Academic Year 2019-2020

BLOCKBOOK AUDIT

Lecturer: Prof. dr. Ignace De Beelde

Department of Accounting, Corporate Finance and Taxation

Ignace.DeBeelde@UGent.be

Name student: ……

TABLE OF CONTENTS

Introduction

Dear student

This blockbook is an important guideline for the course **'Audit'.** In this blockbook you will find answers to your questions about the organization, planning and content of this course. Note that all classes for this course are scheduled in a seven-week time frame (23/9 until 6/11), block 1 of the first semester.

In this course we will continue with the problem based way of teaching which you all have already experienced in the course Human Resource Management, previous academic year. First, the **lectures** will give you the basic theoretical knowledge. Secondly, the **tutorials** will enable you to develop skills required to analyze and evaluate complex accounting and auditing problems. At last, **supervisions** will improve your social and communicative skills and prepare you for the labor market. All these skills are developed by means of an alternative form of learning, **problem based learning**, in which you will have to solve problems in small groups.

The fundamental objective of the 'Audit' course is to make you become familiar with the audit of the financial statements of a company. You have studied the financial statements in the past years and have learned the importance of financial reporting for the functioning of the financial markets. You have also learned how to analyze annual accounts. In previous courses, you learned that companies must make choices in the area of reporting, among others concerning applying the appropriate valuation rules. Apart from verifying whether everything that had to be registered has been registered, one of the tasks of the auditor is examining whether the company has applied the appropriate valuation rules correctly and whether the annual accounts were not manipulated. This should result in a true and fair view of the situation of the company. In that sense the financial audit closes the financial reporting process.

The financial statement audit is the task of an independent expert. To become an auditor, you need to have a thorough knowledge of accounting and auditing techniques. The profession is organized as a free and independent profession to guarantee its independent role. In Belgium this task is fulfilled by a 'bedrijfsrevisor', a certified public accountant.

Both aspects (auditing methodology and the regulation of the profession) are part of this course. The profession experiences a lot of challenges: there is an evolution of a self-regulating profession to a profession with strong external supervising bodies. There is also a growing influence of international audit rules. This results in strong dynamics in the professional field. The large audit firms are actively seeking young graduates in this field.

More specific goals and competences are:

- able to explain concepts and definitions in the audit literature
- gain insights in the role and function of audit in our society
- learn about the audit process
- understand audit issues in the academic literature
- understand the functions of financial reporting
- able to solve complex audit problems
- acquire a critical attitude towards your learning process and that of your fellow students
- develop an active learning attitude: work independently and in team towards the correct solution of the problem

Read this blockbook thoroughly. This manual will inform you where and when the different lectures, supervisions and tutorial meetings are held and what is expected from you for this specific course.

Good luck!

Prof. dr. Ignace De Beelde

Assisting team:

Machteld Hebbrecht

Fanny Buysschaert, Pedagogic teaching staff

Prerequisites

To successfully participate in this course, you should **have an understanding of accounting and financial reporting**. You should be able to analyze financial statements and know how the major types of business transactions are accounted for. You should also have a general knowledge of business and management.

Structure of the course

Lectures

During these lectures the **basic knowledge** for this course is taught. Please consult your class schedule for the exact dates, class hours and locations.

Problem based learning

The Problem based learning (PBL) concept at our faculty is twofold. At the one hand you have the tutorial meetings that focus on **the implementation of the knowledge** as well as on the **social skills**. At the other hand, you have the supervision meetings that focus specific on **the reflecting and social communicative skills.**

The tutorial meetings

In addition to the lectures, our time will be devoted to the discussion of papers and case studies in small groups of 4 to 5 students, together with Professor De Beelde or Machteld Hebbrecht, teaching assistant. Some of these will be organized in plenary sessions, others in tutorial meetings. Part of them will be graded and are part of your final score for this course.

The tutorial meetings are scheduled on **Tuesday October 8 and Tuesday October 29.** Each group will convene separately with Professor De Beelde or with Machteld Hebbrecht for a tutorial meeting of 45 minutes.

The group schedules, locations and groups for these tutorial meetings will be announced on Ufora during the first week. Be sure to **check Ufora** at **the beginning of the first week of block 1**!

The first tutorial will focus on the discussion of an academic paper. It is not an empirical paper, but a discussion paper that summarizes academic literature and has also policy implications. You have to read the paper in advance and prepare the questions that you should discuss during the tutorial.

During the second tutorial, a case will be discussed that focuses on the responsibility of an auditor with respect to fraud detection. It is a complex case and the tutorial will take the format of a fraud risk brainstorming session, as prescribed by the American professional auditing standards. .

For every discussion, different roles such as discussion leader and secretary are assigned. These roles are rotated among the group members. You can find the manual for the different roles at the end of this document. The practical information of who will be the discussion leader or secretary and when, is announced at the beginning of the semester on Ufora. The tutors will assist the discussion leader and group members where necessary.

Before every discussion each student must have read and prepared the materials so each group member can actively participate. **This preparation is required!** To prepare for the tutorial, it is advised to read through the theory of the first lectures. This will simplify discussing the cases during the tutorial meetings. Each group member tries **individually** to find an answer to the tutorial questions and tries to gather useful information. This means that you cannot just reproduce your information during the tutorial. You must be able to explain your position to the team (for example by making a schematic overview or clear formulation of your contribution) and leave room for debate. Every student reports his/her information and knowledge. It is possible to already meet as a team before the tutorial meeting, to have a first exchange of ideas. The discussion leader and the group integrate all the information into one whole. At the end of the session, the case should be solved.

In every tutorial meeting a secretary is assigned. He/she takes care of putting everything mentioned during the tutorial meeting on paper. He/she will post this report **the next day** on Ufora and keep the group members and tutor(s) posted of this report. All of the official documents need to be posted on your private forum on Ufora!

Supervisions

Tutorial meetings focus not only on the learning product (i.e., the knowledge you need to gather as a student for this part of the course) but gaining social and communicative skills which prepare you for the labor market, take up an important place as well. Guiding and evaluating supervisions will be the responsibility of the pedagogic teaching staff, Fanny Buysschaert (Fanny.Buysschaert@UGent.be).

During the semester 3 supervisions are scheduled. You need to choose 2 of the 3 supervisions. Students who take another Problem Based course in this block have also 2 required supervisions (for the two courses in total).

The **first supervision** on **'How to apply for a job'** will be given by Kristof Reynvoet from Stanton Chase (headhunting office). In this supervision meeting, students learn how they prepare and manage a job interview (non-verbal communication, attitudes…). This supervision takes place on Wednesday Oktober 23 from 2.30 pm until 4 pm am in Academieraadzaal, Volderstraat.

The **second supervision** focuses on **'Personal Branding'** and will be provided by ORMIT. In this supervision, we provide the opportunity to further develop your reflective ability, which is considered as an important social skill. In this supervision, you will learn which impression you make on people and how to react to them. Personal branding suggests that success comes from self-packaging. Personal branding involves an asset by defining an individual's body, clothing, physical appearance, digital and online presence and areas of knowledge in a way leading to a uniquely distinguishable, and ideally memorable, impression. This supervision takes place on Friday 25/10 from 10 am until 11.30 am in class room De Smet.

The **third supervision** focuses on your **job application skills.** In small interactive groups, we will work on your communicative skills and prepare you for the labor market. This supervision will be given by Randstad. Personal feedback on your CV and job application skills will also be possible. These supervisions take place on 11/10, 18/10 and 24/10 from 10 am until 12 am in the meeting room (-1 floor, meeting room, KCO, campus Tweekerken). If you can follow one of those three sessions provided by Randstad, you can always contact our Randstad colleagues to have personal feedback on your cv en cover letter (youngtalents_gent@randstad.be).

You need to register on Ufora during the first week (week of 23/9). Note that you are obliged to register before the deadline! Deadline registration: Friday 27/9 noon.

Peer assessment

You will be asked to evaluate each other by means of the peer assessment instrument that can be found on Ufora. The peer assessment instrument investigates your cooperation and involvement in the group happening. It is in your own advantage to fill in this instrument scrupulously, since peer assessment marks will be taken into account for your final grade. You can find the manual on Ufora. The evaluation peer assessment dates will be explicitly mentioned on Ufora.

It is the responsibility of every student to follow up these marks and if wanted, to ask more feedback by the responsible lecturer.

1. Timetable – schematic course overview

ATTENTION:

Tutorials: Meeting room left and right, second floor, Sint Pietersplein 7

Supervision meetings: consult ufora for the exact locations and timetables

Week	**Tutorial meeting/lecture**
Week 1: **Tuesday 24/9, 13 h. – 17.30 h.** **Aud. Vlerick, Hoveniersberg** **Friday 27/9, 13 h. – 17.30 h.** **Aud. Van Vaerenberg, Hoveniersberg**	**Check Ufora for time schedules tutorials, roles and groups.** Introduction / KPMG video: what is audit?/ The risk based audit – overview and key concepts (IFAC GUIDE, CHAPTER 4, 6 and 7) Objective of tutorial 1 The audit process: risk assessment and internal control (IFAC GUIDE, CHAPTER 5 and 8) Individual assessment: case 'FSA'

Week 2: **Tuesday 1/10, 13 h. – 17.30 h.** **De Sterre, S8** **Friday 4/10, 13h. – 17.30 h.** **Aud. Van Vaerenberg, Hoveniersberg**	Risk Analysis: Case Risk identification through analytical skills (in collaboration with Deloitte) – part I Feedback on FSA The organization of the profession (Jongerenraad IBR)
Week 3: **Tuesday 8/10, 8.30 h. – 19 h.** **Class rooms, 2nd floor, Sint Pietersplein 7** **Friday 11/10, 13 h. – 17.30 h.** **De Sterre, S8**	Tutorials: Discussion of Knechel (2016): Audit quality and regulation Case Risk identification through analytical skills (in collaboration with Deloitte) – part II
Week 4: **Tuesday 15/10, 13 h. – 17.30 h.** **De Sterre, S8** **Friday 18/10, 13 h. – 17.30 h.** **De Sterre, S8**	Responding to assessed risks and further procedures (IFAC GUIDE, CHAPTER 8 and 9) Fraud Tesla case explained
Week 5: **Tuesday 22/10, 13 h. – 17.30 h.** **De Sterre, S8** **Friday 25/10, 13 h. – 17.30 h.** **De Sterre, S8**	Audit practice approach (in collaboration with BDO) Substantive testing: Trimlawn case Audit reporting (IFAC GUIDE, CHAPTER 11-17)
Week 6: **Tuesday 29/10, 8h30. – 19 h.** **Classrooms, Sint-Pietersplein 7, 2nd floor**	Tesla case
Week 7: Monday 4/11, 8.30 h. – 13 h.	Assessment

2. Literature

Recommended literature for solving the cases will be available on Ufora. Additional references will be given in class.

3. Evaluation – grading policy

The evaluation for this course is 100% permanent evaluation. There is no second chance examination for this course.

The permanent evaluation is based on active participation during tutorials, practical sessions and supervisions; the contents of assignments, taking into account peer assessment score; and an individual assessment.

You are required to be present during tutorials, supervisions and case discussions. In case of absence without valid reason, you cannot pass this course! Please notify **(in advance!)** the discussion leader, the tutor and the pedagogic teaching staff of your absence. This is a very important attitude that is taken serious in the academic world as well as in corporate cultures.

The relation in percentage will be drawn up as follows:

100%: Permanent evaluation

- 10%: Active and relevant participation in tutorials and supervisions
- 45%: Individual mark for contribution to teamwork (group mark corrected for peer assessment marks)
- 45% Individual assessment

Students have to pass for all three components of the evaluation!

4. Ufora

On Ufora the following will be announced:

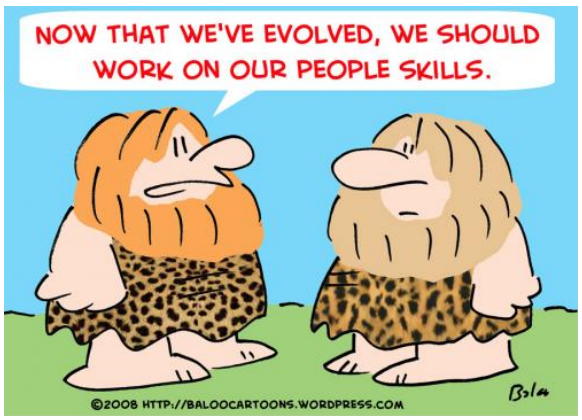
- ✓ Group schedules for the tutorial meetings and supervision meetings
- ✓ Different roles (discussion leader, secretary and presenter) during the meetings
- ✓ Timetable for each group for the tutorial meetings and supervision meetings
- ✓ The cases

It is **advised to consult Ufora on a regular basis**. Moreover urgent arrangements or announcement will be communicated through Ufora.

Presentations, literature, … will be posted on Ufora.

5. Skills book

In this skills book we focus on the skills you need to master in order to be able **to cooperate** effectively **in a tutorial group**.



Being able to work in a team is an important skill that is required in today's work environment. Companies are becoming increasingly aware that the scale of the problems they are confronted which require 'team work'. In order to function well in a team, an employee should not only possess a broad technical knowledge, but strong social and communicative skills as well. In a meeting for example, you need to be able to listen to each other, let other people finish their sentences, dare to speak up, being able to lead, … In other situations you should know how to deal adequately with your colleagues, how to negotiate, to learn how to accept criticism of others but also to learn to give constructive criticism on the work of others, … A tutorial meeting is the place to acquire and expand these skills.

The skills that are illustrated in this **skills book** are important for all members of the tutorial group but also especially for the discussion leader and the secretary.

During the tutorial meetings this guide can be used to check which of the skills have been challenged and properly acquired or need extra attention.

The acquisition of these skills is a learning process. To achieve this a critical view of personal functioning, and that of others, is necessary. During this learning process the peer assessment system plays an important role.

Various elements of PBL are essential. Below you will find an explanation of the most important elements.

a. Participating in the tutorial group

In problem-based learning (tutorial meetings) assignments are tackled in **small (at random chosen) groups**. To allow a tutorial group to function correctly, not only the manner in which the assignments are carried out (method) is important, but also the way in which the group members interact with each other.

In each tutorial meeting one student will function as **discussion leader**. His/her main task is to ensure that the progress of the discussion runs smoothly both in methodology and process. The involved tutor (lecturer) will assist him/her in this task.

Whether or not the progress of the tutorial process runs smoothly, is a shared responsibility of the group members, the discussion leader and the involved tutor.

Next to the discussion leader, **a secretary** will be appointed for each tutorial meeting. He/she will write a report of every tutorial meeting. This **report** will be posted, the **next day**, on the forum (on Ufora) so every group member can consult it. **All official documents need to be posted on your private Forum (<documents).**

b. Evaluation

The evaluation is focused on the content related and process related aspects. Through the frequent peer assessments and supervision moments a fairly accurate view can be given on the process-related evolution of the tutorial groups and the individual students. This evolution will certainly be taken into account during the permanent evaluation.

THE METHOD

During a tutorial meeting, and especially during the first meetings, it can be useful to work according to a specific method. In this manner you will be given a certain structure for discussion. Also the discussion leader can use this manual during the tutorial meetings.

