work.

A2. ISQM 1[32] addresses the engagements for which an engagement quality review is required to be performed. ISQM 2[33] deals with the appointment and eligibility of the engagement quality reviewer and the engagement quality reviewer's responsibilities relating to performing and documenting an engagement quality review, including for a group audit.

A2A. An entity or business unit of a group may also prepare its own group financial statements that incorporate the financial information of those entities or business units it encompasses (that is, a subgroup). This ISA therefore applies to an audit of the group financial statements of such subgroups.

A2AA. A single legal entity may be organized with more than one entity or business unit, for example, a company with operations in multiple locations, such as a bank with multiple branches. When those entities or business units have characteristics such as separate locations, separate management, or separate information systems (including a separate general ledger) and the financial information is required to be aggregated in preparing the single legal entity's financial statements, such financial statements meet the definition of group financial statements because they include the financial information of more than one entity or business unit through a consolidation process.

A2B. In some cases, a single legal entity may configure its information system to capture financial information for more than one product or service line for regulatory reporting or other management purposes. In these circumstances, the entity's financial statements are not group financial statements because there is no aggregation of the financial information of more than one entity or business unit through a consolidation process. Further, capturing separate information (e.g., in a sub-ledger) for regulatory or management purposes does not create separate entities or business units (e.g., divisions) for purposes of this ISA.

Groups and Components (Ref: Para. 3–3A)

A3A. The group's information system, including its financial reporting process, may or may not be aligned with the group's organizational structure. For example, a group may be organized according to its legal structure, but its information system may be organized by function, process, product or service (or by groups of products or services), or geographic locations for management or reporting purposes.

A5. Based on the understanding of the group's organizational structure and information system, the group auditor may determine that the financial information of certain entities or business units may be considered together for purposes of planning and performing audit procedures. For example, a group may have three legal entities with similar business characteristics, operating in the same geographical jurisdiction, under the same management, and using a common system of internal control, including the information system. In these circumstances, the group auditor may decide to treat these three legal entities as one component.

A6. A group may also centralize activities or processes that are applicable to more than one entity or business unit within the group, for example through the use of a shared service center. When such

[32] International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*

[33] ISQM 2, *Engagement Quality Reviews*

centralized activities are relevant to the group's financial reporting process, the group auditor may determine that the shared service center is a component for purposes of the group audit.

A6A. Another consideration that may be relevant to the group auditor's determination of components is how management has determined operating segments in accordance with the disclosure requirements of the applicable financial reporting framework.[34]

Involvement of Component Auditors (Ref: Para. 3B–4)

A7. The involvement of component auditors may be necessary for various reasons. For example, when there are many components across multiple jurisdictions, the group auditor may need the assistance of component auditors to identify, assess and respond to the risks of material misstatement of the group financial statements.

A8. The group auditor may involve component auditors to provide information, or to perform audit procedures, to fulfill the requirements of this ISA. Appendix 1 provides additional guidance about the matters that the group auditor may consider regarding the involvement of component auditors.

A8A. As explained in ISA 200,[35] detection risk relates to the nature, timing and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. Detection risk is a function not only of the effectiveness of an audit procedure but also the application of that procedure by the auditor. Therefore, detection risk is influenced by matters such as adequate planning, the assignment of appropriate resources to the engagement, the exercise of professional skepticism, and the supervision and review of the audit work performed.

A8B. Detection risk is a broader concept than aggregation risk as described in paragraphs 9(a) and A11. In a group audit, there may be a higher probability that the aggregate of uncorrected and undetected misstatements may exceed materiality for the group financial statements as a whole because audit procedures may be performed separately on the financial information of components across the group. Accordingly, component performance materiality is set by the group auditor to reduce aggregation risk to an appropriately low level.

Professional Skepticism (Ref: Para. 5)

A9. ISA 220 (Revised)[36] provides examples of the impediments to the exercise of professional skepticism at the engagement level, unconscious auditor biases that may impede the exercise of professional skepticism when designing and performing audit procedures and evaluating audit evidence. ISA 220 (Revised) also provides possible actions that the engagement team may take to mitigate impediments to the exercise of professional skepticism at the engagement level.

A9A. A group audit engagement may present additional challenges to the exercise of professional skepticism by the engagement team. Such challenges may include, for example:

- When there are a large number of components across multiple jurisdictions, it may be important for the group auditor to remain alert for contradictory information from component auditors, component management and group management with respect to a matter of significance to

[34] See, for example, International Financial Reporting Standard (IFRS) 8, *Operating Segments*

[35] ISA 200, paragraph A45

[36] ISA 220 (Revised), paragraphs A35–A37

the group financial statements.

- Component auditors in different locations may be subject to varying cultural influences, which may affect the nature of the biases to which they are subject.
- The complex structure of some groups may require an additional understanding of the business purpose and activities of certain entities or business units.
- The nature and extent of intragroup transactions (for example, transactions that involve multiple entities and business units within the group or multiple related parties), cash flows or transfer pricing agreements may give rise to additional complexities. In some cases, such matters may also give rise to fraud risk factors in accordance with ISA 240.[37]
- When the group audit is subject to tight reporting deadlines imposed by group management, the ability of the engagement team to make appropriate judgments and appropriately question management's assertions may be affected. In these circumstances, the group auditor may need to communicate with those charged with governance of the group.

A9B. As explained in paragraph A52A, effective two-way communication between the group auditor and component auditors helps to set expectations for component auditors, and facilitates the group auditor's direction and supervision of them and the review of their work. Such communication also provides an opportunity for the group engagement partner to reinforce the need for component auditors to exercise professional skepticism in the work performed for purposes of the group audit.

A9C. The exercise of professional skepticism also may be evident from the group auditor's direction and supervision of engagement team members, including component auditors, and the review of their work. In addition, challenges to the exercise of professional skepticism in a group audit, such as those described in paragraph A9A, may be considered by the group auditor in the evaluation of the sufficiency and appropriateness of audit evidence obtained in accordance with paragraph 49.

A10. Requirements and relevant application material in ISA 315 (Revised 2019),[38] ISA 540 (Revised)[39] and other ISAs also provide examples of areas in an audit where the auditor exercises professional skepticism, or examples of where appropriate documentation may help provide evidence about how the auditor exercised professional skepticism.

Definitions

Aggregation Risk (Ref: Para. 9(a))

A11. Aggregation risk exists in all audits of financial statements, but is particularly important to understand and address in a group audit because there is a greater likelihood that audit procedures will be performed on classes of transactions, account balances or disclosures that are disaggregated across components. Generally, aggregation risk increases as the number of components increases at which audit procedures are performed separately, whether by component auditors or other members of the engagement team.

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[37] ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

[38] ISA 315 (Revised 2019), paragraph A238

[39] ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, paragraph A11

Component (Ref: Para. 9(b))

A12. As noted in paragraph 3A, the group auditor uses professional judgment in determining components at which audit procedures will be performed, including whether to combine certain entities or business units, or functions or activities, for purposes of planning and performing audit procedures. However, the group auditor's consideration of the risks of material misstatement of the group financial statements encompasses all of the entities and business units whose financial information is included in the group financial statements.

Component Auditor (Ref: Para. 9(c))

A13. References in this ISA to the engagement team include the group auditor and component auditors. The engagement team includes individuals from the group auditor's firm and may include individuals from a network firm, a firm that is not a network firm, or an external service provider.

A14. In some circumstances, the group auditor may perform centralized testing on classes of transactions, account balances or disclosures, or may perform audit procedures related to a component. In these circumstances, the group auditor is not considered a component auditor for purposes of this ISA..

Component Management (Ref: Para. 9(d))

A15. Component management refers to management responsible for the financial information or other activity (for example, processing of transactions at a shared service center) at an entity or business unit that is part of the group. When the group auditor combines entities or business units into components (see paragraphs A5–A6), component management refers to the management that is responsible for the financial information or transaction processing that is subject to the audit procedures being performed in relation to that component.

Group Engagement Partner (Ref: Para. 9(j))

A15A. When joint auditors conduct a group audit, the joint engagement partners and their engagement teams collectively constitute the "group engagement partner" and "engagement team" for the purposes of the ISAs. This ISA does not, however, deal with the relationship between joint auditors or the work that one joint auditor performs in relation to the work of the other joint auditor for purposes of the group audit.

Group Financial Statements (Ref: Para. 1A, 9(k))

A16. The requirements for the preparation and presentation of the group financial statements may be specified in the applicable financial reporting framework, which may therefore affect the determination of the financial information of entities or business units to be included in the group financial statements. For example, some frameworks require the preparation of consolidated financial statements when an entity (a parent entity) controls one or more other entities (e.g., subsidiaries) through majority ownership interest or other means. In some cases, the applicable financial reporting framework includes separate requirements for, or may otherwise permit, the presentation of combined financial statements. Examples of circumstances in which the presentation of combined financial statements may be permitted include entities that have no parent but are under common control or entities under common management.

A16A. The term 'consolidation process' as used in this ISA is not intended to have the same meaning as 'consolidation' or 'consolidated financial statements' as defined or described in financial reporting frameworks. Rather, the term 'consolidation process' refers more broadly to the process used to prepare group financial statements. Also see paragraph 1A.

A16B. The detailed aspects of the consolidation process vary from one group to another, depending on the group's structure and information system, including the financial reporting process. However, a consolidation process involves considerations such as the elimination of intragroup transactions and balances and, when applicable, implications of different reporting periods for entities or business units included in the group financial statements.

Leadership Responsibilities for Managing and Achieving Quality on a Group Audit (Ref: Para. 6, 12)

A19. It may not be possible or practical for the group engagement partner to solely deal with all requirements in ISA 220 (Revised), particularly when the engagement team includes a large number of component auditors located in multiple locations. In managing quality at the engagement level, ISA 220 (Revised)[40] permits the engagement partner to assign responsibilities for the design or performance of procedures, tasks or actions to appropriately skilled or suitably experienced members of the engagement team to assist the engagement partner. Accordingly, the group engagement partner may assign responsibilities to other members of the engagement team and these members may assign responsibilities further. In such circumstances, ISA 220 (Revised) requires that the engagement partner shall continue to take overall responsibility for managing and achieving quality on the engagement.[41]

A19A. The group engagement partner's responsibility for managing and achieving quality is supported by a firm culture that demonstrates a commitment to quality. In addressing the requirements in paragraph 12 of this ISA, the group engagement partner may communicate directly to other members of the engagement team and reinforce this communication through personal conduct and actions (e.g., leading by example). As explained in ISA 220 (Revised),[42] a culture that demonstrates a commitment to quality is further shaped and reinforced by the engagement team members as they demonstrate expected behaviors when performing the engagement. The firm's policies or procedures may require the firm or the group engagement partner to take different actions from those applicable to personnel when communicating the expected behaviors to component auditors.