It is useful from the start of the tutorial meetings to take note of the following guidelines:

- ✓ Make **name-tags** with your name on the front and back side of the card. This will enable you to get to know each other and allow the discussion leader and the tutor or pedagogic staff to address you more personally.

- ✓ Everyone **carefully prepares** for the tutorial meetings. Read the case to be discussed in advance, so you will know at the meeting what the subject of the case is.
- ✓ If you are **not able to be present** at the meeting, **warn** the tutor (and pedagogic teaching staff for the supervisions) involved and the responsible discussion leader of that specific meeting with a valid reason.
- ✓ Group members will show **respect** for the feelings, thoughts, standards and values of the others. Every contribution has its merit! Stupid questions do not exist!
- ✓ **Everyone is responsible** for the state of affairs in the tutorial group. Decisions are made based on the on-going discussion. The role of the discussion leader is merely functional. He is not the only one to be held responsible if the discussion does not proceed fluidly.
- ✓ For each different group **a separate forum** (private forum) will be created on which the secretary can post his/her reports, on which the discussion forum will allow certain topics can be discussed, ... Make use of it!
- ✓ All official documents need to be posted on your private forum < documents.
- ✓ If you want to make use of a PowerPoint presentation (**beamer**), contact Fanny Buysschaert.

(POSSIBLE) STEPS TO FOLLOW

Step 1: clearing up notions

All the group members have read the case/problem in advance. People don't always perceive and interpret things in the same way. Therefore the discussion leader will ask for terms that might be difficult to understand. This relates to understanding the text, and in function of this, to understanding separate words. This step is important so that each student will feel comfortable and safe within the group. (group climate, climate setting). Students are expected to be capable of reproducing (paraphrasing) the content of the text, and to be capable of comparing their own interpretation with that of others, and discuss the differences.

Step 2: Determining the nature of the assignment and defining the problem

The tutorial group determines what the central problem and the central question is ('the main issue'). Furthermore you will find out as a group what the nature of that central question is, and what kind of assignment it is. With the word 'problem' is meant: the content-related core of an assignment, the central problem or central question. Solving this problem should be seen more as a way of 'explaining', to give good arguments for your answers. You are expected to see the difference between main issues and side issues. You will draw up different study goals according to the various degrees of importance.

Step 3: Problem analysis/brainstorming

The group makes an inventory of prior knowledge, all kinds of ideas, conceptions, hypotheses and possible solutions that may be relevant for tackling the problem. Prior knowledge provides fertile ground for lodging newly gathered knowledge. In this regard, prior knowledge does not need to be correct. The important thing is to activate an assertive attitude within students. You are capable of actualizing all forms of prior knowledge and knowledge from every day

experience. You learn to make information concrete, by specifying, by summarizing, by conditioning, by appointing consequences, … In these situations you learn to pose questions about things that are not clear to you.

Step 4: Problem analysis/systematic inventory

In this fourth phase you will reflect on the information and material that came forward in phase 3. Here the group will order everything that is useful and you want to take along for the further development of the assignment, and connect it to the problem. In this phase it is important that you gain insight in what was said in phase 3. Furthermore you can criticize the remarks from phase 2 and insert these remarks in the discussion to try and solve more of the problem. At the end of this phase students can review everything thoroughly.

Step 5: Formulating learning goals/objectives

You formulate learning goals and inform how you will try to accomplish them. In other words, on which questions do you still need an answer? The activated prior knowledge will not only show what you already know, but also expose any gaps in the present knowledge. It is in this phase that you will draw up learning goals to fill up these gaps. Learning goals create bridges between activated prior knowledge and new knowledge. In this phase you learn to formulate learning goals as open questions in the form of a hierarchy (in order of importance). Furthermore you will indicate how you plan to tackle these learning goals.

Step 6: Exchange of information

The goal in phase six is the exchange and discussion of the personal information, in which you have worked individually or in group. You exchange information and inform each other about the results that were found. For this it is extremely useful for the students to prepare this reporting well by making schemes, indexes, a short presentation, … During this discussion the discussion leader will find out from the different students whether the compiled information does not contradict each other. In this phase it's still possible to pose questions and explain the difficulties.

At the end of each discussion the tutor (the lecturer) will give the group and the discussion leader a summary of the tutorial meeting (feedback). He indicates what went well or what didn't go well. He indicates both positive points as points that leave room for improvement at the next tutorial meeting. During the tutorial meetings the tutor also redirects the content of the discussions.

You are not expected to know everything to the finest details, but to learn how to discern what is essential and what is not. The point is to attend to the activities in a conscious and focused manner, so you create a sort of roadmap on which you can fall back.

Also the communicative aspect is not neglected; you learn how to convey information to your fellow students in a correct manner (learn to listen, learn to anticipate, …).

PARTICIPATING IN THE TUTORIAL GROUP

DISCUSSION LEADER

The discussion leader attends to different aspects in order to ensure an efficient and effective course of the tutorial meeting:

- ✓ Constructing the content of the tutorial meeting: introduction, structuring the tutorial meeting and discussion, leading the tutorial meeting
- ✓ Posting the agenda for the meeting in advance (private forum Ufora)
- ✓ Applying the methodology of PBL (cfr. steps)
- ✓ The interaction and cooperation between the students

Different functions apply to the discussion leader: preparing, structuring, summarizing, stimulating, enquiring, reformulating and concluding.

If some group members have not added anything to the discussion yet, the discussion leader tries to involve these people in the discussion. He/she tries to keep a clear overview within his/her group. He/she also pays attention to the non-verbal reaction of the group members and tries to maintain a safe and balanced climate within the group.

SECRETARY

The secretary writes the report of the tutorial meeting, and sends this report to all other group members the following day + posts it on Ufora (forum < documents).

The report of the every tutorial meeting should be structuring as following:

1. Administrative data: group number, assignment title, name discussion leader and secretary, name tutor, date, names of absent group members. The absentees have warned the tutor involved and the appointed discussion leader in advance.

2. The mentioned definitions of unclear terms.

3. The mentioned questions, problems and aspects that are part of the assignment. (learning goals)

4. The most important suggested answers to those questions, or solutions to those problems, or explanations of the phenomena described.

5. Unsolved questions, problems and remarks

6. Collection of the learning goals discussed (questions and problems) and the learning goals that still need to be researched.

7. Solutions and/or answers to the postulated learning goals

8. Formulating a summary

GROUP MEMBER

As a member of a tutorial meeting you communicate with your fellow students, both verbally and non-verbally. You will do this by exchanging ideas, thoughts, opinions and feelings. The tutorial meeting is aimed primarily at broadening your knowledge and acquiring insights into the (new) subject matter. By attending these tutorial meetings you will also develop a critical attitude towards the new subject matter, as well as toward your own learning process and that of the other students.

Various functions apply to a group member: providing information, requesting information, summarizing, active listening, giving feedback, asking feedback and receiving feedback. In short, you learn to take on an active learning attitude as a group member.

Practical information

For questions concerning **content, lectures and tutorials**:

Contact Prof.dr. I. De Beelde

Ignace.Debeelde@UGent.be

For questions concerning **tutorials**:

Contact Machteld Hebbrecht

Macheld.Hebbrecht@UGent.Be

For questions concerning **problem based learning (supervisions, peer assessment,…)**:

Contact Fanny Buysschaert

Fanny.Buysschaert@UGent.be

REFERENCES

Dochy, F., Segers, M., Gijbels D. & Van Den Bossche P. (2002). Studentgericht onderwijs en probleemgestuurd onderwijs. Betekenis, achtergronden en effecten. Utrecht: Lemma.

Moust, J.H.C., Bouhuijs, P.A.J., Schmidt, H.G. & de Grave, W.S. (1997). Probleemgestuurd leren, een wegwijzer voor studenten. Groningen/Houten:Wolters-Noordhoff.

Schmidt, H.G. & Moust, J.H.C. (1998). Probleemgestuurd onderwijs. Praktijk en Theorie. Groningen/Houten: Wolters-Noordhoff.

Moust, J.H.C., Bouhuijs, P.A.J. & Schmidt, H.G. (1997). Probleemgestuurd leren. Groningen/Houten: Wolters-Noordhoff.

Moust, J. & Schmidt, H. (1995). Probleemgestuurd leren: een krachtige leeromgeving. Velon tijdschrift voor lerarenopleiders, 16 (4), 40-54.

Van Til, C. & van der Heijden, F. (1998). Studievaardigheden PGO. Vakgroep Onderwijsontwikkeling en Onderwijsresearch (O & O). Universiteit Maastricht.

International Federation of Accountants

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

VOLUME 1—CORE CONCEPTS

FOURTH EDITION

International Federation of Accountants

International Federation of Accountants
529 Fifth Avenue,
New York, NY 10017 USA

This *Guide to Using ISAs in the Audits of Small- and Medium-Sized Entities* was prepared by the International Federation of Accountants (IFAC) with support from its Small and Medium Practices Committee. The committee represents the interests of professional accountants operating in small- and medium-sized practices and other professional accountants who provide services to small- and medium-sized entities.

This publication may be downloaded for individual non-commercial use from the IFAC website: www.ifac.org/smp. The approved text is published in the English language.

IFAC serves the public interest and strengthens the accountancy profession by:
- Supporting the development of high-quality international standards;
- Promoting the adoption and implementation of these standards;
- Building the capacity of professional accountancy organizations; and
- Speaking out on public interest issues.

For further information, please e-mail Christopher Arnold, Head of SME/ SMP and Research at ChristopherArnold@ifac.org.

ISBN: 978-1-60815-353-4

Published by: IFAC International Federation of Accountants®

Contents

Preface

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

Since publication in 2011 of the third edition, the International Audit and Assurance Standards Board (IAASB) has completed projects on Using the Work of Internal Auditors; The Auditor's Responsibilities Relating to Other Information; Auditor Reporting; Disclosures and Non-Compliance with Laws and Regulations (NOCLAR). The fourth edition has therefore been updated for these recent changes in the ISAs, so it is in accordance with the 2016-2017 Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements. We have also taken the opportunity to refine some of the technical content and to make other minor presentational improvements. Mindful that many users may be in the process of translating the Guide, we have endeavored to keep the revisions in this edition to a minimum.

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

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

In order to help member organizations maximize the use of both this Guide and its sister publication, the Guide to Quality Control for Small- and Medium-Sized Practices, IFAC has developed a Companion Manual, along with additional materials, designed to support the use of the Guides for education and training purposes. The Companion Manual includes suggestions on how IFAC member organizations and firms may make best use of the Guides to suit their own needs and jurisdictions.

Readers may be interested in the current projects of the IAASB, which includes Accounting Estimates, Quality Control, ISA 315 (Revised) and Data Analytics. This Guide does not in any way anticipate possible changes in these areas.

Finally, we welcome readers to visit the SMP area of the IFAC website at www.ifac.org/SMP and the @IFAC_SMP Twitter feed for further details about the work of the IFAC SMP Committee, and to the Global Knowledge Gateway (www.ifac.org/Gateway) for access to a wide collection of resources, news and articles.

Monica Foerster
Chair, IFAC SMP Committee
April 2018

Request for Comments

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

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

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

Please submit your comments to Christopher Arnold, Head of SME/ SMP and Research at:

Email: ChristopherArnold@ifac.org
Fax: +1 212-286-9570
Mail: International Federation of Accountants
529 Fifth Avenue
New York, NY 10017, USA

Disclaimer

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

1 HOW TO USE THE GUIDE

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

- **Reading and understanding the ISAs**
  It is assumed that practitioners have read the text of the International Standards on Auditing (ISAs) which are contained in the *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*, and which can be downloaded free of charge from the IAASB Publications & Resources web page at http://www.ifac.org/about-ifac/publications-resources (filter by "Handbooks, Standards, and Pronouncements"). ISA 200.19 states that the auditor shall have an understanding of the entire text of an ISA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. The ISAs, as well as frequently asked questions (FAQs) and other support materials, can also be obtained from the Clarity Center at www.ifac.org/auditing-assurance/clarity-center.
- **Use of professional judgment**
  In order to apply the ISAs effectively, professional judgment is required based on the particular facts and circumstances involved in the firm and each particular engagement.

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

This Guide can be used to:

- Develop a deeper understanding of an audit conducted in compliance with the ISAs;
- Develop a staff manual (supplemented as necessary for local requirements and a firm's procedure) to be used for day-to-day reference, and as a basis for training sessions and individual study and discussion; and
- Help ensure that staff adopt a consistent approach to planning and performing an audit.

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

1.1 Reproduction, Translation, and Adaptation of the Guide

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

1.2 Chapter Content and Organization

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

- Volume 1 — Core Concepts
- Volume 2 — Practical Guidance

This is Volume 1 of the Guide, which provides an overview of the entire audit and a discussion of key audit concepts such as materiality, assertions, internal control, risk assessment procedures, and the use of further audit procedures in responding to assessed risks. It also includes a summary of ISA requirements with respect to:

- Specific areas such as accounting estimates, related parties, subsequent events, going concern, and others;
- Documentation requirements; and
- Forming an opinion on the financial statements.

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

Summary of Organization

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

- **Chapter Title**
- **Audit Process Chart — Extract**
  Most chapters contain an extract from the audit process chart (where applicable) to highlight the particular activities addressed in the chapter.
- **Chapter Content**
  This outlines the content and purpose of the chapter.
- **Relevant ISAs**
  Most chapters in this Guide begin with some extracts from the ISAs that are relevant to the chapter content. These extracts include relevant requirements and, in some cases, the objectives (sometimes highlighted separately if/when a chapter focuses primarily on one particular ISA), selected definitions, and application material. The inclusion of these extracts is not meant to imply that other material in the ISA not specifically mentioned, or other ISAs that relate to the subject matter, do not need to be considered. The extracts in the Guide are based solely on the judgment of the authors as to what is relevant for the content of each particular chapter. For example, the requirements of ISAs 200, 220, and 300 apply throughout the audit process, but have only been addressed specifically in one or two chapters.
- **Overview and Chapter Material**
  The overview in each chapter provides:
  - Extracts from applicable ISAs; and
  - An overview of what is addressed in the chapter.

The overview is followed by a more detailed discussion of the subject matter, and practical step-by-step guidance/methodology on how to implement the relevant ISAs. This can include some cross-references to the applicable ISAs. While the Guide focuses exclusively on the ISAs (other than the 800 series) that apply to audits of historical financial information, reference is also made to the *Code of Ethics for Professional Accountants* issued by the International Ethics Standards Board for Accountants (the IESBA Code), and the International Standard on Quality Control 1 (ISQC 1), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*.