A20. Policies or procedures established by the firm, or that are common network requirements or network services,[43] may support the group engagement partner by facilitating communication between the group auditor and component auditors and supporting the group auditor's direction and supervision of those component auditors and the review of their work.

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[40] ISA 220 (Revised), paragraph 15

[41] ISA 220 (Revised), paragraph 15

[42] ISA 220 (Revised), paragraphs A24 and A28

[43] ISQM 1, paragraphs 48–52

Acceptance and Continuance

Determining Whether Sufficient and Appropriate Audit Evidence Can Reasonably Be Expected To Be Obtained (Ref: Para. 13–14)

A21. In determining whether sufficient appropriate audit evidence can reasonably be expected to be obtained, the group engagement partner may obtain an understanding of matters such as:

- The group structure, including both the legal and organizational structure.
- Business activities that are significant to the group, including the industry and regulatory, economic and political environments in which those activities take place.
- The use of service organizations.
- The use of shared service centers.
- The consolidation process.
- Whether the group auditor:
  - Will have unrestricted access to those charged with governance of the group, group management, those charged with governance of the component, component management, component information; and
  - Will be able to perform necessary work on the financial information of the components when applicable.
- Whether sufficient and appropriate resources are assigned or will be made available in accordance with paragraph 21.

A21A. There may be more complexities with obtaining sufficient appropriate audit evidence in a group audit with components in jurisdictions other than the group auditor's jurisdiction because of cultural and language differences and different laws or regulations (e.g., regulations restricting access to data).

A22. In the case of an initial engagement, the group auditor's understanding of the matters in paragraph A21 may be obtained from:

- Information provided by group management;
- Communication with group management;
- Communication with those charged with governance of the group; and
- Where applicable, communication with component management or the predecessor auditor

A23. For a continuing engagement, obtaining audit evidence may be affected by significant changes, for example:

- Changes in the group structure (e.g., acquisitions, disposals, reorganizations, or changes in how the group financial reporting system is organized).
- Changes in components' business activities that are significant to the group.
- Changes in the composition of those charged with governance of the group, group management, or key management of components for which audit procedures are expected to

be performed.

- New concerns the group auditor has with regard to the integrity and competence of group or component management.
- Changes in the applicable financial reporting framework.

A25. Restrictions may be imposed after the group engagement partner's acceptance of the group audit engagement that may affect the engagement team's ability to obtain sufficient appropriate audit evidence. Such restrictions may include those affecting:

- The group auditor's access to component information, management or those charged with governance of components, or the component auditors (including relevant audit documentation sought by the group auditor); or
- The work to be performed on the financial information of components.
- An inability to obtain sufficient appropriate audit evidence would need to be evaluated, in accordance with ISA 705 (Revised), in forming an opinion on the group financial statements.[44] In exceptional circumstances, such restrictions may lead to withdrawal from the engagement, where withdrawal is possible under applicable laws or regulations.
- New concerns the group engagement team has with regard to the integrity and competence of group or component management.
- Changes in the applicable financial reporting framework.

Agreeing the Terms of Audit Engagements (Ref: Para. 15)

A26. ISA 210 requires the auditor to agree the terms of the audit engagement with management or those charged with governance, as appropriate.[45] The terms of engagement identify the applicable financial reporting framework.[46] Additional matters may be included in the terms of a group audit engagement, such as:

- Communications between the group auditor and component auditors should be unrestricted to the extent possible under laws or regulations;
- Important communications between component auditors and those charged with governance of the component or component management, including communications on significant deficiencies in internal control, should be communicated to the group auditor;
- Communications between regulatory authorities and entities or business units related to financial reporting matters that may be relevant to the group audit should be communicated to the group auditor; and
- The group auditor should be permitted to perform work or request a component auditor to perform work at the component.

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[44] ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

[45] ISA 210, paragraph 9

[46] ISA 210, paragraph 10

Restrictions on Access to Information or People (Ref: Para. 16–17)

A27. Restrictions on access to information or people do not alleviate the requirement for the group auditor to obtain sufficient appropriate audit evidence.

A28. Access to information or people can be restricted for many reasons, such as restrictions imposed by component management, laws or regulations or other conditions, for example, war, civil unrest or outbreaks of disease..

A29. In many cases, the group auditor may be able to overcome restrictions on access to information or people, for example:

- When laws or regulations restrict sending relevant audit documentation across borders, the group auditor may be able to access the relevant audit documentation by one or more of the following:
  - Visiting the location of the component;
  - Reviewing the relevant audit documentation remotely through the use of technology (e.g., videoconferencing, remote access to the audit file), where not prohibited by law or regulations;
  - Requesting the component auditor to prepare and provide a memorandum that addresses the relevant information and holding discussions with the component auditor, if necessary, to discuss the contents of the memorandum; or;
  - Discussing the procedures performed, the results obtained and the conclusions reached with the component auditor.
- When the group has a non-controlling interest in an entity that is accounted for by the equity method, the group auditor may be able to overcome restrictions by determining whether provisions exist (e.g., in the terms of joint venture agreements, or the terms of other investment agreements) regarding access by the group to the financial information of the entity, and requesting management to exercise such rights. Paragraph A29A describes possible procedures to obtain sufficient appropriate audit evidence when the group has a non-controlling interest in an entity that is accounted for by the equity method;
- When war, civil unrest or outbreaks of disease restrict access to relevant audit documentation of a component auditor, the group auditor may be able to access the relevant audit documentation by one or more of the following:
  - Meeting with the component auditor in a location different from where the component auditor is located;
  - Reviewing the relevant audit documentation remotely through the use of technology (e.g., video conferencing, remote access to the audit file), where not prohibited by laws or regulations;
  - Requesting the component auditor to prepare and provide a memorandum that addresses the relevant information and holding discussions with the component auditor, if necessary, to discuss the contents of the memorandum; or

  - Discussing the procedures performed, the results obtained and the conclusions reached with the component auditor.

- When access to component management or those charged with governance of the component is restricted, the group auditor may be able to perform the work themselves by working with group management or those charged with governance of the group.
- Whether one, or a combination, of the above options can overcome restrictions on access to people or information to enable the group auditor to obtain sufficient appropriate audit evidence is a matter of professional judgment.

A29A. When the group has a non-controlling interest in an entity that is accounted for by the equity method and the group auditor's access is restricted, the group auditor's procedures to obtain sufficient appropriate audit evidence are a matter of professional judgment in view of the assessed risks of material misstatement. [47] Such procedures may include:

- Considering financial information that is available from group management, as group management also needs to obtain the entity's financial information in order to prepare the group financial statements.
- Considering publicly available information, such as audited financial statements, public disclosure documents, or quoted prices of equity instruments in the non-controlled entity.
- Considering other sources of information that may corroborate or otherwise contribute to audit evidence obtained. For example, if the group has representatives who are on the executive board or are members of those charged with governance of the non-controlled entity, discussion with them regarding the non-controlled entity and its operations and financial status may be a useful source of information.

A30. When the group auditor cannot overcome restrictions, the group auditor may communicate about the restrictions to the group auditor's firm. The group auditor's firm may discuss with the component auditor's firm about how to overcome the restrictions. The group auditor's firm may also be required by law or regulation to communicate with regulators, listing authorities, or others, about the restrictions or how to overcome the restrictions. The group auditor may also be required by law and regulation to communicate about the restrictions with group management and encourage group management to communicate with regulators. This may be useful when restrictions affect multiple audits in the jurisdiction or by the same firm, for example, because of war, civil unrest or outbreaks of disease in a major economy.

A31. Restrictions on access may have other implications for the group audit. For example, if restrictions are imposed by group management, the group auditor may need to reconsider the reliability of group management's responses to the group auditor's inquiries and may call into question group management's integrity.

Effect of Restrictions on the Auditor's Report on Group Financial Statements

A32. ISA 705 (Revised) contains requirements and guidance about how to address situations where the group auditor is unable to obtain sufficient appropriate audit evidence. Appendix 2 to this ISA contains an example of an auditor's report containing a qualified group audit opinion based on the group

[47] ISA 330, paragraph 7(b)

auditor's inability to obtain sufficient appropriate audit evidence in relation to a component that is accounted for by the equity method.

Law or Regulation Prohibit the Group Engagement Partner from Declining or Withdrawing from an Engagement

A33. Law or regulation may prohibit the group engagement partner from declining or withdrawing from an engagement. For example, in some jurisdictions the auditor is appointed for a specified period of time and is prohibited from withdrawing before the end of that period. Also, in the public sector, the option of declining or withdrawing from an engagement may not be available to the auditor due to the nature of the mandate or public interest considerations. In these circumstances, the requirements in this ISA still apply to the group audit, and the effect of the group auditor's inability to obtain sufficient appropriate audit evidence is addressed in ISA 705 (Revised).

Overall Group Audit Strategy and Group Audit Plan

The Continual and Iterative Nature of Planning and Performing a Group Audit (Ref: Para. 17A)

A33A. As explained in ISA 300,[48] planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. For example, due to unexpected events, changes in conditions, or audit evidence obtained from risk assessment or further audit procedures, the group auditor may need to modify the overall group audit strategy and group audit plan, and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risk. The group auditor may also modify the determination of the components at which to perform audit work as well as the nature, timing and extent to which component auditors are to be involved. ISA 300[49] requires the group auditor to update and change the overall audit strategy and audit plan as necessary during the course of the audit.

A33B. In a continuing group audit engagement the group auditor may have an initial understanding of the group and its environment, the applicable financial reporting framework and the entity's system of internal control obtained through the prior year's audit. This initial understanding may assist the group auditor in developing initial expectations about the classes of transactions, account balances and disclosures that may be significant.

A33C. In an initial group audit engagement, the group auditor may establish the overall group audit strategy and group audit plan based on information obtained from group management, those charged with governance of the group and, where applicable, communication with component management or the predecessor.

Establishing the Overall Group Audit Strategy and Group Audit Plan (Ref: Para. 17A)

A33D. The process of establishing the overall group audit strategy and group audit plan may assist the group auditor in developing expectations for matters such as:

- Whether to perform audit work centrally, at a component or a combination thereof; and

[48] ISA 300, paragraph A2

[49] ISA 300, paragraph 10

- The nature, timing and extent of audit work to be performed with respect to the financial information of the component (e.g., design and perform risk assessment procedures, further audit procedures, or a combination thereof).