- **Consider Points**
  A number of Consider Points are included throughout the Guide. These Consider Points provide practical guidance on audit matters that can easily be overlooked, or where practitioners may have difficulty understanding and implementing certain concepts.
- **Illustrative Case Studies**
  To demonstrate how the ISAs can be applied in practice, Volume 2 of the Guide includes two case studies. At the end of many chapters within Volume 2, two possible approaches to documenting the application of the ISA requirements are discussed. Please refer to Volume 2, Chapter 2 of this Guide for details about the case studies.
- The purpose of the case studies and the documentation presented are purely illustrative. The documentation provided is a small extract from a typical audit file, and it outlines just one possible way of complying with the ISA requirements. The data, analysis, and commentary provided represent only some of the circumstances and considerations that the auditor will need to address in a particular audit. As always, the auditor must exercise professional judgment.
- The first case study is based on a fictional entity called Dephta Furniture. This is a local, family-owned furniture manufacturer with 15 full-time employees. The entity has a simple governance structure, few levels of management, and straightforward transaction processing. The accounting function uses an off- the-shelf, standard software package.
- The second case study is based on another fictional entity called Kumar & Co. This is a micro-sized entity with two full-time staff plus the owner and one part-time bookkeeper.

Other IFAC Publications

This Guide may also be read in conjunction with The *Guide to Quality Control for Small- and Medium-Sized Practices*, which can be downloaded free of charge from the IFAC online publications and resources site at http://www.ifac.org/publications-resources/guide-quality-control-small-and-medium-sized-practices-third-edition-0.

1.3 Glossary of Terms

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

The Guide also uses the following terms:

Anti-Fraud Controls

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

- Policies and procedures that provide additional accountability, such as signed approval for journal entries;
- Improved access controls for sensitive data and transactions;
- Silent alarms;
- Discrepancy and exception reports;
- Audit trails;
- Fraud contingency plans;
- Human resource procedures such as identifying/monitoring individuals with above-average fraud potential (for example, an excessively lavish lifestyle); and
- Mechanisms for reporting potential frauds anonymously.

Pervasive Risks and Controls

Some risks and controls pertain to the entity as a whole. Pervasive controls (also referred to as entity-level controls in some jurisdictions) are designed to help support the functioning of transactional controls. Consequently, pervasive risks and controls are considered at the financial statement level.

Risks and controls that have pervasive effects on the financial statements are those that, in the auditor's judgment:
(a) Are not confined to specific elements, accounts or items of the financial statements;
(b) If so confined, represent or could represent a substantial proportion of the financial statements; or
(c) Relate to disclosures that are fundamental to users' understanding of the financial statements.

Pervasive controls are often less tangible than controls that operate at the assertion level. As such, they form the all-important foundation upon which other internal controls (such as transactional controls) are built. Examples of pervasive controls include management's commitment to ethical behavior, their attitude toward the system of internal control, and the process for hiring competent people, preventing fraud and period-end financial reporting.

Transactional Risks and Controls

Some risks and controls pertain to the individual financial statement areas or to specific assertions (assertion level). Transactional controls are designed by management to mitigate transactional risks. Their purpose is to ensure that all transactions are properly authorized, processed and recorded in the accounting records at the correct amount and in the correct period.

Management

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

Those Charged With Governance (TCWG)

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

Owner-Manager

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

Small- and Medium-Sized Practice (SMP)

An accounting practice/firm that exhibits the following characteristics:
- Its clients are mostly small- and medium-sized entities (SMEs);
- External sources are used to supplement limited in-house technical resources; and
- It employs a limited number of professional staff.

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

1.4 Acronyms Used in the Guide

AR	Accounts receivable
Assertions (combined)[1]	C= Completeness AV = Accuracy and valuation E = Existence P = Presentation
CAATs	Computer-assisted audit techniques
CU	Currency units (standard currency unit is referred to as "€")
F/S	Financial statements
HR	Human resources
IAASB	International Auditing and Assurance Standards Board
IC	Internal Control. The five major components of internal control are as follows: CA = Control activities CE = Control environment IS = Information systems MO = Monitoring RA = Risk assessment
IESBA Code	IESBA Code of Ethics for Professional Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
ISAs	International Standards on Auditing
ISAEs	International Standards on Assurance Engagements
IAPSs	International Auditing Practice Statements
IPSASs	International Public Sector Accounting Standards
ISQC	International Standard on Quality Control
ISREs	International Standards on Review Engagements
ISRSs	International Standards on Related Services
IT	Information technology
KAM	Key Audit Matters
PC	Personal computer
R&D	Research and development
RMM	Risks of material misstatement
RAPs	Risk assessment procedures
SME	Small- and medium-sized entity
SMP	Small- and medium-sized practice
TOC	Tests of controls
TCWG	Those charged with governance
WP	Work papers, working papers

[1] Note that some of the assertions defined in ISA 315 (Revised) have been combined in this manual for ease of use in practice. Where applicable, the Individual assertions (before being combined) can also be tested separately.

2 THE ISAs

Structure of the ISAs

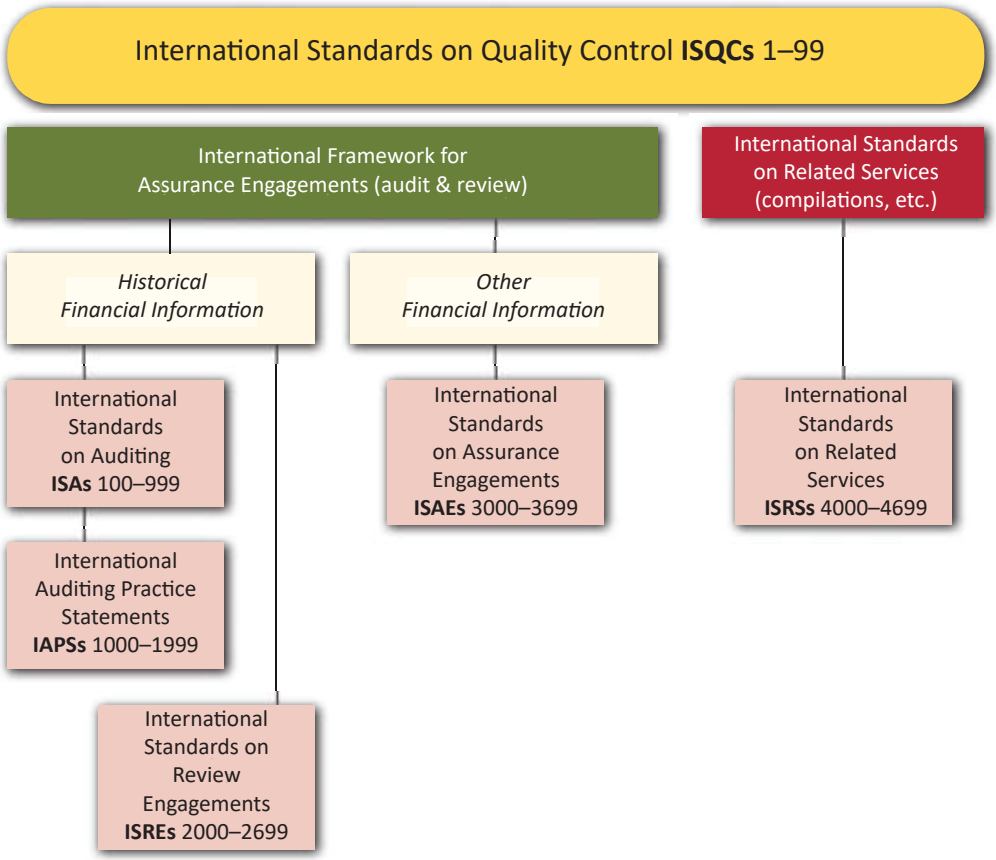
The ISAs have a common structure, as outlined below.

ISA Element	Comments
Introduction	An explanation of the purpose and scope of the ISA, including how the ISA relates to other ISAs, the subject matter of the ISA, specific expectations on the auditor and others, and the context in which the ISA is set.
Objectives	The objective to be achieved by the auditor as a result of complying with the requirements of the ISA. To achieve the overall objectives of the auditor, the auditor is required to use the objectives stated in relevant ISAs in planning and performing the audit, keeping in mind the interrelationships among the ISAs. ISA 200.21 (a) requires the auditor to: (a) Determine whether any audit procedures in addition to those required by the ISAs are necessary in pursuance of the objectives stated in the ISAs; and (b) Evaluate whether sufficient appropriate audit evidence has been obtained.
Definitions	A description of the meanings attributed to certain terms for purposes of the ISAs. These are provided to assist in the consistent application and interpretation of the ISAs. They are not intended to override definitions that may be established for other purposes, such as those contained in laws or regulations. Unless otherwise indicated, these terms carry the same meanings throughout the ISAs.
Requirements	This section outlines the specific auditor requirements. Each requirement contains the word "shall." For example, ISA 200.15 contains the following requirement: "The auditor shall plan and perform an audit with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated."

ISA Element	Comments
Application and Other Explanatory Material	The application and other explanatory material provides further explanation of the requirements of an ISA, and guidance for carrying them out. In particular, it may: • Explain more precisely what a requirement means or is intended to cover; • Where applicable, include considerations specific to smaller entities; and • Include examples of procedures that may be appropriate in the circumstances. However, the actual procedures selected by the auditor require the use of professional judgment based on the particular circumstances of the entity and the assessed risks of material misstatement. While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an ISA. The application and other explanatory material may also provide background information on matters addressed in an ISA.
Appendices	Appendices form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related ISA, or within the title and introduction of the appendix itself.

2.1 ISA Index and Cross-References

The ISA Framework is illustrated below.



The following table cross-references the ISAs and ISQC 1 to the corresponding chapters in the Guide. Note: This table only includes cross-references to the chapters in the Guide in which the primary application requirements of the respective standards are addressed. Further references to any given standard may also appear in other chapters.

ISA/ ISQC 1 Reference		Volume and Chapters V1 = Volume 1 V2 = Volume 2
ISQC 1	Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements	V1-3, 16, V2-4
200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing	V1-3, 4
210	Agreeing the Terms of Audit Engagements	V2-4
220	Quality Control for an Audit of Financial Statements	V1-3, 16, V2-4, 21
230	Audit Documentation	V1-3, 16, V2-18
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	V1-8, 9, 16 V2-7, 8, 9, 10
250 (Revised)	Consideration of Laws and Regulations in an Audit of Financial Statements	V1-15
260 (Revised)	Communication with Those Charged with Governance	V2-16, 22
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	V2-13, 22
300	Planning an Audit of Financial Statements	V1-9, 16 V2-4, 5, 7, 16
315 (Revised)	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	V1-4, 5, 6, 8, 16 V2-7, 8, 9, 10, 11, 12, 14
320	Materiality in Planning and Performing an Audit	V1-7, V2-6
330	The Auditor's Responses to Assessed Risks	V1-4, 9, 10, 16 V2-10, 16, 17, 21
402	Audit Considerations Relating to an Entity Using a Service Organization	V1-15
450	Evaluation of Misstatements Identified during the Audit	V2-6, 21, 22
500	Audit Evidence	V1-9, V2-16, 17
501	Audit Evidence—Specific Considerations for Selected Items	V1-15
505	External Confirmations	V1-10
510	Initial Audit Engagements—Opening Balances	V1-15
520	Analytical Procedures	V1-10, V2-21
530	Audit Sampling	V2-17
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	V1-11, V2-21
550	Related Parties	V1-12
560	Subsequent Events	V1-13
570 (Revised)	Going Concern	V1-14
580	Written Representations	V2-19
600	Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)	V1-15
610 (Revised 2013)	Using the Work of Internal Auditors	V1-15
620	Using the Work of an Auditor's Expert	V1-15
700 (Revised)	Forming an Opinion and Reporting on Financial Statements	V1-4, 17
701	Communicating Key Audit Matters in the Independent Auditor's Report	V1-4, 17

ISA/ ISQC 1 Reference		Volume and Chapters V1 = Volume 1 V2 = Volume 2
705 (Revised)	Modifications to the Opinion in the Independent Auditor's Report	V2-23
706 (Revised)	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	V2-24
710	Comparative Information—Corresponding Figures and Comparative Financial Statements	V2-25
720 (Revised)	The Auditor's Responsibilities Relating to Other Information	V1-15
800 (Revised)	Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks	Not addressed*
805 (Revised)	Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement	Not addressed*
810	Engagements to Report on Summary Financial Statements	Not addressed*

* ISAs 800 (Revised), 805 (Revised), and 810 were considered to have limited application in the audits of SMEs at the present time, so this edition of the Guide does not specifically address them.

The following table cross-references the Guide's chapters to the principal ISA Chapters addressed.

Note: This table provides a general cross-reference only. Many chapters in this Guide cover aspects addressed by more than one particular ISA.

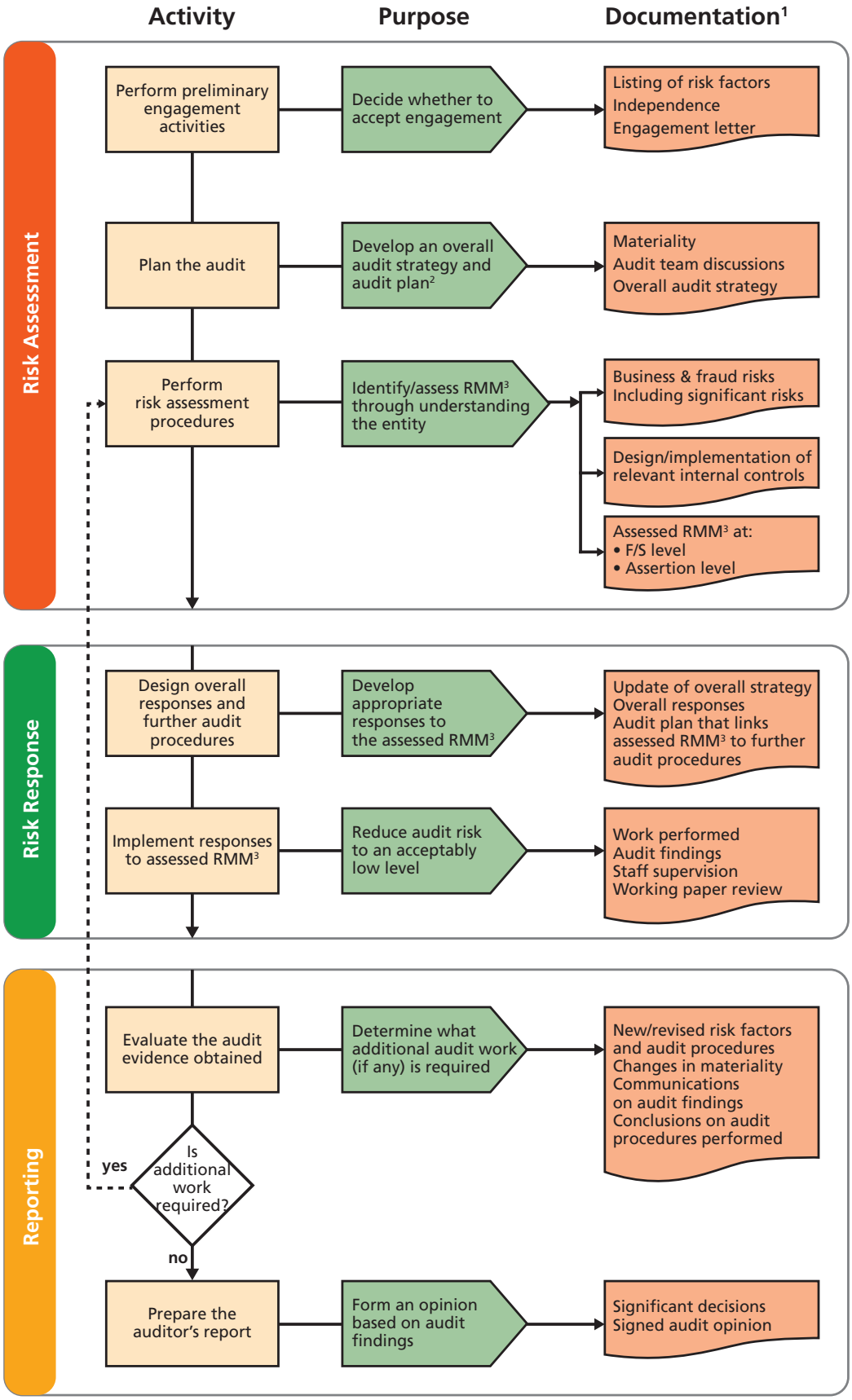
Chapter	Title	ISA /ISQC 1 Reference
V1 – 3	Ethics, ISAs, and Quality Control	ISQC 1, 200, 220
V1 – 4	The Risk-Based Audit—Overview	Multiple
V1 – 5	Internal Control—Purpose and Components	315 (Revised)
V1 – 6	Financial Statement Assertions	315 (Revised)
V1 – 7	Materiality and Audit Risk	320
V1 – 8	Risk Assessment Procedures	240, 315 (Revised)
V1 – 9	Responding to Assessed Risks	240, 300, 330, 500
V1 – 10	Further Audit Procedures	330, 505, 520
V1 – 11	Accounting Estimates	540
V1 – 12	Related Parties	550
V1 – 13	Subsequent Events	560
V1 – 14	Going Concern	570 (Revised)
V1 – 15	Summary of Other ISA Requirements	250 (Revised), 402, 501, 510, 600, 610 (Revised 2013), 620, 720 (Revised)
V1 – 16	Audit Documentation	ISQC 1, 220, 230, 240, 300, 315 (Revised), 330
V1 – 17	Forming an Opinion on Financial Statements	700 (Revised), 701
V2 – 4	Engagement Acceptance and Continuance	ISQC 1, 210, 220, 300
V2 – 5	Overall Audit Strategy	300
V2 – 6	Determining and Using Materiality	320, 450
V2 – 7	Audit Team Discussions	240, 300, 315 (Revised)
V2 – 8	Inherent Risks—Identification	240, 315 (Revised)
V2 – 9	Inherent Risks—Assessment	240, 315 (Revised)