A33E. The auditor may also use information obtained during the engagement acceptance and continuance process in establishing the overall group audit strategy and group audit plan, for example, in relation to the resources needed to perform the group audit.

Components at Which to Perform Audit Work (Ref: Para. 17A(a))

A33F. The determination of components at which to perform audit work is a matter of professional judgment. Matters that may influence the group auditor's determination include, for example:

- The disaggregation of significant classes of transactions, account balances and disclosures in the group financial statements across components, considering the size and nature of assets, liabilities and transactions, at the location or business unit relative to the group financial statements.
- The nature of events or conditions that may give rise to risks of material misstatement at the assertion level of the group financial statements thatassociated with the component, for example:
    - Newly formed or acquired entities or business units.
    - Entities or business units in which significant changes have taken place.
    - Significant transactions with related parties.
    - Abnormal fluctuations identified by analytical procedures performed at group level, as required by ISA 315 (Revised 2019).[50]
- The nature and extent of commonality of controls and whether, and if so, how, the group centralizes activities relevant to financial reporting.

Resources (Ref: Para. 17A(b), 25)

A33G. Factors that influence the group auditor's determination about the resources needed to perform the group audit and the nature, timing and extent to which component auditors are to be involved is a matter of professional judgment and include, for example:

- The understanding of the group, the components within the group at which audit work is to be performed and whether to perform work centrally, at components ort a combination thereof.
- The knowledge and experience of the engagement team members. For example, the involvement of experts may be needed on complex matters. In addition, component auditors may have greater experience and a more in-depth knowledge than the group auditor of the local industries in which components operate, local laws or regulations, business practices, language and culture.
- The initial expectations about the potential risks of material misstatement.

[50] ISA 315 (Revised 2019), paragraph 14(b)

- The amount or location of resources to allocate to specific audit areas. For example, the extent to which components are dispersed across multiple locations may impact the need to involve component auditors in specific locations.
- Access arrangements. For example, when the group auditor's access to a component in a particular jurisdiction is restricted, component auditors may need to be involved.
- The nature of the components' business activities, including their complexity or specialization of operations.
- The group's system of internal control, including the information system in place, and its degree of centralization. For example, the involvement of component auditors may be more likely when the system of internal control is decentralized.
- Previous experience with the component auditor.

A33H. When the group auditor determines that component auditors will be involved in the group audit, the group auditor may involve the component auditors throughout the different phases of an audit, for example, component auditors may:

- Perform risk assessment procedures (see paragraph 25); and
- Respond to the assessed risks of material misstatement (see paragraph 37).
- The nature, timing and extent to which component auditors are to be involved depends on the facts and circumstances of the group audit engagement. Often component auditors will be involved in all phases of the audit, but the group auditor may decide to involve component auditors only in a certain phase.

A33I. ISA 300[51] requires the group engagement partner and other key members of the engagement team to be involved in planning the audit. The involvement of component auditors in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process. When component auditors are involved, one or more individuals from a component auditor may be key members of the engagement team and therefore involved in planning the audit. The group engagement partner's uses professional judgment in determining which component auditors to involve in planning the audit. This may be affected by the nature, timing and extent to which the component auditors are involved in designing and performing risk assessment or further audit procedures.

Consideration When Component Auditors Are Involved (Ref: Para. 18–19)

A34. In evaluating whether the group auditor has the ability to be sufficiently and appropriately involved in the work of the component auditor, the group auditor may obtain an understanding of whether the component auditor is subject to any restrictions that limit communication with the group auditor, including with regard to sharing audit documentation with the group auditor. The group auditor may also obtain an understanding about whether audit evidence related to components located in a different jurisdiction may be in a different language and may need to be translated for use by the group auditor.

[51] ISA 300, paragraph 5

A35A. Where the component auditor is unable to cooperate with the group engagement team, the group auditor may request the component auditor to provide the reasons why. When the component auditor is unable as a result of restrictions imposed by a law or regulation, the group auditor may be able to take appropriate action to address the matter, including adjusting the nature of the work requested to be performed and obtaining sufficient appropriate audit evidence relating to the work to be performed at the component without involving that component auditor (in accordance with paragraph 22).

Relevant Ethical Requirements, Including Those Related to Independence (Ref: Para. 20)

A36. When performing work at a component for a group audit engagement, the component auditor is subject to ethical requirements, including those relating to independence, that are relevant to the group audit. Such requirements may be different or in addition to those applying to the component auditor when performing an audit on the financial statements of an entity or business unit that is part of the group for statutory, regulatory or other reasons in the component auditor's jurisdiction.

A37. In communicating relevant ethical requirements, the group auditor may consider whether additional information or training for component auditors is necessary with respect to the provisions of the ethical requirements that are relevant to the group audit engagement.

A38. ISA 220 (Revised) requires the engagement partner to remain alert throughout the audit engagement, through observation and making inquiries as necessary, for actual or suspected breaches of relevant ethical requirements by the engagement team.[52] Becoming aware of actual or suspected breaches of relevant ethical requirements may be more challenging in a group audit, particularly where component auditors do not use common network requirements. In such circumstances, the group auditor may also instruct component auditors to communicate relevant information timely to the group engagement partner, such that the group engagement partner has sufficient time to respond and address the actual or suspected breach.

A39. As described in ISQM 1, there may be circumstances when the fee quoted for an engagement is not sufficient given the nature and circumstances of the engagement and where such insufficiency may diminish the firm's ability to perform the engagement in accordance with professional standards and applicable legal or regulatory requirements. The level of fees, including their allocation to component auditors, and the extent to which they relate to the resources required may be a more important consideration by the firm in respect to group audit engagements where, for example, there are multiple components at which audit procedures are performed. For example, in a group audit the firm's financial and operational priorities may place constraints on the determination of the components at which audit work will be performed, as well as the resources needed, including the involvement of component auditors. In such circumstances, these constraints do not override the group engagement partner's responsibility for achieving quality at the engagement level or the requirements for the group auditor to obtain sufficient appropriate audit evidence on which to base the group audit opinion.

A39A. Relevant ethical requirements may also contain provisions regarding the identification and evaluation of threats and how they are to be dealt with. For example, the International Ethics Standards Board of Accountants' (IESBA) International Code of Ethics for Professional Accountants (including

[52] ISA 220 (Revised), paragraph 19

International Independence Standards) (IESBA Code) explains that a self-interest threat to compliance with the fundamental principle of professional competence and due care may arise if the fee quoted for an audit engagement is so low that it might be difficult to perform the engagement in accordance with professional standards.[53].

Engagement Resources (Ref: Para. 21)

A40A. When sufficient or appropriate resources are not made available in relation to work to be performed by a component auditor, the group engagement partner may discuss the matter with the component auditor, group management or the firm and may subsequently request the component auditor or the firm to make sufficient and appropriate resources available.

A40B. ISA 220 (Revised)[54] provides guidance regarding matters the engagement partner may take into account when determining the competence and capabilities of the engagement team. This determination is particularly important in a group audit because the engagement team may include component auditors (i.e., individuals from another firm). Paragraph A24 of ISA 220 (Revised) indicates that the firm's policies or procedures may require the firm or the engagement partner to take different actions from those applicable to personnel when obtaining an understanding of whether an individual from another firm has the appropriate competence and capabilities to perform the audit engagement. For example, as part of the confirmation as required by paragraph 19, the group auditor may ask the component auditor to confirm that the component auditor has the appropriate competence and capabilities, including sufficient time to perform the assigned audit procedures at the component.

Competence and capabilities of the component auditors

A41. Determining whether the component auditor has the appropriate competence and capabilities influences the nature, timing and extent of the group engagement partner's direction and supervision of the component auditor and the review of their work. Determining whether the component auditor has the appropriate competence and capabilities is a matter of professional judgment and is influenced by the nature and circumstances of the group audit engagement.

A42. In determining whether component auditors have the appropriate competence and capabilities to perform the necessary procedures at the component for purposes of the group audit, the group engagement partner may consider matters such as:

- Previous experience with or knowledge of the component auditor.
- The component auditor's specialized skills (e.g., industry specific knowledge).
- The component auditor's understanding of the applicable financial reporting framework relevant to the group financial statements, and any instructions provided by group management.
- The degree to which the group auditor and component auditor are subject to common systems of quality management, for example, whether the group auditor and a component auditor:

[53] IESBA Code, paragraph 330.3 A2

[54] ISA 220 (Revised), paragraph A71

  - Use common resources to perform the work (e.g., audit methodologies or information technology (IT) applications);
  - Share common policies or procedures affecting engagement performance (e.g., direction and supervision and review of work or consultation;
  - Are subject to common monitoring activities; or
  - Have other commonalities, including common leadership or a common cultural environment.
- The consistency or similarity of:
  - Laws or regulations or legal system;
  - Language and culture;
  - Education and training;
  - Professional oversight, discipline, and external quality assurance; or
- Information obtained through interactions with component management, those charged with governance, and other key personnel, such as internal auditors.

A43. The procedures to determine the component auditor's competency and capability may include, for example:

- An evaluation of the information communicated by the group auditor's firm to the group auditor, including:
  - The firm's ongoing communication related to monitoring and remediation, in circumstances when the group auditor and component auditor are from the same firm.[55]
  - Information from the network about the results of the monitoring activities undertaken by the network across the network firms.
  - Obtaining confirmations from the professional body or bodies to which the component auditor belongs, the authorities by which the component auditor is licensed, or other third parties.
- Discussing the matters in paragraph A51 with the component auditor.
- Requesting the component auditor to confirm the matters referred to in paragraph 20 in writing.
- Discussing the component auditor's competence and capabilities with colleagues in the group engagement partner's firm that have worked directly with the component auditor.
- In subsequent years, requesting that the component auditor confirm whether anything in relation to the matters listed in paragraph 21(a)–(b) has changed since the previous year.
- Obtaining published external inspection reports

[55] ISQM 1, paragraph 53

A44. The group engagement partner's firm and the component auditor's firm may be members of the same network and may be subject to common network requirements or use common networks services.[56] When determining whether component auditors have the appropriate competence and capabilities to perform work in support of the group audit engagement, the group engagement partner may be able to depend on such network requirements, for example, those addressing professional training, or recruitment or that require the use of audit methodologies and related implementation tools. In accordance with ISQM 1, the firm is responsible for designing, implementing and operating its system of quality management, and the firm may need to adapt or supplement network requirements or network services to be appropriate for use in its system of quality management, taking into account the nature and circumstances of the firm and the engagements it performs

Automated tools or techniques

A45. As described in ISA 220 (Revised),[57] when determining whether the engagement team has the appropriate competence and capabilities, the group engagement partner may take into consideration such matters as the expertise of the component auditor in the use of automated tools or techniques. When the group auditor requires component auditors to use specific automated tools and techniques when performing audit procedures, the group auditor may include in communications with component auditors that the use of such automated tools and techniques need to comply with the group auditor's instructions.

Application of the Group Auditor's Understanding of a Component Auditor (Ref: Para. 22)

A46A. ISA 220 (Revised)[58] requires the engagement partner to take responsibility for other members of the engagement team having been made aware of relevant ethical requirements that are applicable given the nature and circumstances of the audit engagement, and the firm's related policies or procedures. This includes policies or procedures that address circumstances that may cause a breach of relevant ethical requirements, including those related to independence, and the responsibilities of members of the engagement team when they become aware of breaches. The firm's policies or procedures also may address breaches of independence requirements by component auditors, and actions the group auditor may take in those circumstances. Such actions may include the component auditor evaluating the significance of the breach, determining whether actions may be taken to satisfactorily address the consequences of the breach, and communicating with the group auditor. No further actions or involvement of the group auditor may be needed with respect to the work of the component auditor if the group auditor agrees that the component auditor has satisfactorily addressed the breach.

A47. If a component auditor is not independent in accordance with ethical requirements that are relevant to the group audit, the group auditor cannot overcome this by being involved in the work of the component auditor or by supplementing the work of component auditor by performing additional risk assessment or further audit procedures on the financial information of the component.

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[56] ISQM 1, paragraphs 58–59

[57] ISA 220 (Revised), paragraph A20

[58] ISA 220 (Revised), paragraphs 17

A48. Serious concerns are those concerns that cannot be overcome. The group engagement partner may be able to overcome less than serious concerns about the component auditor's professional competency (e.g., lack of industry specific knowledge), or the fact that the component auditor does not operate in an environment that actively oversees auditors, by the group auditor being more involved in the work of the component auditor or by directly performing further audit procedures on the financial information of the component.

Engagement Performance (Ref: Para. 23)

A48A. ISA 220 (Revised)[59] includes requirements and guidance regarding the engagement partner's responsibility for the nature, timing and extent of the direction and supervision of the members of the engagement team and the review of their work. For a group audit, the approach to direction, supervision and review will be tailored by the group auditor based on the facts and circumstances of the engagement, and will generally include a combination of addressing the group auditor's firm policies or procedures and group audit-engagement specific responsesThe complexity of the group's structure. A group may be more complex than a single entity because a group may have several subsidiaries, divisions or other business units, including in multiple locations. Also, a group's legal structure may be different from the operating structure, for example, for tax purposes. Complex structures often introduce factors that may give rise to increased susceptibility to material misstatements, such as whether goodwill, joint ventures or special purpose entities are accounted for appropriately and whether adequate disclosures have been made.

A49. It may be not possible or practical for the group engagement partner to solely determine the nature, timing and extent of direction, supervision and review, particularly when the engagement team includes a large number of component auditors that may be located in multiple locations. In managing quality at the engagement level, the group engagement partner may assign such responsibilities to other members of the engagement team.

A50. If component auditors are from a firm other than the group auditor's firm, the firm's policies or procedures may be different, or different actions may need to be taken, respectively, in relation to the nature, timing and extent of direction and supervision of those members of the engagement team, and the review of their work. In particular, firm policies or procedures may require the firm or the group engagement partner to take different actions from those applicable to members of the engagement team within the firm or the network, for example, in relation to the form, content and timing of communications with component auditors, including the use of group auditor instructions to component auditors. ISA 220 (Revised) provides examples of actions that may need to be taken in such circumstances.[60]

A51. In addition, the nature, timing and extent of direction and supervision and review of the component auditor's work may be tailored by taking into account the nature and circumstances of the engagement and, for example:

- The assessed risks of material misstatement. For example, if the group auditor has identified a component that includes a significant risk, a corresponding increase in the extent of direction and supervision of the component auditor and a more detailed review of the component

[59] ISA 220 (Revised), paragraphs 30, A81–A89 and A94–A97

[60] ISA 220 (Revised), paragraph A24

auditor's audit documentation may be appropriate.

- The competence and capabilities of the component auditors performing the audit work. For example, if the group auditor has no previous experience working with a component auditor, the group auditor may communicate more detailed instructions, introduce greater in-person supervision, increase the frequency of discussions with component auditors, or assign more experienced group auditors to oversee the component auditor as the work is performed.
- The location of engagement team members, including the extent to which engagement team members are dispersed across multiple locations, including where service delivery centers are used.
- Access to component auditors' audit documentation. For example, where component auditor working papers cannot be transferred out of the jurisdiction, greater in-person supervision of the component auditor and in-person or electronic review of the component auditor's audit documentation may be appropriate (see also paragraphs A27–A32).

A52. There are different ways in which the group engagement partner may direct and supervise component auditors and review their work, for example:

- Meetings or calls with component auditors to communicate about identified and assessed risks, issues, findings and conclusions.
- Reviews of the component auditor's documentation in person or remotely when permitted by law and regulation.
- Participating in the closing and other key meetings between the component auditors and component management.

Communications with Component Auditors (Ref: Para. 23A)

A52A. Clear and timely communication between the group auditor and the component auditors about their respective responsibilities, along with clear direction to the component auditors about the nature, timing and extent of the work to be performed and the matters expected to be communicated to the group auditor, helps establish the basis for effective two-way communication. Effective two-way communication between the group auditor and the component auditors also helps to set expectations for component auditors, and facilitates the group auditor's direction and supervision of them and the review of their work.

A52B. Other factors that may also contribute to effective two-way communication include:

- Clarity of the instructions to the component auditor, particularly when the component auditor is from another firm and may not be familiar with the policies and procedures of the group auditor.
- A mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form of communications. For example, it may be better to discuss matters that need timely attention in a face-to-face meeting (in person or by videoconference) or by audioconference rather than by exchanging emails.
- A mutual understanding of the person(s) from the group auditor and component auditors who

have responsibility for managing communications regarding particular matters.

- The process for taking action and reporting back on matters communicated by the group auditor.

A52C. The nature, timing and extent of communications between the group auditor and component auditors depends on the facts and circumstances of the group audit engagement, including the nature and extent of involvement of the component auditors and the degree to which the group auditor and component auditors are subject to common systems of quality management.

Form of communications

A52D. The form of the communications between the group auditor and component auditors may vary based on factors such as the nature of the audit work the component auditors have been requested to perform, and the extent to which communication capabilities are integrated into the audit tools used for the group audit.

A52E. The form of communications also may be affected by such factors as:

- The significance, complexity or urgency of the matter.
- Whether the matter will be communicated to group management and those charged with governance of the group.

A52F. Communication between the group auditor and the component auditor may not necessarily be in writing. However, the group auditor's verbal communications with the component auditors may be supplemented by written communication, such as a set of instructions regarding the work to be performed, when the group auditor wants to give particular attention to, or promote a mutual understanding about, certain matters. In addition, the group auditor may meet onsite with the component auditor to discuss significant matters or to review relevant parts of the component auditor's audit documentation.

A52G. Paragraph 44 requires the group auditor to request the component auditor to communicate matters relevant to the group auditor's conclusion with regard to the group audit. As explained in paragraph A112A, the form and content of the component auditor's deliverables are influenced by the nature and extent of the audit work the component auditor has been requested to perform.

A52H. Regardless of the form of communication, the documentation requirements of this and other ISAs apply.

Timing of communications

A52I. The appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances may include the nature, timing and extent of work to be performed by the component auditor and the action expected to be taken by the component auditor. For example, communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.

Non-compliance with laws or regulations (Ref: Para. 20, 23A)

A52J. The group engagement partner may become aware of information about non-compliance or suspected non-compliance with laws or regulations. In such circumstances, the group engagement partner may have an obligation under relevant ethical requirements, laws or regulations, to communicate the matter to the component auditor.[61] The obligation of the group engagement partner to communicate non-compliance or suspected non-compliance may extend to components that are not included in the scope of the group audit (e.g., components for which an audit is required by statute, regulation or for another reason, but for which no additional procedures are performed for purposes of the group audit).

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

A53. ISA 315 (Revised 2019) contains requirements and guidance regarding the auditor's responsibility to obtain an understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control.[62] Appendix 3 of this ISA provides further explanation of the components of the group's system of internal control, including controls over the group's financial reporting process and the consolidation process.

A55. The group auditor's understanding of the group and its environment, the applicable financial reporting framework, and the group's system of internal control may be obtained through communications with:

- Group management, component management and other appropriate individuals within the entity, including individuals within the internal audit function (if the function exists) and individuals who have knowledge of the group's system of internal control, accounting policies and practices, and the consolidation process;
- Component auditors; or
- Auditors that perform an audit for statutory, regulatory or another reason on the financial statements of an entity or business unit that is part of the group.

A55A. Obtaining an understanding of the group, identifying risks of material misstatement and assessing inherent risk and control risk may be performed in different ways depending on preferred audit techniques or methodologies and may be expressed in different ways. Accordingly, when component auditors are involved in the design and performance of risk-assessment procedures, the group auditor may need to communicate its preferred approach with component auditors or provide instructions. [Previously paragraph A71D]

The Group and Its Environment (Ref: Para. 24(a))

A56. An understanding of the group's organizational structure and its business model may enable the group auditor to understand such matters as:

- The complexity of the group's structure. A group may be more complex than a single entity because a group may have several subsidiaries, divisions or other business units, including in multiple locations. Also, a group's legal structure may be different from the operating structure,

[61] See, for example, Section 360.17 and Section 360.18 of the IESBA Code

[62] ISA 315 (Revised 2019), paragraphs A50–A89

for example, for tax purposes. Complex structures often introduce factors that may give rise to increased susceptibility to material misstatements, such as whether goodwill, joint ventures or special purpose entities are accounted for appropriately and whether adequate disclosures have been made.