Chapter	Title	ISA /ISQC 1 Reference
V2 – 10	Significant Risks	240, 260 Revised, 315 (Revised), 330
V2 – 11	Understanding Internal Control	315 (Revised)
V2 – 12	Evaluating Internal Control	315 (Revised)
V2 – 13	Communicating Deficiencies in Internal Control	265
V2 – 14	Concluding the Risk Assessment Phase	315 (Revised)
V2 – 16	The Responsive Audit Plan	260 (Revised), 300, 330, 500
V2 – 17	Determining the Extent of Testing	330, 500, 530
V2 – 18	Documenting Work Performed	230
V2 – 19	Written Representations	580
V2 – 21	Evaluating Audit Evidence	220, 330, 450, 520, 540
V2 – 22	Communicating with Those Charged with Governance	260 (Revised), 265, 450
V2 – 23	Modifications to the Auditor's Report	705 (Revised)
V2 – 24	Emphasis of Matter and Other Matter Paragraphs	570 (Revised), 706 (Revised)
V2 – 25	Comparative Information	710

2.2 The Audit Process

The audit approach outlined in this Guide has been divided into three phases — risk assessment, risk response, and reporting. This is illustrated in Exhibit 2.2-1. For each of the audit phases, the exhibit outlines the major activities, their purpose and the resulting documentation. Additional information on the activities and documentation required in each of the three phases is outlined throughout this Guide and particularly in Volume 2, which follows a typical audit from start to finish.

Exhibit 2.2-1



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

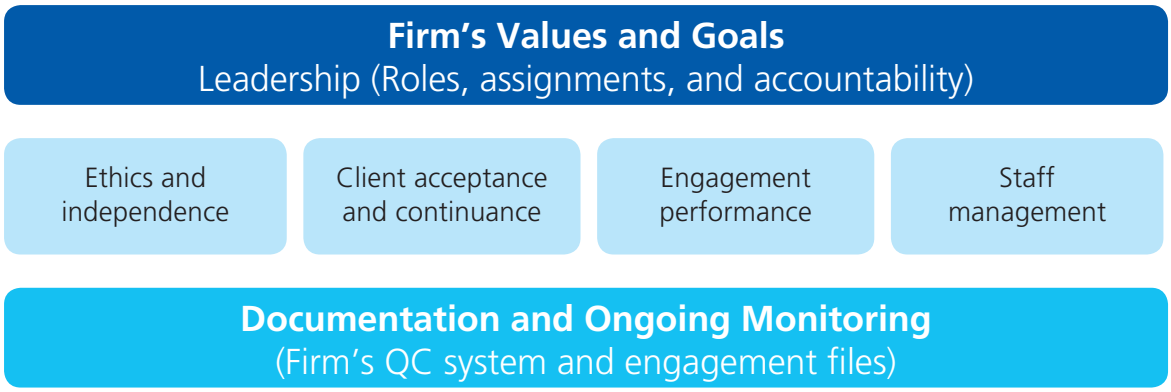
VOLUME 1

CORE CONCEPTS

3 ETHICS, ISAs, AND QUALITY CONTROL

Chapter Content	Relevant ISAs
Matters to be addressed in a firm's system of quality control to ensure compliance with ethical (including independence) requirements and the ISAs.	ISQC 1, 200, 220

Exhibit 3.0-1



Paragraph #	ISQC/ISA Objective(s)
ISQC 1.11	The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that: (a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and (b) Reports issued by the firm or engagement partners are appropriate in the circumstances.
220.6	The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that: (a) The audit complies with professional standards and applicable legal and regulatory requirements; and (b) The auditor's report issued is appropriate in the circumstances.
ISQC 1.13	Personnel within the firm responsible for establishing and maintaining the firm's system of quality control shall have an understanding of the entire text of this ISQC, including its application and other explanatory material, to understand its objective and to apply its requirements properly.
ISQC 1.18	The firm shall establish policies and procedures designed to promote an internal culture recognizing that quality is essential in performing engagements. Such policies and procedures shall require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent) to assume ultimate responsibility for the firm's system of quality control. (Ref: Para. A4-A5)
ISQC 1.19	The firm shall establish policies and procedures such that any person or persons assigned operational responsibility for the firm's system of quality control by the firm's chief executive officer or managing board of partners has sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility. (Ref: Para. A6)
ISQC 1.29	The firm shall establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the competence, capabilities, and commitment to ethical principles necessary to: (a) Perform engagements in accordance with professional standards and applicable legal and regulatory requirements; and (b) Enable the firm or engagement partners to issue reports that are appropriate in the circumstances. (Ref: Para. A24-A29)
ISQC 1.32	The firm shall establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances. Such policies and procedures shall include: (a) Matters relevant to promoting consistency in the quality of engagement performance; (Ref: Para. A32-A33) (b) Supervision responsibilities; and (Ref: Para. A34) (c) Review responsibilities. (Ref: Para. A35)
ISQC 1.48	The firm shall establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. This process shall: (a) Include an ongoing consideration and evaluation of the firm's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner; (b) Require responsibility for the monitoring process to be assigned to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility; and (c) Require that those performing the engagement or the engagement quality control review are not involved in inspecting the engagements. (Ref: Para. A64-A68)
ISQC 1.57	The firm shall establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control. (Ref: Para. A73-A75)

Paragraph #	ISQC/ISA Objective(s)
200.14	The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. (Ref: Para. A16-A19)
200.15	The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A20-A24)
200.16	The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A25-A29)
220.17	On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (Ref: Para. A18-A20)
220.18	The engagement partner shall: (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters; (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm; (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and (d) Determine that conclusions resulting from such consultations have been implemented. (Ref: Para. A21-A22)
220.19	For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall: (a) Determine that an engagement quality control reviewer has been appointed; (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and (c) Not date the auditor's report until the completion of the engagement quality control review. (Ref: Para. A23-A25)

3.1 Overview

Performing quality work begins with strong leadership within the firm and engagement partners committed to the highest ethical standards.

This chapter focuses on developing the system of quality control within a firm. It provides some practical guidance on matters that need to be considered whenever a firm decides to perform audit engagements.

The provision of quality audits and related services is vital to:
- Safeguarding the public interest;
- Maintaining client satisfaction;
- Delivering value for money;
- Ensuring compliance with professional standards; and
- Establishing and maintaining a professional reputation.

The IFAC *Guide to Quality Control for Small- and Medium-Sized Practices* provides a detailed description of the quality control standards and guidance on how to implement a system of quality control for small- and medium-sized practices (SMPs).[1]

The *Code of Ethics for Professional Accountants* (effective January 1, 2011), issued by the IESBA, can be downloaded from the IFAC website.[2]

[1] The web link is: http://web.ifac.org/publications/small-and-medium-practices-committee/implementation-guides.
[2] The web link is: https://www.ethicsboard.org/iesba-code.

3.2 Quality Control Systems

The system of quality control in an accounting firm could be mapped to the five internal control elements that auditors are required to evaluate as part of understanding any entity being audited. In a firm, these five internal control elements would also be applicable to control systems in place (other than quality control), such as time and billing, office workflow, expense control, and marketing activities.

The following diagram maps the quality control elements outlined in ISQC 1 and ISA 220 to the five internal control components contained in ISA 315 (Revised), which are applicable to entities being audited. Each of these five control elements is more fully addressed in Volume 1, Chapter 5 of this Guide.

Exhibit 3.2-1

Internal Control Elements (ISA 315 (Revised))	Firm-Level QC Elements (ISQC 1)	Engagement-Level QC Elements (ISA 220)
Control Environment *(Tone at the Top)*	Leadership Responsibilities for Quality within the Firm Relevant Ethical Requirements Human Resources	Leadership Responsibilities for Quality on Audits Relevant Ethical Requirements Assignment of Engagement Teams
Risk Assessment *(What Could Go Wrong?)*	Acceptance and Continuance of Client Relationships and Specific Engagements	Acceptance and Continuance of Client Relationships and Audit Engagements Risks that the report might not be appropriate in the circumstances
Information Systems *(Tracking performance)*	Quality Control System Documentation	Audit Documentation
Control Activities *(Prevent & detect/correct controls)*	Engagement Performance	Engagement Performance
Monitoring *(Are the firm's/engagement's objectives being met?)*	Ongoing Monitoring of the Firm's Quality Control Policies and Procedures	Applying Results of Ongoing Monitoring to Specific Audit Engagements

3.3 The Control Environment

Delivery of high-quality and cost-effective services is the principal driver of success for professional audit firms. Quality service is also vital in relation to the public-interest responsibilities of professional accountants.

The provision of quality services should always be a key objective in the firm's business strategy; that objective needs to be communicated to all personnel on a regular basis, and the results monitored. This requires leadership and accountability for promised actions. Poor quality control can lead to inappropriate opinions, poor client service, lawsuits, and loss of reputation.

Hindrances to a strong tone at the top could include matters set out below.

Exhibit 3.3-1

Hindrance	Description
Poor Attitudes	A poor attitude is at the heart of most hindrances to quality. It includes such attitudes (but not necessarily this extreme) as the following: • Firm continually operates in a crisis mode; • Poorly planned engagements and activities are the norm; • Poor commitment to quality or compliance with the highest ethical standards; • Not caring about the expectations of quality by the public and other stakeholders; • Regarding changes in auditing standards as only applicable to big entities. Some practices and terminology may get changed to demonstrate compliance on the surface, but in substance, the old audit practices continue as before; • Belief that there is no risk to the firm in small audits — so work performed should be minimal; • Audit work tailored to the fee received — not the risk involved; • Clients considered totally trustworthy by the control partner; • Minimizing or avoiding the need for "engagement quality control reviews"; • Belief that, because the clients pay the bill, they must get what they want; • Partners keeping (or accepting) an audit client (for the fees generated) even though it is (would be) highly risky for the firm; • Unwillingness to adopt standard firm policies on quality control. A partner wants files and working papers to be prepared his/her way without regard for what others do; and • Asking staff to follow the firm's policies, but not complying personally (i.e., "do what I say, not what I do").
Unwillingness to Invest in Training or Development	Conducting a quality audit is dependent on attracting and retaining qualified and competent people to perform the work. This requires ongoing professional development and performance appraisals for all partners and professional staff (every period). Lack of investment in staff also leads to staff turnover.
Lack of Discipline	A failure to discipline partners or staff when the firm's policies are willfully contravened sends a very clear message to personnel that written policies are really not that important. This undermines compliance with all of the firm's policies, and increases the risk to the firm.

A healthy tone at the top can be set by the firm's management and engagement partners through the following activities.

Exhibit 3.3-2

Setting the Tone	Description
Establish the Firm's Objectives, Priorities, and Values	This could include: • An unwavering commitment to quality and high ethical standards; • Investment in staff's learning, training, and skills development; • Investment in the required technological, human, and financial resources; • Policies to ensure sound engagement and fiscal management; and • Risk tolerances for use in decision-making.
Communicate Regularly	Reinforce the firm's values and commitments by communicating regularly (verbally and in writing) with staff. Communications would address the need for integrity, objectivity, independence, professional skepticism, staff development, and accountability to the public. Communications could be made through the Performance-appraisal system, partner updates, emails, office meetings, and internal newsletters.
Update the Quality Control Manual	Each period, update the firm's quality control policies and procedures to address weaknesses and any new requirements.
Hold People Accountable	Assign clear responsibilities and accountabilities for quality-control functions (such as independence issues, consultation, file review, etc.).
Develop Staff Competence and Reward Quality Work	Develop staff through: • Clear job descriptions and documented annual performance appraisals that make quality of work a priority; • Providing incentives/rewards for delivering quality work; and • Taking disciplinary action when the firm's policies are willfully contravened.

Setting the Tone	Description
Continually Improve	Take prompt action to correct deficiencies when identified, such as through the firm's engagement file monitoring, including the cyclical inspection of completed engagement files.
Set an Example	Provide staff with a role model in the positive example set by partners in their day-to-day behavior. For example, if a policy emphasizes the need for quality work, a staff member should then not be criticized for legitimately going over the budgeted time.

3.4 Firm Risk Assessment

Risk management is an ongoing process that helps a firm to anticipate negative events, develop a framework for effective decision-making, and profitably deploy the firm's resources.

Some form of risk management occurs in most firms, and it is often informal and undocumented. Individual partners typically identify risks and respond to them based on their direct involvement with the firm and with their clients. Formalizing and documenting the process for the firm as a whole is a proactive and more effective approach to risk assessment. This does not have to be time-consuming or cumbersome to implement. Notably, effectively managing the firm's risk assessment can result in less stress for partners and staff, savings in time and costs, and improved chances of achieving the firm's goals.