- The geographic locations of the group's operations. Having a group that is located in multiple geographical locations may give rise to increased susceptibility to material misstatements. For example, different geographical locations may involve different languages, cultures and business practices.
- The structure and complexity of the group's IT environment. A complex IT environment often introduces factors that may give rise to increased susceptibility to material misstatements. For example, a group may have a complex IT environment because of multiple IT systems that are not integrated due to recent acquisitions or mergers. Therefore, it may be particularly important to obtain an understanding of the complexity of the security over the IT environment, including vulnerability of the IT applications, databases, and other aspects of the IT environment. Further, an understanding of change management controls, automated application controls and interface controls may be obtained to understand the integrity of a complex IT environment. A group may also use one or more external service providers for aspects of its IT environment.
- Relevant regulatory factors, including the regulatory environment. Different laws or regulations may introduce factors that may give rise to increased susceptibility to material misstatements. A group may have operations that are subject to a high degree of complex laws or regulations in multiple jurisdictions, or entities or business units in the group that operate in multiple industries that are subject to different types of laws or regulations.
- The ownership, and relationships between owners and other people or entities, including related parties. Understanding the ownership and relationships can be more complex in a group that operates over multiple jurisdictions and when there are changes in ownership through formation, acquisition or joint ventures. These factors may give rise to increased susceptibility to material misstatements.

A57. Obtaining an understanding of the degree to which the group's activities are similar may enable the group auditor to identify similar risks of material misstatement across components and design an appropriate response.

A58. The financial results of entities or business units are ordinarily measured and reviewed by group management. Inquiries of group management may reveal that group management relies on certain key indicators to evaluate the financial performance of the group's entities and business units and take action. The group auditor's understanding of such performance measures may help to identify:

- Areas where there is increased susceptibility to the risk of material misstatement (e.g., due to pressures on component management to meet certain performance measures).
- Controls over the group's financial reporting process.

The Group's System of Internal Control

The Nature and Extent of Commonality of Controls (Ref: Para. 24(c)(i))

A59. Group management may design controls that are intended to operate in a common manner across multiple entities or business units (i.e., common controls). For example, group management may design common controls for inventory management, that operate using the same IT system and that are implemented across all entities or business units in the group. Common controls may exist in each component of the group's system of internal control, and they may be implemented at different levels within the group (e.g., at the level of the consolidated group as a whole, or for other levels of aggregation within the group). Common controls may be direct controls or indirect controls. Direct controls are controls that are precise enough to address risks of material misstatement at the assertion level. Indirect controls are controls that support direct controls.[63]

A60. The understanding of the components of the group's system of internal control therefore includes understanding the commonality of the controls within those components across the group. That understanding may help the group auditor to appropriately respond to the assess risks of material misstatement. When the group auditor plans to test the operating effectiveness of identified controls[64] that are common across the group, the group auditor evaluates the design and determines the implementation of those controls in accordance with ISA 315 (Revised 2019).

A61. To determine the commonality of an identified control across the group, the group auditor may consider whether:

- The control is designed centrally and required to be implemented as designed (i.e., without modification) at some or all components;
- The control is implemented and, if applicable, monitored by individuals with similar responsibilities and capabilities at all the components where the control is implemented;
- If a control uses information from IT applications, the IT applications and other aspects of the IT environment that generate the information are the same across the components or locations; or
- If the control is automated, it is configured in the same way in each IT application across the components.

A62. Judgment may often be needed to determine whether an identified control is a common control. For example, group management may require that all entities and business units perform a monthly evaluation of the aging of customers' accounts that are generated from a specific IT application. When the aging reports are generated from different IT applications or the implementation of the IT application differs across entities or business units, the group auditor may need to consider whether the control can still be determined to be common. This is because of differences in the design of the control that may exist due to the existence of different IT applications (e.g., whether the IT application is configured in the same manner across components, and whether there are effective general IT controls across different IT applications).

A63. Consideration of the level at which controls are performed within the group (e.g., at the level of the consolidated group as a whole or for other levels of aggregation within the group) and the degree of centralization and commonality may be important to the understanding of how information is

[63] ISA 315 (Revised 2019), paragraph A5

[64] ISA 315 (Revised 2019), paragraph 26(a)

processed and controlled. In some circumstances, controls may be performed centrally (e.g., performed only at a single entity or business unit), but may have a pervasive effect on other entities or business units (e.g., a shared services center that processes transactions on behalf of other entities or business units within the group). Typically, the processing of transactions and related controls at a shared service center operates in the same way for those transactions being processed by the shared service center regardless of the entity or business unit (e.g., the processes, risks, and controls for those transactions being processed by the shared service center, regardless of the source of the transaction, are the same). In such cases, it may be appropriate to identify the controls and evaluate the design and determine the implementation of the controls, and if applicable test operating effectiveness, as a single population

Centralized Activities (Ref: Para. 24(c)(ii))

A64. Group management may centralize some of its activities, for example financial reporting or accounting functions may be performed for a particular group of common transactions or other financial information in a consistent and centralized manner for multiple entities or business units (e.g., where the initiation, authorization, recording, processing, or reporting of revenue transactions is performed at a shared service center).

A65. Obtaining an understanding of how centralized activities fit into the overall group structure, and the nature of the activities undertaken, may help the group auditor to identify and assess risks of material misstatement and appropriately respond to such risks. For example, controls at a shared service center may operate independently from other controls, or they may be dependent upon controls at an entity or business unit from which financial information is derived (e.g., sales transactions may be initiated and authorized at a component, but the processing may occur at the shared service center).

A65A. The group auditor may involve component auditors in testing the operating effectiveness of common controls or controls at centralized activities. In such circumstances, effective collaboration between the group auditor and component auditors is important as the audit evidence obtained through testing the operating effectiveness of common controls or controls at centralized activities supports the group auditor's determination of the nature, timing and extent of substantive procedures to be performed.

Communications About Significant Matters that Support the Preparation of the Group Financial Statements (Ref: Para. 24(c)(iv))

A66. Group entities or business units may use a financial reporting framework for statutory, regulatory or another reason that is different from the financial reporting framework used for the group's financial statements. In such circumstances, an understanding of group management's financial reporting processes to align accounting policies and, where relevant, financial reporting period-ends that differ from that of the group, enables the group auditor to understand how adjustments, reconciliations and reclassifications are made, and whether they are made centrally by group management or by the entity or business unit.

Instructions by group management to entities or business units

A67. In applying ISA 315 (Revised 2019),[65] the group auditor is required to understand how group

[65] ISA 315 (Revised 2019), paragraph 25(b)

management communicates significant matters that support the preparation of the group financial statements. To achieve uniformity and comparability of financial information, group management may issue instructions (e.g., communicate financial reporting policies) to the entities or business units that include details about financial reporting processes or may have policies that are common across the group. Obtaining an understanding of group management's instructions may affect the group auditor's identification and assessment of the risks of material misstatement of the group financial statements. For example, in certain circumstances, inadequate instructions may increase the likelihood of misstatements due to the risk that transactions are incorrectly recorded or processed, or that accounting policies are incorrectly applied.

A68. The group auditor's understanding of the instructions or policies may include the following:

- The clarity and practicality of the instructions for completing the reporting package.
- Whether the instructions:
  - Adequately describe the characteristics of the applicable financial reporting framework and the accounting policies to be applied;
  - Address information necessary to prepare disclosures that are sufficient to comply with the requirements of the applicable financial reporting framework, for example, disclosure of related party relationships and transactions, and segment information;
  - Address information necessary for making consolidation adjustments, for example, intra-group transactions and unrealized profits, and intra-group account balances; and
  - Include a reporting timetable.

Engagement Team Discussion (Ref: Para. 24)

A69. The group engagement partner's determination of which members of the engagement team to include in the discussions and the topics to be discussed, is affected by factors such as initial expectations about the risks of material misstatement and the expected involvement of component auditors.

A70. The discussions provide an opportunity to:

- Share knowledge of the components and their environments, including which components' activities are centralized.
- Exchange information about the business risks of the components or the group, and how inherent risk factors may affect susceptibility to misstatement of classes of transactions, account balances and disclosures.
- Exchange ideas about how and where the group financial statements may be susceptible to material misstatement due to fraud or error.[66]
- Identify policies followed by group or component management that may be biased or designed to manage earnings that could lead to fraudulent financial reporting.

[66] ISA 240, paragraph 16 requires the engagement team discussion to place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud may occur.

- Consider known external and internal factors affecting the group that may create an incentive or pressure for group management, component management, or others to commit fraud, provide the opportunity for fraud to be perpetrated, or indicate a culture or environment that enables group management, component management, or others to rationalize committing fraud.
- Consider the risk that group or component management may override controls.
- Consider whether uniform accounting policies are used to prepare the financial information of the components for the group financial statements and, where not, how differences in accounting policies are identified and adjusted (where required by the applicable financial reporting framework).
- Discuss fraud that has been identified, or information that indicates existence of a fraud.
- Share information about risks of material misstatement of the financial information of a component that may apply more broadly to some, or all, of the other components.
- Share information that may indicate non-compliance with national laws or regulations, for example, payments of bribes and improper transfer pricing practices.
- Identify risks of material misstatement relevant to components where the exercise of professional skepticism may be particularly important.
- Discuss any events or conditions identified by group management, component management or the engagement team, that may cast significant doubt on the group's ability to continue as a going concern.

Considerations When Component Auditors Are Involved

Communications with Component Auditors (Ref: Para. 26–26A)

A72. The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.[67] In a group audit there may be a higher risk of material misstatement of the group financial statements, including due to fraud, associated with related party relationships when:

- The group structure is complex;
- The group's information systems are not integrated and therefore less effective in identifying and recording related party relationships and transactions; and
- There are numerous or frequent related party transactions between entities and business units.
- Planning and performing the audit with professional skepticism as required by ISA 200,[68] is therefore particularly important when these circumstances exist.