A simple risk assessment process can be used in any size of firm, even a sole proprietorship. It consists of the following activities.

Exhibit 3.4-1

Activity	Description
Establish the Risk Tolerances for the Firm	These tolerances could be quantitative amounts, such as allowable write-offs of work in process, or qualitative factors, such as characteristics of clients that would not be acceptable to the firm. Once established, these tolerances provide partners and staff with a useful reference point for decision-making (e.g., write-offs and client acceptance, etc.).
Identify What Can Go Wrong	Identify the events (that is, the risk factors or exposures) that could prevent the firm from achieving its stated goals. This step implies that the firm has already established clear objectives and a commitment to performing quality work.
Prioritize Risks	Using the risk tolerances established above, prioritize the events identified based on an assessment of likelihood and impact.
What is the Response Needed?	Develop an appropriate response to the assessed risks to reduce the potential impact to within the firm's acceptable tolerances. Potential events (risks) with the highest priority would be addressed first.
Assign Responsibility	For all risks that require action or monitoring, assign someone with the responsibility to take the appropriate action and to manage the risk on a day-to-day basis.
Monitor Progress	Require periodic (simple) reports from each person assigned to manage risks on behalf of the firm (this could address matters such as compliance with the firm's quality control procedures, training requirements, staff appraisals, and independence issues addressed).

A sample of a firm's risk assessment worksheet could be as shown in the following exhibit.

Exhibit 3.4-2

Firm _____ Prepared by _____

Date prepared _____

#	Event—Risk Factor What would prevent the firm's goals being achieved	Likely consequences	Inherent risk assessment			Firm's response to mitigate/manage risk	Who is responsible?	Residual Risk (H, M, L)	Additional action required?	
			Likelihood to occur	Impact	Combined score				What?	Who?
1	*A high-risk client is accepted by firm*	*Unbillable time and/or litigation.*	*4*	*4*	*16*	*QC manual sets out criteria and managing partner must approve all new clients.*	*Managing Partner*	*Low*	*None*	
2	*Independence issue may not be identified on new/existing client*	*Inappropriate to give an opinion, the result of which could be a loss of reputation in the community.*	*2*	*4*	*8*	*QC manual sets out rules. Staff sign annual declaration and Jack Billing addresses any issues raised.*	*Jack Billing*	*Low*	*None*	
3	*Audit engagements are not properly planned*	*Time wasted by staff. Missed risk factors (that is, fraud) and inadequate audit response.*	*4*	*5*	*20*	*A planning meeting required on all audits. Cindy keeps a list of clients and records planning dates. Joe Gisp follows up with partners.*	*Joe Gisp*	*Low*	*None*	
4	*Staff unaware of new clarity standards coming into force*	*Poor quality work that does not comply with ISA standards.*	*4*	*5*	*20*	*Joe Gisp enrolls staff in training courses appropriate to their needs.*	*Joe Gisp*	*Medium*	*Joe to develop process for tracking if staff actually attend courses.*	*Joe Gisp by 1/1/xx*

Notes:

Assess likelihood to occur on a scale of 1 - 5 (Remote = 1 Unlikely = 2 Possible = 3 Likely = 4 Almost certain = 5)

Assess the impact on a scale of 1 - 5 (Immaterial = 1 Minor = 2 Moderate = 3 Major = 4 Material = 5)

Assess the residual risk as low, moderate, or high. This is the remaining risk after the firm response has been applied

3.5 Information Systems

Most firms have well-developed information systems for keeping track of clients, time and billing, expenditures, staff, and engagement file management. However, information systems that track the quality of work produced and compliance with the firm's quality control manual are often not as well developed.

Information systems should also be designed to address the risks identified and assessed as part of the firm's risk assessment process.

Aspects of quality control that merit documentation and ongoing review include keeping track of the matters set out in the following exhibit.

Exhibit 3.5-1

Keep track of:	Description
Firm's Risk Exposure and Staff's Commitment to Quality	• Client acceptance/continuance assessments. • Reports from all persons responsible for some aspect of quality. This could include minutes of committee meetings (i.e., quality control), issues addressed, or simply that there is nothing to report. • Firm-wide communications on the subject of quality. • Most recent monitoring report, and the specific action steps required for each deficiency found or recommendation made (who, what, when, etc.). Also track dates when action steps are completed and send out reminders when necessary. • Details of any client or third-party complaints about the firm's work or the behavior of the firm's personnel. Also track how these complaints were investigated, the results and communication with the complainant, and any actions taken.
Ethics and Independence	• List of prohibited investments. • Details on what ethical (including independence) threats were identified, and the relevant safeguards that have been applied to eliminate or at least mitigate such threats.

Keep track of:	Description
Personnel	• Offer of employment. • Evidence of reference checks performed on new employees. • Actions to mentor, guide, and train new recruits. • Copy and date of the annual staff confirmations on independence, and staff knowledge of the firm's quality control manual. • Evidence of staff appraisals, including the date, and any actions resulting such as attending training, etc. • Staff scheduling, with comparisons of planned scheduling to actual. • Dates of internal and external training sessions, the topics covered, and the names of those who attended. • Details of any disciplinary actions taken.
Engagement Management	• Dates the team planning meeting was scheduled and when it actually took place for all audit engagements. • What files require engagement quality control reviews, who is assigned, and the planned date. Then match the plan to who actually performed the review; when it occurred; and any issues raised and their resolution. • Reasons for any departures from any applicable ISA requirement, and the alternative audit procedures performed to achieve the aim of that requirement. • Details of consultations with others, and resolution of audit/accounting issues raised, if any. • Reasons for engagement delays and how such delays were addressed and resolved. These could include changes in staff personnel, delays in obtaining information, unavailability of client staff, scope restrictions, and any disagreements with client management. • Dating of the auditor's report and compliance with the 60-day recommendation for assembly of final engagement files. • How monitor's comments on the file were addressed.

3.6 Control Activities

Control activities are designed to ensure compliance with the firm's established policies and procedures.

One possible way to design, implement, and monitor quality control is to follow the PDCA (plan-do-check-act) process. Each of the elements is described below.

Exhibit 3.6-1

Step	Description
PLAN	Establish the objectives and quality control processes necessary to deliver the required outputs.
DO	Implement the new processes, often on a small scale if possible.
CHECK	Measure the new processes, and compare the results against the expected results to ascertain any differences.
ACT	Analyze the differences to determine their cause. Each will be part of either one or more of the P-D-C-A steps. Determine where to apply changes that include improvement.

For example, a firm objective may be not to release the audit report until all queries and outstanding items have been cleared. The required policy is that the final engagement report may not be released, filed, or otherwise distributed until certain specified approvals have been obtained. Implementation of the policy could be controlled through a final release process wherein a person verifies that all approvals have in fact been obtained and documented. The effectiveness of the policy could be checked by periodic inspections of the approval sign-offs. If deviations are identified, the reasons would be investigated, and appropriate action such as discipline, training, or changes in the policy would be considered.

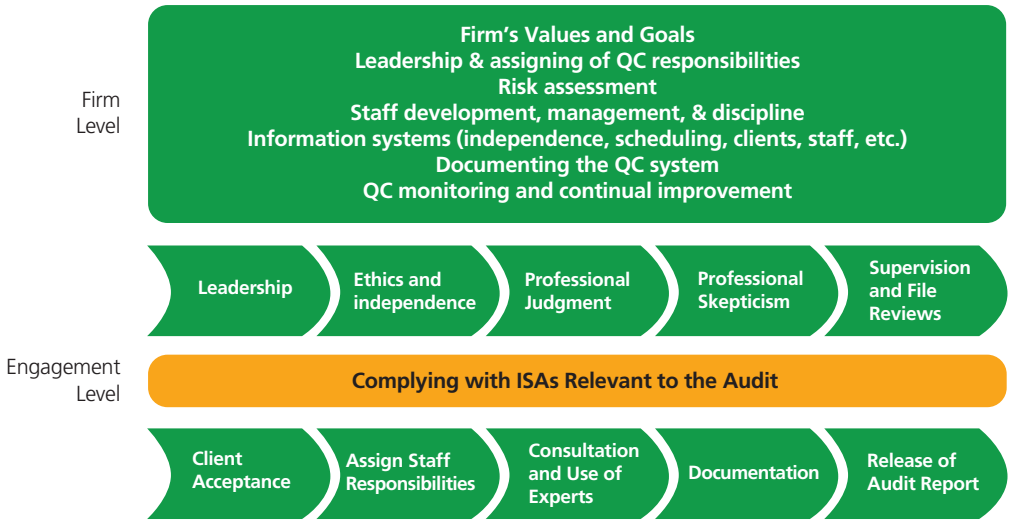
Control activities to address all policies and procedures would not be possible or cost-effective. Firms should use professional judgment and their assessment of risk to determine what controls need to be implemented. Control activities could be considered for:

- All the policies and procedures documented in the firm's quality control manual;
- Office workflow policies;
- Operational policies and procedures; and
- Other personnel-related policies and procedures.

The scope for control-activity design would address all the quality control, ethical, and independence requirements and the firm's compliance with ISAs relevant to the audit.

Exhibit 3.6-2

Scope of Possible Control Activities:



3.7 Monitoring

An important element of a control system is the monitoring of its fitness and operational effectiveness. This can be achieved through an independent review of the operating effectiveness of the firm-level and engagement-level policies/procedures, and inspection of completed engagement files.

An effective monitoring process helps to develop a culture of continual improvement, wherein partners and staff are committed to quality work and rewarded for improving performance.

A firm's monitoring process could be divided into two parts, as follows:

- **Ongoing policy monitoring** (other than the cyclical file inspections)
  An ongoing (suggest annual) consideration and evaluation of the firm's system of quality control helps to ensure that the policies and procedures in place are relevant, adequate, and operating effectively. When performed and documented on an annual basis, this monitoring will support the requirement to communicate with staff each year about the firm's plans to improve engagement quality. This scope of ongoing monitoring addresses each of the quality control elements, and includes an assessment of whether:
  - The firm's quality control manual has been updated for new requirements and developments,
  - Those assigned quality control responsibilities in the firm (if any) have actually fulfilled their roles,
  - Written confirmations (by partners and staff) have been obtained to ensure each individual's compliance with the firm's policies and procedures on independence and ethics,
  - There is ongoing professional development for partners and staff,
  - Decisions related to acceptance and continuance of client relationships and specific engagements are in compliance with the firm's policies and procedures,
  - The code of ethics has been followed,
  - Suitably qualified people were assigned as the engagement quality control reviewers and completion of such reviews occurred before the audit report was dated,
  - Communication has been made to the appropriate personnel about deficiencies that have been identified, and

  - Appropriate follow-up has been made to ensure that identified deficiencies in quality have been addressed on a timely basis.

- **Cyclical completed file inspections**
  The ongoing consideration and evaluation of the firm's system of quality control includes a cyclical inspection of at least one completed engagement file for each partner. This is required to ensure compliance with professional/legal requirements, and that assurance reports being issued are appropriate in the circumstances. Cyclical inspections help to identify deficiencies and training needs, and enable the firm to make necessary changes, on a timely basis.

Upon completion of the review, the monitor would prepare a report that, after discussion with the partners, would be communicated to all managers and professional staff along with the action steps to be taken.

Who can be appointed as monitor?

- **Monitoring of firm-level policies**
  The review of compliance with the firm's policies would be performed by a suitably qualified person who ideally is not also responsible for managing or developing quality control within the firm. However, ISQC 1 recognizes that this may not always be possible in smaller firms, so self-monitoring is acceptable. Alternatively, an individual external to the firm, with the competence and capabilities to act as an engagement partner, could be appointed. This would enhance the independence and objectivity of the firm.
- **Completed file inspections**
  The person appointed to inspect completed engagement files must be suitably qualified, and must not have been involved in performing the engagement or the engagement quality control review on the file.

3.8 Compliance with Relevant ISAs

Paragraph #	Relevant Extracts from ISAs
200.18	The auditor shall comply with all ISAs relevant to the audit. An ISA is relevant to the audit when the ISA is in effect and the circumstances addressed by the ISA exist. (Ref: Para. A55-A59)
200.22	Subject to paragraph 23, the auditor shall comply with each requirement of an ISA unless, in the circumstances of the audit: (a) The entire ISA is not relevant; or (b) The requirement is not relevant because it is conditional and the condition does not exist. (Ref: Para. A74-A75)
200.23	In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in a ISA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Ref: Para. A76)
230.12	If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in an ISA, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure. (Ref: Para. A18-A19)

The ISAs set out the responsibilities and requirements of auditors in conducting an audit. As stated in ISA 200.18, 22, and 23, each relevant requirement (set out in the requirements section of the ISAs) is to be followed by the auditor, except in exceptional circumstances, where alternative audit procedures would be performed to achieve the aim of that particular requirement. Note the following.

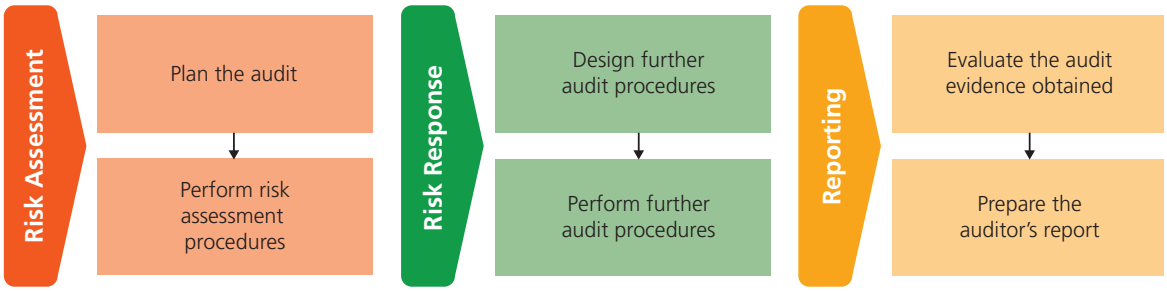
Exhibit 3.8-1

ISAs	Description
Status	The ISAs, taken together, provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. The ISAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics.
Relevance	Some ISAs (and therefore all of their requirements) may not be relevant in the circumstances (e.g., internal audit or group accounts). Some ISAs contain conditional requirements. These requirements are relevant when the circumstances envisioned apply and the condition exists. Departures from relevant ISA requirements need to be documented, along with the alternative audit procedures performed and the reasons for the departure.
Local Laws	Auditors may be required (in addition to the ISAs) to comply with certain legal or regulatory requirements or other auditing standards of a specific jurisdiction or country.
Other	The scope, effective date, and any specific limitation of the applicability of a specific ISA is made clear in the ISA. However, the effective date of the ISA may also be affected by legal requirements in a particular jurisdiction. Unless otherwise stated in the ISA, the auditor is permitted to apply an ISA before the effective date specified therein.