A72A. The group auditor may communicate the matters in paragraph 26A to other component auditors, if these matters are relevant to the work of those component auditors. *Element of Unpredictability*

[67] ISA 550, paragraph 2

[68] ISA 200, paragraphs 17 and A53–A54

Identifying and Assessing the Risks of Material Misstatement

A72B. The group auditor's process to identify and assess the risks of material misstatement of the group financial statements is cumulative and iterative and may be challenging, particularly where the component's business activities are complex or specialized, or when there are many components across multiple locations. In applying ISA 315 (Revised 2019),[69] the group auditor develops initial expectations about the potential risks of material misstatement and an initial identification of the significant classes of transactions, account balances and disclosures of the group financial statements based on their understanding of the group and its environment, the applicable financial reporting framework and the group's system of internal control. [Previously paragraph A78]

A72C. The initial expectations about the potential risks of material misstatement take into account the group auditor's understanding of the group, including its entities or business units, and the environments and industries in which they operate. Based on the initial expectations, the group auditor may, and often will, involve component auditors in risk assessment procedures as they have direct knowledge and experience with the entities or business units which may be helpful in understanding the business activities and related risks, and where risks of material misstatement of the group financial statements may arise in relation to those entities or business units. [Previously paragraph A79]

A72D. For the identified risks of material misstatement at the assertion level, a separate assessment of inherent risk and control risk is required by ISA 315 (Revised 2019).[70] The group auditor assesses the inherent risk by assessing the likelihood and magnitude of identified risks of material misstatement, taking into account the inherent risk factors. After identifying the risks of material misstatement, including those communicated by component auditors, the group auditor determines the relevant assertions and related significant classes of transactions, account balances and disclosures of the group financial statements. The group auditor's process (or the process of component auditors to whom risk assessment procedures are assigned) of assessing the identified risks of material misstatement at the assertion level also includes the determination of significant risks. [Previously paragraph A79A]

A72E. Based on the risk assessment procedures performed, the group auditor may determine that an assessed risk of material misstatement of the group financial statements only arises in relation to financial information of certain components. For example, the risk of material misstatement relating to a legal claim may only exist in entities or business units that operate in a certain jurisdiction. [Previously paragraph A79C]

A72F. Appendix 4 sets out examples of events and conditions that, individually or together, may indicate risks of material misstatement of the group financial statements, whether due to fraud or error. [Previously paragraph A79D]Consolidation Adjustments and Reclassifications (Ref: Para. 34(b))

Fraud

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69 ISA 315 (Revised 2019), paragraph 22

66 ISA 315 (Revised), paragraph 31 – 34 71 ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

A72G. The auditor is required to identify and assess the risks of material misstatement of the financial statements due to fraud, and to design and implement appropriate responses to the assessed risks.[71] Information used to identify the risks of material misstatement of the group financial statements due to fraud may include the following:

- Group management's assessment of the risks that the group financial statements are materially misstated as a result of fraud.
- Group management's process for identifying and responding to the risks of fraud in the group, including any specific fraud risks identified by group management, or classes of transactions, account balances, or for which a risk of fraud is higher.
- Whether there are particular components for which the risks of material misstatement due to fraud is higher.
- Whether any fraud risk factors or indicators of management bias exist in the consolidation process.
- How those charged with governance of the group monitor group management's processes for identifying and responding to the risks of fraud in the group, and the controls group management has established to mitigate these risks.
- Responses of those charged with governance of the group, group management, appropriate individuals within the internal audit function (and if considered appropriate, component management, the component auditors, and others) to the group auditor's inquiry whether they have knowledge of any actual, suspected, or alleged fraud affecting a component or the group. [Previously paragraph A80].

Considerations When Component Auditors Are Involved (Ref: Para. 26C)

A72H. When the group auditor involves component auditors in the design and performance of risk assessment procedures, the group auditor remains responsible for having an understanding of the group and its environment, the applicable financial reporting framework and the group's system of internal control to have a sufficient basis for the assessment of the risks of material misstatement of the group financial statements in accordance with paragraph 26B. [Previously paragraph A71]

A72I. When the audit evidence obtained from the risk assessment procedures does not provide an appropriate basis for the identification and assessment of the risks of material misstatement, ISA 315 (Revised 2019)[72] requires the group auditor to perform additional risk assessment procedures until audit evidence has been obtained to provide such a basis. [Previously paragraph A71B]

Component Performance Materiality (Ref: Para. 29(a))

A73. Paragraph 29(a) requires the group auditor to determine component performance materiality for each of the components where audit procedures are performed on financial information that is disaggregated. The component performance materiality amount may be different for each component. Also, the component performance materiality amount for an individual component need

[71] ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

[72] ISA 315 (Revised 2019), paragraph 35

not be an arithmetical portion of the group performance materiality and, consequently, the aggregate of component performance materiality amounts may exceed group performance materiality.

A74. This ISA does not require component performance materiality to be determined for each class of transactions, account balance or disclosure for components at which audit procedures are performed. However, if, in the specific circumstances of the group, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the group financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, ISA 320 requires the auditor to determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.[73] In these circumstances, the group auditor may need to consider whether a component performance materiality lower than the amount communicated to the component auditor may be appropriate for those particular classes of transactions, account balances or disclosures.[74]

A75. The determination of component performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. Factors the group auditor may take into account in setting component performance materiality include the following:

- The extent of disaggregation of the financial information across components (e.g., as the extent of disaggregation across components increases, a lower component performance materiality generally would be appropriate to address aggregation risk). The relative significance of the component to the group may affect the extent of disaggregation (e.g., if a single component represents a large portion of the group, there likely may be less disaggregation across components).
- Expectations about the nature, frequency, and magnitude of misstatements in the component financial information, for example:
    - Whether there are risks that are unique to the financial information of the component (e.g., industry-specific accounting matters, unusual or complex transactions).
    - The nature and extent of misstatements identified at the component in prior audits.

A75A. To address aggregation risk, paragraph 29(a) requires component performance materiality to be lower than group performance materiality. As explained in paragraph A75, as the extent of disaggregation across components increases, a lower component performance materiality amount generally would be appropriate to address aggregation risk. In some circumstances, however, component performance materiality may be set at an amount closer to group performance materiality because there is less aggregation risk, such as when the account balance or class of transactions for one component represents a substantial portion of the respective significant class of transactions or significant account balance in the group financial statements.

A76. In some cases, further audit procedures may be performed by the group auditor or a component auditor on a significant class of transactions or significant account balance as a single population

[73] ISA 320, paragraphs 10 and A11–A12

[74] ISA 320, paragraph A13

(i.e., not disaggregated across components). In such cases, group performance materiality often will be used for purposes of performing these procedures.

'Clearly Trivial' Threshold (Ref: Para: 29(b))

A77. The threshold for communicating misstatements to the group auditor is set at an amount equal to, or lower than, the amount regarded as clearly trivial for the group financial statements. In accordance with ISA 450,[75] this threshold is the amount below which misstatements would not need to be accumulated because the group auditor expects that the accumulation of such amounts clearly would not have a material effect on the group financial statements.

Communicating Component Performance Materiality to Component Auditors (Ref. Para. 30)

A77A. In some cases, it may be appropriate for the group auditor to involve the component auditor in determining an appropriate component performance materiality amount, in view of the component auditor's in-depth knowledge of the component and potential sources of misstatement of the component financial information. In this regard, the group auditor also may consider communicating group performance materiality to the component auditor to support collaboration in determining whether component performance materiality, in relation to group performance materiality, is appropriate in the circumstances.

A77B. Because component performance materiality is based, at least in part, on expectations about the nature, frequency, and magnitude of misstatements in the component financial information, ongoing communication between the component auditor and the group auditor is important, particularly if the number and magnitude of misstatements identified by the component auditor are higher than expected.

Responding to the Assessed Risks of Material Misstatement (Ref: Para. 33)

Performing Further Audit Procedures

Performing Further Audit Procedures Centrally

A86. The group auditor may design and perform further audit procedures centrally if the audit evidence to be obtained from performing further audit procedures on one or more classes of transactions, account balances or disclosures in the aggregate will respond to the assessed risks of material misstatement. For example, if the accounting records for the revenue transactions of the entire group are maintained centrally (e.g., at a shared service center), the group auditor may perform further audit procedures to address the assessed risks of material misstatement of the related classes of transactions, account balances, and disclosures. Factors that may be relevant to the auditor's determination of whether to perform further audit procedures centrally include, for example:

- The level of centralization of activities relevant to financial reporting.
- The nature and extent of commonality of controls.
- The similarity of the group's activities and business lines.

A88. The group auditor may determine that the financial information of several components can be considered as one population for the purpose of performing further audit procedures, for example, when transactions are considered to be homogenous because they share the same characteristics,

[75] ISA 450, paragraph A3

the related risks of material misstatement are the same, and controls are designed and operating in a consistent way.

A88A. When further audit procedures are performed centrally, component auditors may still be involved. For example, when the group has multiple shared-service centers, the group auditor may involve component auditors in the performance of further audit procedures for these shared service centers.

Performing Further Audit Procedures at the Component Level

A88B. In other circumstances, procedures to respond to the risks of material misstatement at the group financial statement level that are related to the financial information of a component may be more effectively performed at the component level. This may be the case when the group has:

- Different revenue streams;
- Multiple lines of business;
- Operations across multiple locations; or
- De-centralized systems of internal control.

Numerous Individual Components that Are not Individually Financially Significant

A89. The group auditor may have identified a significant class of transactions, account balance or disclosure in the group financial statements that comprises classes of transactions, account balances or disclosures at many entities and business units, none of which individually result in a risk of material misstatement at the group financial statement level. In some cases, it may be possible for the group auditor to obtain sufficient appropriate audit evidence by performing audit procedures centrally on these classes of transactions, account balances or disclosures, e.g., if they are homogeneous, subject to common controls and access to appropriate information can be obtained. The use of automated tools and techniques may be helpful in these circumstances

A89A. In other cases, it may be necessary for the group auditor to perform audit procedures at selected individually financially insignificant components to address the risks of material misstatement of the group financial statements. The determination of the components at which audit procedures may need to be performed, and the nature, timing and extent of audit procedures to be performed at the selected components, are matters of professional judgment. In these circumstances, introducing an element of unpredictability in the components selected for testing also may be helpful in relation to the risks of material misstatement of the group financial statements due to fraud (also see paragraph A91).

A90. The group auditor may perform substantive analytical procedures in accordance with ISA 520[76] to address the risks of material misstatement at the assertion level for classes of transactions, account balances or disclosures in the group financial statements. Depending on the circumstances of the engagement, the financial information of the components may be aggregated by the group auditor at appropriate levels for purposes of developing expectations and determining the amount of any difference of recorded amounts from expected values in performing the substantive analytical procedures

[76] ISA 520, *Analytical Procedures*

The Nature and Extent of Further Audit Procedures

A90A. In determining the nature and extent of further audit procedures to be performed at a component, the group auditor may:

- Design and perform further audit procedures on the entire financial information of the component;
- Design and perform further audit procedures on one or more classes of transactions, account balances or disclosures; or
- Perform specific further audit procedures. [Previously paragraph A97]

A90B. The group auditor shall take responsibility for the nature, timing and extent of further audit procedures to be performed. However, as described in paragraph 3, component auditors can be, and often are, involved in all phases of the group audit, including in the performance of further audit procedures.