4 THE RISK-BASED AUDIT—OVERVIEW

Chapter Content	Relevant ISAs
Auditor objectives, basic elements, and approach to performing a risk-based audit.	Multiple

Exhibit 4.0-1



Paragraph #	ISA Objective(s)
200.11	In conducting an audit of financial statements, the overall objectives of the auditor are: (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and (b) To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

Paragraph #	Relevant Extracts from ISAs
200.3	The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general-purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with ISAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1)
200.5	As the basis for the auditor's opinion, ISAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. (Ref: Para. A30-A54)
200.A36	The risks of material misstatement may exist at two levels: • The overall financial statement level; and • The assertion level for classes of transactions, account balances, and disclosures.
200.A42	The ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement." However, 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 non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.
200.A47	The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from: • The nature of financial reporting; • The nature of audit procedures; and • The need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

4.1 Overview

The auditor's overall objectives as stated in ISA 200.11 can be summarized as follows:

- To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

Reasonable Assurance

Reasonable assurance is a high but not absolute level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The auditor cannot provide absolute assurance due to the inherent limitations

in the work carried out. This results from the majority of audit evidence (on which the auditor draws conclusions and bases the auditor's opinion) being persuasive rather than conclusive.

Inherent Limitations of an Audit

The following exhibit outlines some of the inherent limitations of audit work performed.

Exhibit 4.1-1

Limitations	Reasons
The Nature of Financial Reporting	The preparation of financial statements involves: • Judgment by management in preparing the financial statements and applying the presentation and disclosure requirements in the applicable financial reporting framework; and • Subjective decisions or assessments (such as estimates) by management involving a range of acceptable interpretations or judgments.
Nature of Audit Evidence Available	Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. This evidence tends to be persuasive in character rather than conclusive. Audit evidence is primarily obtained from audit procedures performed during the course of the audit. It may also include information obtained from other sources such as: • Previous audits; • A firm's quality control procedures for client acceptance and continuance; • The entity's accounting records; and • Audit evidence prepared by an expert employed or engaged by the entity.
The Nature of Audit Procedures	Audit procedures, however well designed, will not detect every misstatement. Consider the following: • Any sample of less than 100% of a population introduces some risk that a misstatement will not be detected; • Management or others may not provide, intentionally or unintentionally, the complete information required. Fraud may involve sophisticated and carefully organized schemes designed to conceal it; and • Audit procedures used to gather audit evidence may not detect that some information is missing.
Timeliness of Financial Reporting	The relevance/value of financial information tends to diminish over time, so a balance needs to be struck between the reliability of information and its cost. Users of financial statements expect that the auditor will form his or her opinion within a reasonable period of time and at a reasonable cost. Consequently, it is impracticable to address all information that may exist, or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

Scope of an Audit

The scope of the auditor's work and the opinion provided are usually confined to whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. As a result, an unmodified auditor's report does not assure the future viability of the entity, nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

Any extension of this basic audit responsibility, such as that required by local laws or securities regulations, would require the auditor to undertake further work and to modify or expand the auditor's report accordingly.

Material Misstatements

A material misstatement (either individually or the aggregate of all uncorrected misstatements and missing/misleading disclosures in the financial statements) has occurred when it could reasonably be expected to influence the economic decisions of users made on the basis of the financial statements.

Assertions

Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements. They relate to the recognition, measurement and presentation of classes of transactions and events, account balances and disclosures in the financial statements. For example, the completeness assertion relates to all transactions and events that should have been recorded having been recorded. They are used by the auditor to consider the different types of potential misstatements that may occur.

4.2 Audit Risk

Audit risk is the risk of expressing an inappropriate audit opinion on financial statements that are materially misstated. The objective of the audit is to reduce this audit risk to an acceptably low level.

Audit risk has two key elements, as illustrated below.

Exhibit 4.2-1

Risk	Nature	Source
Inherent and Control Risks	The financial statements may contain a material misstatement.	Entity objectives/operations and management's design/ implementation of internal control.
Detection Risk	The auditor may fail to detect a material misstatement in the financial statements.	Nature and extent of the procedures performed by the auditor.

To reduce audit risk to an acceptably low level, the auditor is required to:

- Assess the risks of material misstatement; and
- Limit detection risk. This may be achieved by performing procedures that respond to the assessed risks of material misstatement, both at the financial statement level and at the assertion level for classes of transactions, account balance, and disclosures.

Audit Risk Components

The major components of audit risk are described in the following exhibit.

Exhibit 4.2-2

Nature	Description	Commentary
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.	This includes events or conditions (internal or external) that could result in a misstatement (error or fraud) in the financial statements. The sources of risk (often categorized as business or fraud risks) can arise from the entity's objectives, the nature of its operations/industry, the regulatory environment in which it operates, and its size and complexity.

Nature	Description	Commentary
Control Risk	The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.	Management designs controls to mitigate a specified inherent (business or fraud) risk factor. An entity assesses its risks (risk assessment) and then designs and implements appropriate controls to reduce its risk exposure to a tolerable (acceptable) level. Controls may be: • Pervasive in nature, such as management's attitude toward control, commitment to hiring competent people, and prevention of fraud. These controls are assessed at the financial statement level; and • Specific to the initiation, processing, or recording of a particular transaction. These are often called business process, activity-level, or transaction controls.
Detection Risk	The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.	The auditor assesses the risks of material misstatement (inherent and control risk) at the financial statement and assertion levels. Audit procedures are then developed to reduce audit risk to an acceptably low level. This includes consideration of the potential risk of: • Selecting an inappropriate audit procedure; • Misapplying an appropriate audit procedure; or • Misinterpreting the results from an audit procedure.

Note: The ISAs define the risk of material misstatement at the assertion level as consisting of two components: inherent risk and control risk. Consequently, the ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement." However, the auditor may make separate or combined assessments of inherent and control risk, depending on preferred audit techniques or methodologies and practical considerations.

CONSIDER POINT

Separate business and fraud risks

Many inherent risks can result in both business and fraud risks. For example, a new accounting system may create potential for errors (business risk), but may also provide an opportunity for someone to manipulate financial results or misappropriate funds (fraud risk).

So when a business risk is identified always consider whether this also creates a fraud risk. If it does, record and assess the fraud risk separately from the business risk factors. Otherwise it is possible that the audit response will only address the business-risk element and not the fraud risk.

Recording fraud risks

Fraud is often identified through the examination of:

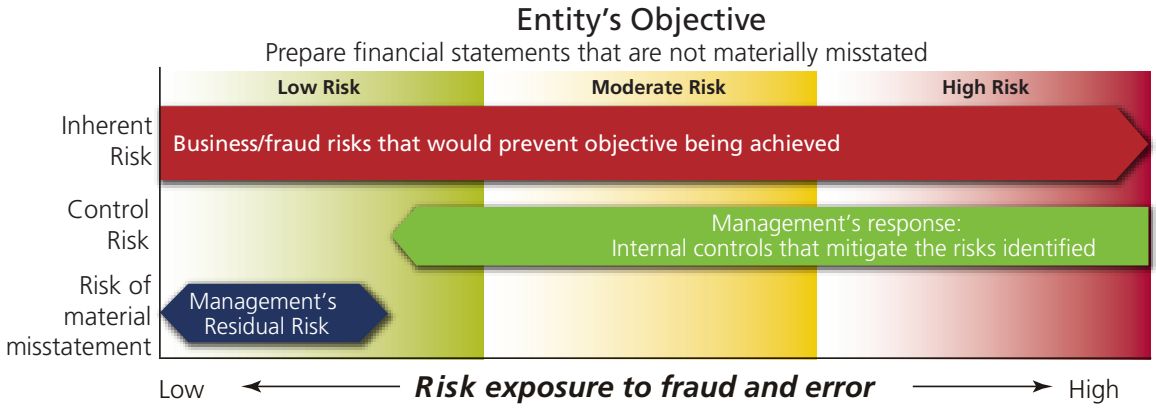
- Unusual patterns, exceptions and oddities in transactions/events; or
- Individual(s) with the motive, opportunity, and rationalization to commit fraud.

If such matters are observed (during any stage of the audit) they should be recorded and assessed as fraud risks, even if they seem on the surface to be immaterial. Recording such risks will help ensure they are appropriately considered when developing the audit response.

Summary of the Audit Risk Components

Exhibit 4.2-3

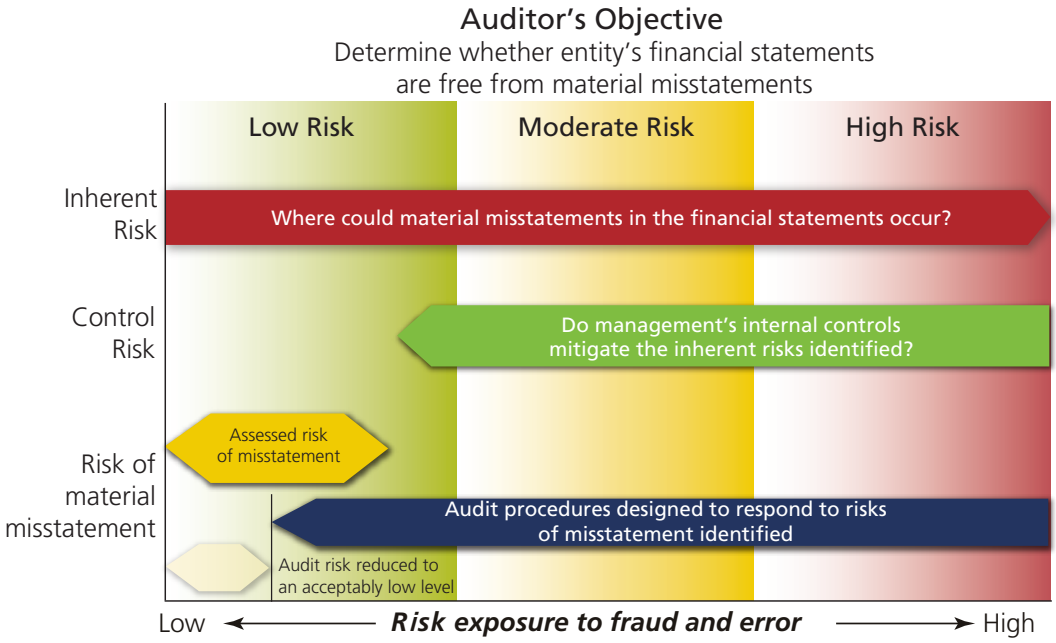
The following chart shows the interrelationship between risk and control. The inherent risk bar contains all the business and fraud risk factors that could result in the financial statements being materially misstated (before any consideration of internal control). The control risk bars reflect the pervasive and transactional control procedures put into effect by management to mitigate the risk that the financial statements are misstated. The extent to which the control risk bars do not completely mitigate the inherent risks is often called management's residual risk, risk appetite or risk tolerance.



Note: The length of the bars in the exhibit would vary based on the particular circumstances and risk profile of the entity.

Exhibit 4.2-4

This chart outlines the auditor's role in assessing the risks of material misstatement in the financial statements and then performing responsive audit procedures designed to reduce the audit risk to an appropriately low level.



Note: The length of the bars in the exhibit would vary based on the particular circumstances and risk profile of the entity, and the nature of the auditor's response.

4.3 How to Perform a Risk-Based Audit

Paragraph #	Relevant Extracts from ISAs
200.15	The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A20-A24)
200.16	The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A25-A29)
200.17	To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A30-A54)
200.21	To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant ISAs in planning and performing the audit, having regard to the interrelationships among the ISAs, to: (Ref: Para. A69-A71) (a) Determine whether any audit procedures in addition to those required by the ISAs are necessary in pursuance of the objectives stated in the ISAs; and (Ref: Para. A72) (b) Evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: Para. A73)

A risk-based audit has three key steps, as illustrated below.

Exhibit 4.3-1

Steps (Phases)	Description
Risk Assessment	Performing risk assessment procedures to identify and assess the risks of material misstatement in the financial statements. This includes the assessment of significant risks, control deficiencies and identified or suspected non-compliance with laws and regulations that will be addressed in the audit and communicated to TCWG. The auditor would also select key audit matters for inclusion in the auditor's report for listed entities and for all audits where ISA 701, related to key audit matters, is to be applied as required by local law, regulation or voluntarily.
Risk Response	Designing and performing further audit procedures that respond to identified and assessed risks of material misstatement, at both the financial statement and assertion levels.
Reporting	This involves: • Forming an opinion based on the audit evidence obtained and the evaluation of the financial statement presentation and disclosures; and • Preparing and issuing a report that is appropriate to the conclusions reached.

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

Exhibit 4.3-2

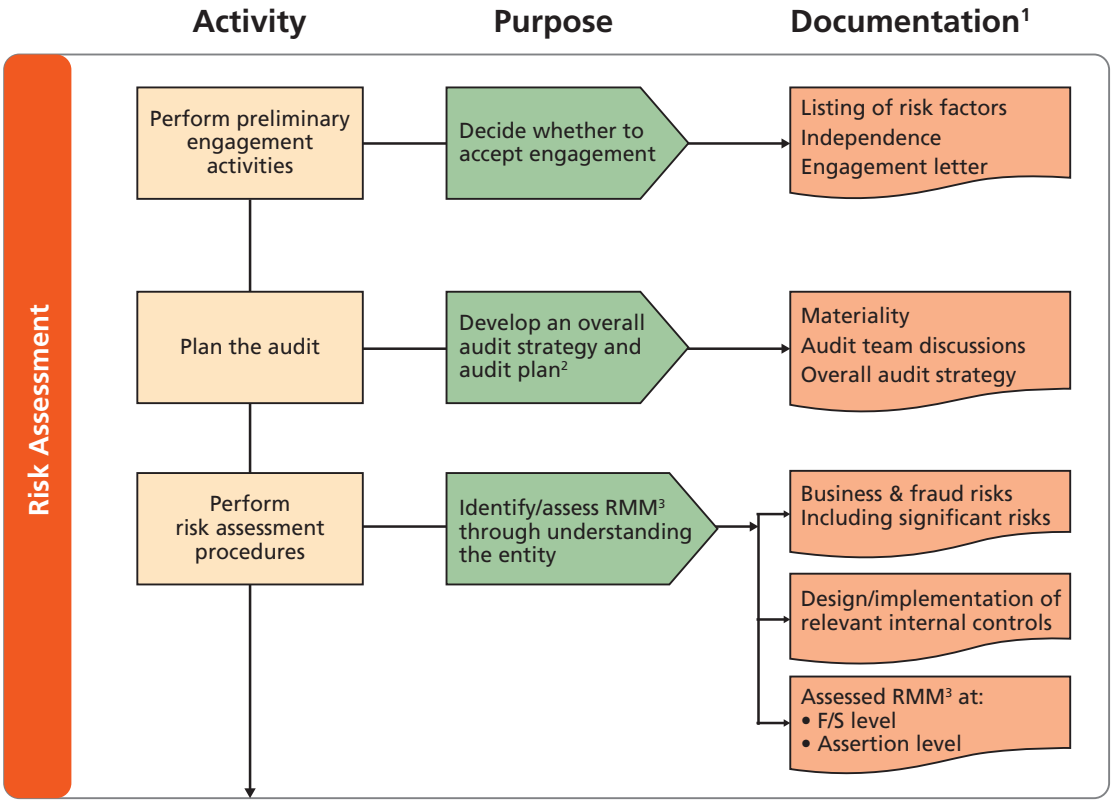
* an "event" is simply a business or fraud risk factor (see descriptions in Exhibit 4.2-2). This would also include risks resulting from the absence of internal control to mitigate the potential for material misstatements in the financial statements.