Design and Perform Further Audit Procedures on the Entire Financial Information of the Component

A90C. The group auditor may determine that designing and performing further audit procedures on the entire financial information of a component is an appropriate approach, including when:

- Audit evidence needs to be obtained on all or a significant proportion of a component's financial information to respond to the assessed risks of material misstatement of the group financial statements.
- There is a pervasive risk of material misstatement of the group financial statements due to the existence of events or conditions at the component that may be relevant to the group auditor's evaluation of group management's assessment of the group's ability to continue as a going concern. [Previously paragraph A98]**Subsequent Events** (Ref: Para. 47–48)

Design and perform further audit procedures on one or more classes of transactions, account balances or disclosures

A90D. The group auditor may determine that designing and performing further audit procedures on one or more classes of transactions, account balances, or disclosures of the financial information of a component is an appropriate approach to address an assessed risk of material misstatement of the group financial statements. For example, a component may have limited operations but holds a significant portion of the land and buildings of the group or has significant tax balances. [Previously paragraph A100]

Perform specific further audit procedures

A90E. The group auditor may determine that performing specific further audit procedures on the financial information of a component is an appropriate approach, including when audit evidence needs to be obtained with respect to specific assertions. For example, the group auditor may centrally test the class of transaction, account balance or disclosure and may require the component auditor to perform specific further audit procedures at the component (e.g., specific further audit procedures related to the valuation of claims or litigations in the component's jurisdiction or the existence of an asset). [Previously paragraph A101]

Element of Unpredictability

A91. Including an element of unpredictability in the type of work to be performed, the entities or business units at which procedures are performed and the extent to which the group auditor is involved in the work, may increase the likelihood of identifying a material misstatement of the components' financial information that may give rise to a material misstatement of the group financial statements due to fraud.[77]

Operating Effectiveness of Controls that Are Common Across the Group

A92. If the group auditor intends to rely on the operating effectiveness of controls that operate throughout the group in determining the nature, timing and extent of substantive procedures to be performed at either the group level or at the components, the group auditor, in accordance with ISA 330,[78] is required to design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of those controls. This includes obtaining sufficient appropriate audit evidence that the controls are operating at the components as designed. The group auditor may request the component auditor to assist the group auditor in performing these procedures.

A93. If more deviations than expected are detected as a result of testing the operating effectiveness of the controls, the group auditor may need to revise the group audit plan. Possible revisions to the group audit plan may include:

- Requesting additional substantive procedures to be performed at certain components.
- Identifying and testing the operating effectiveness of other relevant controls that are designed and implemented effectively.
- Increasing the number of components selected for further audit procedures.

A93A. When the operating effectiveness of controls is tested centrally (e.g., controls at a shared service center or testing of common controls), the group auditor may need to communicate information about the audit work performed with component auditors. For example, when a component auditor is requested to design and perform further audit procedures on the entire financial information of the component, or design and perform further audit procedures on one or more classes of transactions, account balances or disclosures, the component auditor may need information about the control testing performed to determine the nature, timing and extent of the substantive procedures.

Consolidation Process

Consolidation Procedures (Ref: Para. 34(a))

A94. The further audit procedures on the consolidation, including sub-consolidations, may include:

- Determining that the journal entries necessary are reflected in the consolidation; and
- Evaluating the operating effectiveness of the controls over the consolidation process and responding appropriately if any controls are determined to be ineffective.

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[77] ISA 240, paragraph 30(c)

[78] ISA 330, paragraph 8

Consolidation Adjustments and Reclassifications (Ref: Para. 34(b))

A95. The consolidation process may require adjustments and reclassifications to amounts reported in the group financial statements that do not pass through the usual IT applications, and may not be subject to the same controls to which other financial information is subject. The group auditor's evaluation of the appropriateness, completeness and accuracy of the adjustments and reclassifications may include:

- Evaluating whether significant adjustments appropriately reflect the events and transactions underlying them;
- Determining whether those entities or business units whose financial information has been included in the group financial statements were appropriately included;
- Determining whether significant adjustments have been correctly calculated, processed and authorized by group management and, where applicable, by component management;
- Determining whether significant adjustments are properly supported and sufficiently documented; and
- Evaluating the reconciliation and elimination of intra-group transactions, unrealized profits, and intra-group account balances.

Consolidation Process (Ref: Para. 39)

A102. The appropriate level of the group auditor's involvement may depend on the circumstances and the structure of the group and other factors, such as the group auditor's previous experience with the component auditors that perform procedures on the consolidation and sub-consolidations (also see paragraphs A42 and A51) and the circumstances of the group audit engagement (e.g., if the financial information of an entity or business unit has not been prepared in accordance with the same accounting policies applied to the group financial statements).

Using Audit Evidence from an Audit Performed for Another Purpose (Ref: Para. 42)

A103. An audit may be performed on the financial statements of an entity or business unit that is part of the group, and an auditor's report has been issued for statutory, regulatory or other reasons. For example, when an entity or business unit has been acquired close to year-end. If an audit has been performed and an auditor's report has been issued for statutory, regulatory or other reasons, the group auditor may use audit evidence from that audit if the group auditor is satisfied that the work is appropriate for the group auditor's purposes. If the audit procedures performed are not an appropriate response to the assessed risks of material misstatement of the group financial statements, the group auditor may decide not to use the audit evidence from that audit. Alternatively, the group auditor may plan to have additional audit procedures performed on the component, to address the assessed risks of material misstatement of the group financial statements.

A104. In addition to the factors in paragraph 42, factors that may affect the group auditor's decision whether to use the audit evidence from an audit that has already been performed due to statutory, regulatory or other reasons to provide audit evidence for the group audit may include the following:

- Differences in the financial reporting framework applied in preparing the financial statements of the entity or business unit and that applied in preparing the group financial statements.

- Differences in the auditing and other standards applied by the component auditor and those applied in the audit of the group financial statements.
- Differences in the financial reporting period-end between the financial statements of the entity or business unit and the financial statements of the group.

Communication about Matters Relevant to the Group Auditor's Conclusion

Communication about Matters Relevant to the Group Auditor's Conclusion with Regard to the Group Audit (Ref: Para. 44)

A111A. Although the matters required to be communicated in accordance with paragraph 44 relate to the group auditor's conclusion with regard to the group audit, certain matters may need to be communicated timely in the course of the component auditor's procedures. Such matters may include, for example:

- Information on instances of non-compliance with ethical requirements relevant to the group audit, including identified breaches of independence provisions;
- Information on instances of non-compliance with laws or regulations;
- Newly arising significant risks of material misstatement, including risks of fraud;
- Identified or suspected fraud or illegal acts involving component management or employees that could have a material effect on the group financial statements; or
- Significant and unusual transactions.

Communication of Misstatements of Component Financial Information (Ref: Para. 44(c))

A111B. Knowledge about corrected and uncorrected misstatements across components may alert the group auditor to potential pervasive internal control deficiencies, when considered along with the communication of deficiencies in accordance with paragraph 44(e). In addition, a higher than expected number of identified misstatements (uncorrected or corrected) may indicate a higher risk of undetected misstatements, which may lead the group auditor to conclude that additional audit procedures need to be performed at certain components.

Communications with Those Charged with Governance of the Component (Ref: Para. 44(f))

A112. In certain circumstances, the group auditor may combine certain entities or business units into components for purposes of planning and performing the group audit (see paragraphs A4–A6). In these circumstances, the group auditor may need to use professional judgment to determine, in accordance with ISA 260 (Revised),[79] the appropriate person(s) in the governance structure of those entities or business units with whom to communicate, in view of the nature of the matters to be communicated.

Component Auditor's Overall Findings or Conclusions (Ref: Para. 44(h))

A112A. The form and content of the deliverables from the component auditor are influenced by the nature

[79] ISA 260 (Revised), paragraph 11

and extent of the audit work the component auditor has been requested to perform. The component auditor's overall findings or conclusions may take the form of a conclusion or opinion on the audit work performed by the component auditor for purposes of the group audit.

Reviewing the Component Auditor's Audit Documentation (Ref: Para. 45A)

A112C. ISA 220 (Revised) requires the engagement partner to determine that the nature, timing and extent of direction, supervision and review is planned and performed in accordance with the firm's policies or procedures, professional standards and applicable legal and regulatory requirements and is responsive to the nature and circumstances of the audit engagement and the resources assigned or made available to the engagement team.[80] Accordingly, when determining whether, and the extent to which, it is necessary to review parts of the component auditor's audit documentation, paragraph 45A requires the group auditor to consider the work performed by the component auditor and the competence and capabilities of the component auditor.

A113. Paragraph A51 provides factors that the group auditor may take into account in tailoring the nature, timing and extent of the direction and supervision of the component auditor, and the review of their work, to the facts and circumstances of the group audit. Other factors that may affect the nature, timing and extent of the review of the component auditor's audit documentation in the circumstances include:

(a) The degree to which the component auditor was involved in risk assessment procedures and in the identification and assessment of the risks of material misstatement of the group financial statements;

(b) The significant judgments made by, and the findings or conclusions of, the component auditor with respect to matters that are material to the group financial statements;

(c) The matters communicated to the group auditor in accordance with this ISA; and

(d) The fact that the component auditor's audit documentation has been subjected to the component auditor's firm's policies or procedures for review of audit documentation

Subsequent Events

A114. The group auditor may:

(a) Request a component auditor to perform subsequent events procedures to assist the group auditor to identify events that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements.

(b) Perform procedures to cover the period between the date of communication of subsequent events by the component auditor and the date of the auditor's report on the group financial statements.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 49)

[80] ISA 220 (Revised 2020), paragraph 30

A114A. The audit of group financial statements is a cumulative and iterative process. As the group auditor performs planned audit procedures, the audit evidence obtained may cause the group auditor to modify the nature, timing or extent of other planned audit procedures as information may come to the group auditor's attention that differs significantly from the information on which the risk assessment was based. For example:

- The misstatements identified at a component may need to be considered in relation to other components; or
- The group auditor may become aware of access restrictions to information or people at a component because of changes in the environment (e.g., war, civil unrest or outbreaks of disease).

In such circumstances, the group auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions.

A115. The evaluation required by paragraph 49 assists the group auditor in determining whether the overall group audit strategy and group audit plan developed to respond to the assessed risks of material misstatement of the group financial statements continues to be appropriate. The requirement in ISA 330[81] for the auditor, irrespective of the assessed risks of material misstatement, to design and perform substantive procedures for each material account balance, class of transactions and disclosure also may be helpful for purposes of this evaluation in the context of the group financial statements.