The various tasks involved in each of these three phases are outlined below. Each phase is addressed in more detail in subsequent chapters of this Guide.

Risk Assessment

Paragraph #	ISA Objective(s)
315.3	The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

Exhibit 4.3-3



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

An effective risk assessment phase would include the following.

Exhibit 4.3-4

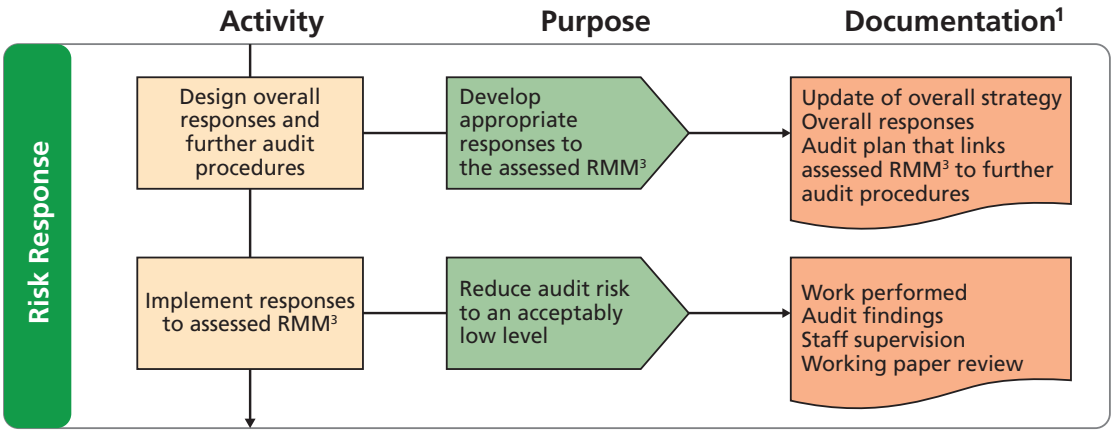
Requirements	Description
Up-Front Involvement of Senior Team Members	The engagement partner and other key members of the engagement team need to be actively involved in planning the audit, and in planning and participating in the discussion among engagement team members. This will ensure the audit plan takes advantage of their experience and insight. Note that ISAs usually refer to the term "auditor" as the person(s) performing the engagement. Where an ISA intends a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used.
An Emphasis on "Professional Skepticism"	The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism, or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.
Planning	The time spent in audit planning (developing the overall audit strategy and audit plan) will ensure that audit objectives are properly met, and that the work of audit staff is always focused on gathering evidence on the most critical areas of potential misstatement.

Requirements	Description
Team Discussions and Ongoing Communication	A team planning discussion/meeting with the engagement partner present provides an excellent forum for: • Informing staff about the client in general and discussing potential risk areas; • Discussing the effectiveness of the overall audit strategy and the audit plan and then making changes as necessary; • Brainstorming how fraud could occur and then designing an appropriate response; • Discussing disclosures where there are higher risks of material misstatement; and • Allocating audit responsibilities and setting time frames. Ongoing communication among the audit team throughout the engagement is also important, for example discussing and addressing audit issues, unusual activities or possible indicators of fraud. This will enable timely communications to management and, where necessary, changes to the audit strategy and audit procedures.
Focus on Risk Identification	The most important step in a risk assessment process is to identify all the relevant risks. If business and fraud risk factors are not identified by the auditor, they will not be assessed or documented, and an appropriate audit response will not be designed. This is why well-designed risk assessment procedures are so important to the effectiveness of the audit. These risk assessment procedures also need to be performed by the appropriate level of staff.
Financial Statement Disclosures	In assessing risks, disclosures in the financial statements are also taken into account. Disclosures in the financial statements of SMEs may be less detailed or less complex (for example, some financial reporting frameworks allow smaller entities to provide fewer disclosures in their financial statements). However this does not relieve the auditor of the responsibility to obtain an understanding of disclosures and assess the risks of material misstatement in disclosures that are required.
Ability to Evaluate Management's Response(s) to Risk	A key step in the risk assessment process is to evaluate the effectiveness of management's responses (that is, management's control design/implementation), if any, to mitigate the identified risks of material misstatement in the financial statements. In smaller entities, more reliance will likely be placed on the control environment (such as the competence and integrity of managements, etc.) and less on the traditional control activities (such as segregation of duties, etc.).
Use of Professional Judgment	The ISA audit requirements require the use and then documentation of significant judgments made by the auditor throughout the audit. Typical examples of tasks throughout the risk assessment process include: • Deciding to accept or continue with the client; • Developing the overall audit strategy; • Establishing materiality; • Assessing risks of material misstatement, including the identification of significant risks and other areas where special audit consideration may be necessary; and • Developing expectations for use when performing analytical procedures.

Risk Response

Paragraph #	ISA Objective(s)
330.3	The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Exhibit 4.3-5



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

In this phase, the auditor considers the reasons (inherent and control risks) for the risk assessments at the financial statement level and at the assertion level (for each class of transactions, event, account balance, and disclosure), and develops responsive audit procedures.

The auditor's response to the assessed risks of material misstatement is documented in an audit plan that:
- Contains an overall response to the risks identified at the financial statement level;
- Identifies the material financial statement areas and significant disclosures; and
- Contains the nature, extent, and timing of specific audit procedures tailored to respond to the assessed risks of material misstatement at the assertion level.

The overall responses address assessed risks of material misstatement at the financial statement level. Such responses would include the assignment and supervision of appropriate personnel, need for professional skepticism, the extent of corroboration required for management's explanations/representations, consideration of the type of audit procedures to be performed, and what documentation would be examined in support of material transactions.

Further audit procedures generally consist of substantive procedures such as tests of details, analytical procedures, and tests of controls (where there is an expectation that such controls have been operating effectively during the period).

Some of the matters the auditor should consider when planning the appropriate mix of audit procedures to respond to identified risks include the following:

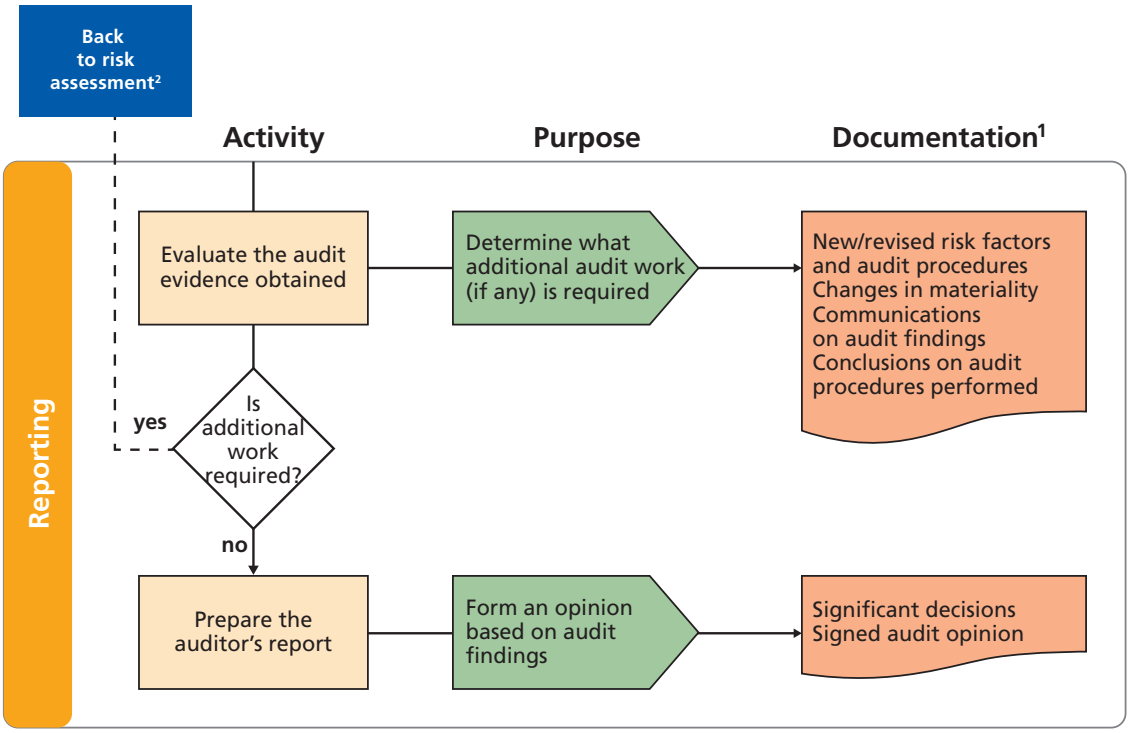
- **Use of tests of controls**
  - Identify relevant internal controls that, if tested, would reduce the need/scope for other substantive procedures. As a general rule, the sample size for testing controls is often significantly less than that of a substantive test of a transaction stream. Assuming that the relevant controls operate consistently and control deviations are unlikely, the use of tests of controls can often result in less work being performed. However, there is no requirement that the operating effectiveness of internal controls (direct or indirect) be tested.
  - Identify any assertions that cannot be addressed by substantive procedures alone. For example, this can often apply to completeness of sales in a small entity, and situations where there is highly automated processing of transactions (such as Internet sales) with little or no manual intervention.
- **Substantive analytical procedures**
  These are procedures for which the total amount of a transaction stream can be reliably predicted based on available evidence. This expectation is compared to the actual amount in the accounting records, and the extent of any misstatement readily identified (see Volume 1, Chapter 10). In some cases, if the assessed risk for a particular assertion is low (without considering related controls), the auditor may determine that substantive analytical procedures alone would provide sufficient appropriate audit evidence.

- **Unpredictability**
  The need to incorporate an element of unpredictability in procedures performed, such as when responding to a risk of material misstatement due to possible fraud. For example, visits to inventory count locations could be unannounced or certain procedures could be carried out prior to the year-end that are unannounced. Unpredictability also needs to be considered in how much information is provided to management with regard to planned audit procedures and their timing.
- **Management override**
  The need for specific audit procedures to address the potential for management override.
- **Significant risks**
  The audit response to "significant risks" that have been identified. (See Volume 2, Chapter 10.)

Reporting

Paragraph #	ISA Objective(s)
700.6	The objectives of the auditor are: (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and (b) To express clearly that opinion through a written report.

Exhibit 4.3-6



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

The final phase of the audit is to assess the audit evidence obtained and determine whether it is sufficient and appropriate to reduce audit risk to an acceptably low level.

It is important during this phase of the audit to determine:
- Any change in the assessed level of risk;
- Whether conclusions drawn from the work performed are appropriate;
- If any suspicious circumstances have been encountered; and
- That additional risks (not previously identified) have been appropriately assessed and further audit procedures performed as required.

A team debriefing meeting (towards or at the end of the fieldwork) is not a specific requirement of the ISAs, but can be useful for staff to discuss the audit findings, identify any indications of fraud, and determine the need (if any) to perform any further audit procedures.

When all procedures have been performed and conclusions reached:
- Audit findings should be reported to management and those charged with governance; and
- An audit opinion should be formed and a decision made on the appropriate wording for the auditor's report.

4.4 Documentation

Sufficient audit documentation is required to enable an experienced auditor, having no previous connection with the audit, to understand:
- The nature, timing, and extent of the audit procedures performed;
- The results of performing those procedures and the audit evidence obtained; and
- Significant matters arising during the audit, the conclusions reached thereon; and significant professional judgments made in reaching those conclusions.

Audit documentation for a smaller entity is generally less extensive than that for the audit of a larger entity. For example, various aspects of the audit could be recorded together in a single document, with cross-references to supporting working papers, as appropriate.

It is not necessary for the auditor to document:
- Every minor matter considered, or every professional judgment made, in an audit; and
- Compliance with matters for which compliance is demonstrated by documents included within the audit file. For example, an audit plan on file demonstrates that the audit was planned, and a signed engagement letter demonstrates that the auditor has agreed to the terms of the audit engagement.

4.5 Benefits of the Risk-Based Audit

Some of the benefits of the risk-based approach are summarized in the exhibit below.

Exhibit 4.5-1

Benefits	Description
Time Flexibility When Audit Work Needs to Be Performed	Because risk assessment procedures do not involve the detailed testing of transactions and balances, they can be performed well before the period end, assuming no major operational changes are anticipated. This can help in balancing the workload of audit staff more evenly throughout the period. It may provide the client with time to respond to identified (and communicated) weaknesses in internal control and other requests for assistance before the commencement of period-end audit fieldwork. However, where interim financial information is not readily available, the analytical risk assessment procedures may have to be performed at a later date.
Audit Team's Effort Focused on Key Areas	By understanding where the risks of material misstatement can occur in financial statements, the auditor can direct the audit team's effort toward high-risk areas and perhaps reduce work in lower-risk areas. This will also help to ensure that audit staff resources are used effectively.
Audit Procedures Focused on Specific Risks	Further audit procedures are designed to respond to assessed risks. Consequently, tests of details that only address risks in general terms may be significantly reduced or even eliminated.
Understanding of Internal Control	The required understanding of internal control enables the auditor to make informed decisions on whether to test the operating effectiveness of internal control. Tests of controls (for which some controls may only require testing every three years) will often result in much less work being required than performing extensive tests of details. (See Volume 2, Chapter 17.)
Timely Communication of Matters of Interest to Management	The improved understanding of internal control may enable the auditor to identify weaknesses in internal control (such as in the control environment and general IT controls) that were not previously recognized. Communicating these weaknesses to management on a timely basis will enable them to take appropriate action, which is to their benefit. This may also save time in performing the audit.

4.6 ISAs for Smaller Audits

Paragraph #	Relevant Extracts from Application Material in ISAs
200.A65	When appropriate, additional considerations specific to audits of smaller entities and public sector entities are included within the application and other explanatory material of an ISA. These additional considerations assist in the application of the requirements of the ISA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the ISAs.
200.A66	For purposes of specifying additional considerations to audits of smaller entities, a "smaller entity" refers to an entity which typically possesses qualitative characteristics such as: (a) Concentration of ownership and management in a small number of individuals (often a single individual — either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and (b) One or more of the following: (i) Straightforward or uncomplicated transactions; (ii) Simple record-keeping; (iii) Few lines of business and few products within business lines; (iv) Few internal controls; (v) Few levels of management with responsibility for a broad range of controls; or (vi) Few personnel, many having a wide range of duties. These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.
200.A67	The considerations specific to smaller entities included in the ISAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.
200.A68	The ISAs refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the "owner-manager."

ISAs do not distinguish the audit approach required for a one-person entity from that required for a national entity employing thousands of people. An audit is an audit. Consequently, the basic approach to an audit does not change just because the entity is small.

The word "audit" is intended to convey a clear message to users of financial statements. That message is that the auditor has obtained reasonable assurance that the financial statements are free from material misstatements, regardless of the size or type of the entity that has been audited.