A115A. In performing the evaluation required by paragraph 49, information that the group auditor may take into account with respect to the audit evidence obtained from the work performed by component auditors depends on the facts and circumstances of the group audit, and may include:

- The communications from the component auditors required by paragraph 44, including the overall findings or conclusions of the component auditors on the work performed for purposes of the group audit;
- Other communications from the component auditors throughout the group audit, including those required by paragraph 26A;
- The group auditor's direction and supervision of the component auditors, and review of their work, including, as applicable, the group auditor's review of the component auditor's audit documentation in accordance with paragraph 45A. [Previously paragraph A112B]

A115B. In some circumstances, an overall summary memorandum or report describing the work performed and the results thereof may provide a basis on its own for the group auditor to conclude that the work performed and audit evidence obtained by the component auditor is sufficient for purposes of the group audit. This may be the case, for example, when the component auditor has been requested to perform specific further audit procedures as identified and communicated by the group auditor.

Evaluating the Effect on the Group Audit Opinion (Ref: Para. 50)

[82] ISA 705 (Revised), paragraphs 20 and 24

A116. The group engagement partner's evaluation may include a consideration of whether corrected and uncorrected misstatements communicated by component auditors indicate a systemic issue (e.g., with respect to transactions subject to common accounting policies or common controls) that may affect other components.

Auditor's Report

Auditor's Report (Ref: Para: 52)

A117. Although component auditors may perform work on the financial information of the components for the group audit and as such are responsible for their overall findings or conclusions, the group engagement partner or the group engagement partner's firm is responsible for the group audit opinion.

A118. When the group audit opinion is modified because the group auditor was unable to obtain sufficient appropriate audit evidence in relation to the financial information of one or more components, the Basis for Qualified Opinion or Basis for Disclaimer of Opinion section in the auditor's report on the group financial statements describes the reasons for that inability.[82] In some circumstances, a reference to a component auditor may be necessary to adequately describe the reasons for the modified opinion, e.g., when the component auditor is unable to perform or complete the work requested on the component financial information due to circumstances beyond the control of component management.

Communication with Group Management (Ref: Para. 53A–55)

A119A. The group audit plan may be complex due to the number and nature of the entities and business units comprising the group. In addition, as explained in paragraph A5, the group auditor may determine that certain entities or business units may be considered together as a component for purposes of planning and performing the group audit. Therefore, discussing with group management an overview of the group auditor plan may be helpful with respect to coordinating the work performed at components, including when component auditors are involved, and in identifying component management (see paragraph A15).

A120. ISA 240 contains requirements and guidance on communication of fraud to management and, where management may be involved in the fraud, to those charged with governance.[83]

A121. Group management may need to keep certain material sensitive information confidential. Examples of matters that may be significant to the financial statements of the component of which component management may be unaware include the following:

- Potential litigation.
- Plans for abandonment of material operating assets.
- Subsequent events.
- Significant legal agreements.

[82] ISA 705 (Revised), paragraphs 20 and 24

[83] ISA 240, paragraphs 41–43

Communication with Those Charged with Governance of the Group (Ref: Para. 56)

A122. The matters the group auditor communicates to those charged with governance of the group may include those brought to the attention of the group auditor by component auditors that the group auditor judges to be significant to the responsibilities of those charged with governance of the group. Communication with those charged with governance of the group may take place at various times during the group audit. For example, the matter referred to in paragraph 56(a) may be communicated after the group auditor has determined the work to be performed on the financial information of the components. On the other hand, the matter referred to in paragraph 56(b) may be communicated at the end of the audit, and the matters referred to in paragraph 56(c)–(d) may be communicated when they occur.

A123. ISA 260 (Revised)[84] requires the auditor to communicate with those charged with governance an overview of the planned scope and timing of the audit. With respect to a group audit, the group auditor's determination of the planned scope and approach is based on the understanding of the group and its environment in accordance with paragraph 24 of this ISA. This understanding helps the group auditor to determine components at which audit work will be performed, including whether certain of the group's entities or business units may be considered together as a component, and the nature, timing and extent to which component auditors are to be involved.

Communication of Identified Deficiencies in Internal Control

A123A. In accordance with ISA 265, the group auditor is responsible for determining, on the basis of the audit work performed, whether one or more identified deficiencies. Individually or in combination, constitute significant deficiencies.[85] The group auditor may request input from the component auditor as to whether an identified deficiency or combination of deficiencies at the component is a significant deficiency in internal control.

Documentation (Ref: Para. 57)

A123B. As explained in paragraph A6 of ISA 230, other ISAs contain specific documentation requirements that are intended to clarify the application of ISA 230 in the particular circumstances of those other ISAs. The Appendix to ISA 230 lists other ISAs that contain specific documentation requirements and guidance.

A123C. The audit documentation for the group audit supports the group auditor's evaluation in accordance with paragraph 49 as to whether sufficient appropriate audit evidence has been obtained on which to base the group audit opinion. [Previously paragraph A123A.]

A124. The audit documentation for the group audit comprises:

- The documentation residing in the group auditor's file; and
- The separate documentation residing in the respective component auditor audit files relating to the work performed by the component auditors for purposes of the group audit (component auditor documentation).

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[84] ISA 260 (Revised), paragraph 15

[85] ISA 265, paragraph 8

A124x. The final assembly and retention of the audit documentation for a group audit is subject to the policies or procedures of the group auditor's firm in accordance with ISQM 1.[86] The group auditor may provide specific instructions to component auditors regarding the assembly and retention of the documentation of work performed by them for purposes of the group audit.

Basis for the Group Auditor's Determination of Components (Ref: Para: 57(b))

A124y. Documentation of the basis for the group auditor's determination of components may be evidenced in various ways, including fulfillment of the following requirements:

- Paragraph 17A, which requires the group auditor to determine the components at which audit work will be performed, based on the group auditor's understanding of the group's organizational structure and information system.
- Paragraph 26B, which requires the group auditor to take responsibility for the identification and assessment of the risks of material misstatement of the group financial statements.
- Paragraph 56(a), which requires the group auditor to communicate with those charged with governance of the group an overview of the work to be performed at the components of the group and the nature of the group auditor's planned involvement in the work to be performed by component auditors.

Basis for the Group Auditor's Determination of the Competence and Capabilities of Component Auditors (Ref: Para: 57(ca))

A124z. ISQM 1 provides guidance regarding the firm's policies or procedures that address the competence and capabilities of the engagement team.[87] Such policies or procedures also may describe or provide guidance about the documentation of the determination of the competence and capabilities of the engagement team, including component auditors.

A124A. [Moved to paragraph A127A]

A124B. [Moved to paragraph A127A]

A124C. [Moved to paragraph A127B]

Documentation of the Direction and Supervision of Component Auditors and the Review of Their Work (Ref: Para. 57(d))

A124D. As described in paragraph A48A, the approach to direction, supervision and review in a group audit will be tailored by the group auditor based on the facts and circumstances of the engagement, and will generally include a combination of responses specific to the group audit and addressing the group auditor's firm policies or procedures. Such policies or procedures may also describe or provide guidance about the documentation of the group auditor's direction and supervision of the engagement team and the review of their work.

A125. ISA 300 requires the auditor to describe, in the audit plan, the nature, timing and extent of the planned direction and supervision of engagement team members and the review of their work. When

[86] ISQM 1, paragraphs 31(f) and A83–A85

[87] ISQM 1, paragraph A96

component auditors are involved, the extent of such descriptions will often vary by component, recognizing that the planned nature, timing and extent of direction and supervision of component auditors, and review of their work, is influenced by the factors described in paragraphs A33E and A33F.

A126. When component auditors are involved in the group audit, the group auditor's documentation of its involvement in the work of component auditors may include, for example:

- Required communications with component auditors, including instructions issued and other confirmations required by this ISA.
- The rationale for the selection of visits to component auditor sites, attendees at meetings and the nature of the matters discussed.
- Matters discussed in audioconferences or videoconferences with component auditors or component management.
- The rationale for the group auditor's determination of component auditor audit documentation selected for review.
- Changes in the planned nature and extent of involvement with component auditors, and the reasons why.

A127. Paragraph 45A requires the group auditor to consider certain matters in determining whether, and the extent to which, it is necessary to review parts of the component auditor's audit documentation Paragraph A113 includes other factors that may affect the nature, timing and extent of the review of audit documentation of component auditors.

A127A. Component auditor documentation generally need not be replicated in the group auditor's audit file. However, depending on the facts and circumstances, the group auditor may decide to replicate or retain copies of certain component auditor documentation in the group auditor's audit file (e.g., for ease of accessibility). For example, the group auditor may determine that copies of certain component auditor documentation may be helpful to facilitate the review by the group engagement partner or engagement quality reviewer for the group audit, or to supplement the description of a particular matter in the communication from the component auditor. Examples of such component auditor documentation may include:

- A listing or summary of the significant judgments made by the component auditor, and the conclusions reached thereon, that are relevant to the group audit;
- Matters that may need to be communicated to those charged with governance of the group; or
- Matters that may be determined to be key audit matters to be communicated in the auditor's report on the group financial statements. [Previously paragraphs A124A and A124B]

A127B. When required by law or regulation, certain component auditor documentation may need to be included in the group auditor's audit file, for example, to facilitate the request of a regulatory authority to review documentation related to work performed by a component auditor. [Previously paragraph A124C]

A128. Policies or procedures established by the firm in accordance with the firm's system of quality management, or resources provided by the firm or a network, may assist the group auditor in

documenting the direction and supervision of component auditors and the review of their work. For example, an electronic audit tool may be used to facilitate communications between the group auditor and component auditors, and also may also be used for audit documentation, including indicating the names of the group auditor reviewer(s) and the date(s) and extent of the review.

Additional Considerations When Access to Component Auditor Documentation is Restricted

A129. Audit documentation for a group audit may present some additional complexities or challenges in certain circumstances. This may be the case, for example, when law or regulation may restrict the component auditor from providing documentation outside of its jurisdiction.

A130. In these circumstances, the group auditor may be able to overcome the restrictions , such as when the group auditor is able to review the component auditor documentation by visiting the component auditor's location, or remotely when permitted by law or regulation (see paragraph A29). In these circumstances, the group auditor's documentation nonetheless needs to comply with the requirements of this ISA, including with respect to the documentation of the nature, timing and extent of the group auditor's direction and supervision of component auditors and the review of their work. The guidance in paragraph A113 may be helpful to the group auditor in determining the extent of the review of the component auditor documentation in these circumstances. The guidance in paragraphs A127A and A127B provides examples of circumstances in which certain component auditor documentation may be included in the group auditor's audit file.

A130A. If the group auditor is unable to obtain access to the component auditor documentation, the group auditor may need to consider whether a scope limitation exists that may require a modification to the opinion on the group financial statements. See paragraph A32.