This issue of proportionality was addressed by IAASB staff in a Staff Questions and Answers document, entitled *Applying ISAs Proportionately with the Size and Complexity of an Entity*,[1] issued in August 2009. Its purpose is to assist auditors in applying the clarified ISAs in a cost-effective manner. The response to the question "How do the ISAs address the fact that the characteristics of an SME are significantly different from those of a larger, more complex entity" was as follows:

> "The auditor's objectives are the same for audits of entities of different sizes and complexities. This, however, does not mean that every audit will be planned and performed in exactly the same way. The ISAs recognize that the specific audit procedures to be undertaken to achieve the auditor's objectives and to comply with the requirements of the ISAs may vary considerably depending on whether the entity being audited is large or small and whether it is complex or relatively simple.
>
> The requirements of the ISAs, therefore, focus on matters that the auditor needs to address in an audit and do not ordinarily detail the specific procedures that the auditor should perform.
>
> The ISAs also explain that the appropriate audit approach for designing and performing further audit procedures depends on the auditor's risk assessment. For example, based on the required understanding of the entity and its environment, including its internal control and the assessed risks of material misstatement, the auditor may determine that a combined approach using both tests of controls and substantive procedures is an effective approach in the circumstances in responding to the assessed risks. In other cases, for example, in the context of an SME audit where there are not many control activities in

[1] *Applying ISAs Proportionately with the Size and Complexity of an Entity* is at www.ifac.org/publications-resources/applying-isas-proportionately-size-and-complexity-entity-0.

the SME that can be identified by the auditor, the auditor may decide that it is efficient to perform further audit procedures that are primarily substantive procedures.

It is also important to note that the ISAs acknowledge that the appropriate exercise of professional judgment is essential to the proper conduct of an audit. Professional judgment is necessary, in particular, regarding decisions about the nature, timing, and extent of audit procedures used to meet the requirements of the ISAs and gather audit evidence. However, while the auditor of an SME needs to exercise professional judgment, this does not mean that the auditor can decide not to apply a requirement of an ISA except in exceptional circumstances and provided that the auditor performs alternative audit procedures to achieve the aim of the requirement."

The key points in the excerpt above can be summarized as follows:

- Audit objectives are the same for any size of audit;
- The specific audit procedures required may vary considerably depending on the size of entity and the assessed risks;
- The ISAs focus on matters the auditor needs to address — not on the details of specific procedures;
- The design of further audit procedures depends on the auditor's risk assessment;
- The appropriate exercise of professional judgment is essential in tailoring the procedures to respond appropriately to the assessed risks; and
- Professional judgment cannot be used to avoid compliance with any ISA requirements except in exceptional circumstances.

In addition, the ISAs contain a number of paragraphs that address considerations specific to audits of SMEs. This material provides useful guidance material in applying specific ISA requirements in the context of an SME audit.

Some suggestions for successfully implementing ISAs on smaller engagements are included in the following exhibit.

Exhibit 4.6-1

1. Take time to read the clarified ISAs and to train staff.

Failure to understand the requirements can lead to:

- The entire risk assessment phase of the audit becoming an "add-on" to the other substantive audit work performed. It should be the risk assessment that drives the selection of audit procedures to be performed, not a standardized listing of procedures that could be applied to any entity. The purpose of the risk assessment is to focus the audit effort on areas where there is a greater risk of material misstatement in the financial statements, and away from less risky areas.
- Turning what should be a simple audit into a complex and time-consuming project. This can arise if efforts are focused on completing needless standard audit forms and checklists, rather than using professional judgment to scale the work according to the size and complexity of the entity being audited and the risks involved.
- Failure to comply with an ISA ("the auditor shall") requirement.

2. Take time to plan well, no matter how small the engagement.

It has been said an hour spent in planning can save many more in execution. Effective audit planning is often the difference between a quality audit within budget and a poor-quality audit that goes over budget. This does not necessarily mean holding dedicated team meetings in the office. On very small engagements, planning can be achieved through brief discussions at the start of the engagement and as the audit progresses.

Key areas to address in planning:

- Encourage staff to identify areas where the usual audit procedures seem excessive in relation to the risk of misstatement being addressed.
- Take time to ensure that each staff member understands the necessity and purpose of the documentation he or she is required to complete. Countless hours can be lost by staff attempting to complete forms they do not understand.
- Discuss the potential for fraud. Encourage staff to be skeptical and inquisitive, and empower them to raise issues, observations, or unexplained matters.
- Discuss known related parties and the nature/size of transactions.
- Consider whether the audit documentation prepared in previous periods can simply be updated for changes that have occurred, rather than be prepared all over again. Documentation and assessment of risk factors and relevant internal controls should be sufficient to enable auditors in subsequent periods to leverage their understanding of the entity and focus attention on new industry trends, key operational changes, new inherent risks, and revised internal controls.

3. Evaluate the control environment.

Take time to understand the pervasive internal controls that are part of the control environment. Pervasive controls are quite different from transactional controls; they address such matters such as integrity and ethics, corporate governance, employee competence, management's attitudes toward control, fraud prevention, risk management, and control monitoring. If the "tone at the top" is poor, management override can easily occur, and even the very best transactional controls over processes such as purchases and sales could be undermined.

4. Aim for continual improvement.

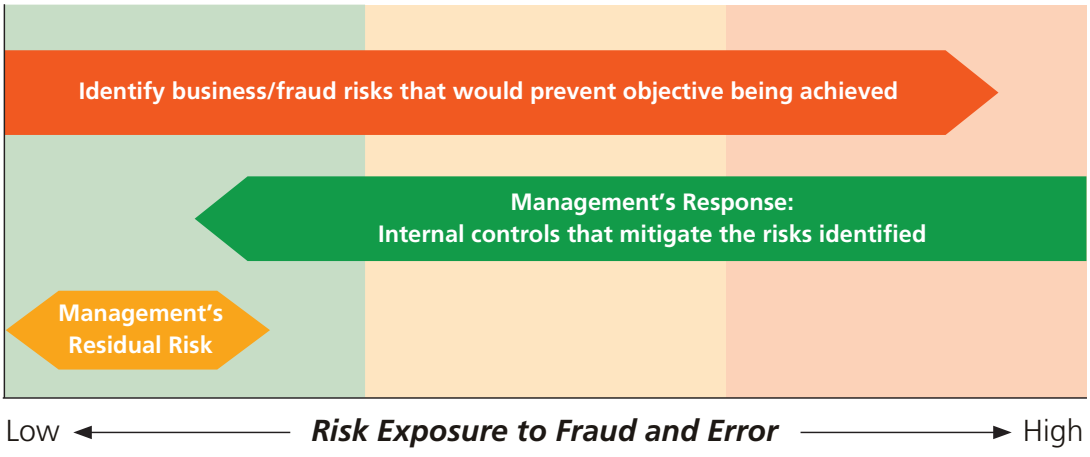
There is a tendency for some auditors to blindly follow the example of the previous auditor, resulting in a file that mirrors that of the previous year. A much better approach is to continually review/challenge the work performed in previous years, and identify changes that will make the audit more efficient and effective.

5 INTERNAL CONTROL — PURPOSE AND COMPONENTS

Chapter Content	Relevant ISA
To outline the purpose, scope, and nature of internal control over financial reporting, including the five components to be evaluated by the auditor.	315 (Revised)

Exhibit 5.0-1

Entity Objective = Prepare financial statements that are not materially misstated



The first bar in the chart represents all the business and fraud risk factors that could result in the financial statements being materially misstated (before any consideration of internal control). The second bar reflects the control procedures designed and implemented by management to mitigate the identified risks. The extent to which the second bar does not completely mitigate the identified risks is often called management's residual risk.

Paragraph #	Relevant Extracts from ISAs
315.4(c)	Internal control — The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.
315.12	The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A50-A73)
315.13	When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A74-A76)

5.1 Overview

Internal control is designed, implemented, and maintained by those charged with governance and management of other personnel to address identified business and fraud risks that threaten the achievement of stated objectives, such as the reliability of financial reporting.

The auditor is required to understand how the entity addresses each of the five components of internal control as they relate to a financial statement audit. These components are described in this chapter and in ISA 315 (Revised) paragraphs 4(c), 14-24 and A76-A117. Appendix 1 of ISA 315 (Revised) also provides further explanation on each of these components.

This understanding of internal control is required to determine control risk. The understanding is to be obtained irrespective of any decision by the auditor to test such controls as part of an audit strategy.

Note: Only internal controls that are relevant to the audit need to be identified, documented and assessed. A relevant control is one that addresses a risk of misstatement in the financial statements.

5.2 Internal Control Objectives

Internal control is management's response intended to mitigate an identified risk factor or achieve a control objective. There is a direct relationship between an entity's objectives and the internal control it implements to ensure their achievement. Once objectives are set, it is possible to identify and assess potential events (risks) that would prevent the achievement of the objectives. Based on this information, management can develop appropriate responses, which will include the design of internal control.

Internal control objectives can be broadly grouped into four categories:
- Strategic, high-level goals that support the mission of the entity;
- Financial reporting (internal control over financial reporting);
- Operations (operational controls); and
- Compliance with laws and regulations.

Internal control relevant to an audit primarily pertains to financial reporting. This addresses the entity's objective of preparing financial statements for external purposes.

Operational controls, such as production and staff scheduling, quality control, and employee compliance with health and safety requirements, would not normally be relevant to the audit, except where:
- The information produced is used to develop an analytical procedure; or
- The information is required for disclosure in the financial statements.

For example, if production statistics were used as a basis for an analytical procedure, the controls to ensure the accuracy of such data would be relevant. If non-compliance with certain laws and regulations has a direct and material effect on the financial statements, the controls for detecting and reporting on such non-compliance would be relevant.

Internal Control Components

The term "internal control" as used in ISA 315 (Revised) is broader than just control activities such as segregation of duties, authorizations and account reconciliations, etc. Internal control encompasses five key components:

- The control environment;
- The entity's risk assessment process;
- The information system, including the related business processes, relevant to financial reporting and communication;
- Control activities relevant to the audit; and
- Monitoring of internal control.

These components as they relate to the entity's financial reporting objectives are illustrated below.

The Five Components of Internal Control

Exhibit 5.2-1

The division of internal control into these five components provides a useful framework for auditors in understanding the different aspects of an entity's internal control system. However, it should be noted that:

The way in which the internal control system is designed and implemented will vary based on the entity's size and complexity. Smaller entities often use less formal means and simpler processes and procedures to achieve their objectives. The five components of internal control may not be so clearly distinguished; however, their underlying purposes are equally valid. For example, an owner-manager may (and, in the absence of additional staff, should) perform functions belonging to several of the components of internal control.

- Different terminology or frameworks from those used in ISA 315 (Revised) can be used to describe the various aspects of internal control and their effect on the audit, but all five components are to be addressed in the audit.
- The auditor's primary consideration is whether, and how, a specific control prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures, and their related assertions.

A summary of the five internal control components follows.

5.3 The Control Environment

Paragraph #	Relevant Extracts from ISAs
315.14	The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether: (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A77–A87)

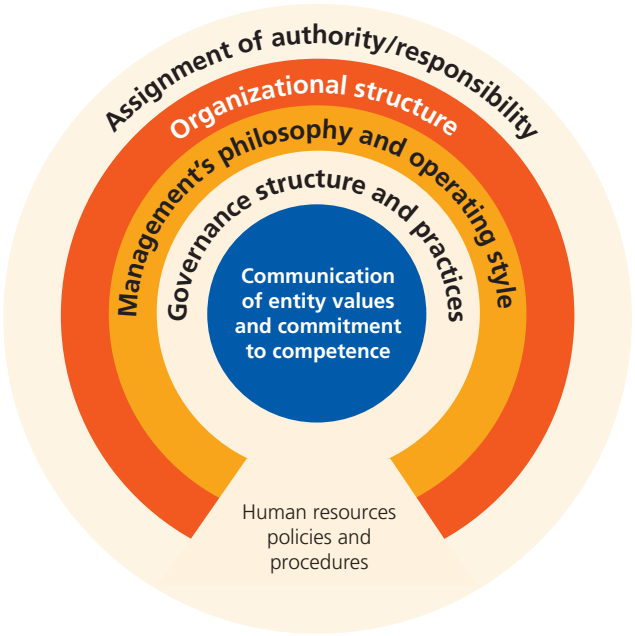
The control environment is the foundation for effective internal control, providing discipline and structure for the entity. It sets the tone of an organization, influencing the control consciousness or awareness of its people.

The control environment addresses the governance and management functions. It also addresses the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance within the entity.

Note: Control-environment controls are generally pervasive in nature. They will not directly prevent, or detect and correct, a material misstatement. Instead, they form an important foundation upon which all other controls will be built.

Exhibit 5.3-1 outlines the various elements of the control environment that need to be considered. Note that the importance and order (priority) of these elements will inevitably vary from entity to entity.

Exhibit 5.3-1



Control environment controls will influence the auditor's evaluation of the effectiveness of other control activities that may address specific areas such as sales and purchase transactions. For example,

if management has a negative attitude toward control in general, this will undermine the effectiveness of other controls (such as sales, etc.) no matter how well they were designed.

The auditor's evaluation of the design of the entity's control environment would include the elements set out below.

Exhibit 5.3-2

Key Elements to Address	Description
Communication and Enforcement of Integrity and Other Ethical Values	Integrity and ethical values are essential (foundational) elements, which influence the effectiveness of the design, administration, and monitoring of other controls.
Commitment to Competence	Management's consideration of the competence levels for particular jobs, and how those levels translate into requisite skills and knowledge.
Participation by Those Charged with Governance	Attributes of those charged with governance such as: • Their independence from management; • Their experience and stature; • The extent of their involvement and the information they receive, and the scrutiny of activities; and • The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
Management's Philosophy and Operating Style	Management's approach to taking and managing business risks, and management's attitudes and actions toward financial reporting, information processing, accounting functions, and personnel.
Organizational Structure	The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
Assignment of Authority and Responsibility	How authority and responsibility for operating activities are assigned, and how reporting relationships and authorization hierarchies are established.
Human Resources Policies and Practices	Recruitment, orientation, training, evaluating, counselling, promoting, compensating, and remedial actions.

The controls outlined above are pervasive to the entire entity and are often more subjective to evaluate than the traditional control activities (such as segregation of duties). Therefore, the auditor will exercise professional judgment in this evaluation.

Control-environment strengths can compensate or even replace weak transactional controls in some situations. However, control-environment weaknesses can undermine and even negate good design in other components of internal control. For example, if a culture of honesty and ethical behavior did not exist, the auditor would have to consider carefully what types of (additional) audit procedures would be effective in finding material misstatements in the financial statements. In some cases, the auditor may conclude that internal control has broken down to such an extent that the only option is to withdraw from the engagement.

The Control Environment in Smaller Entities

The control environment within small entities will differ from larger entities, but is just as important. This is particularly true when the entity does not have the staff or resources to implement traditional control activities such as segregation of duties.

In smaller entities, the active involvement of a competent owner-manager (a control-environment strength) may well reduce the need for other control activities, such as segregation of duties. Consequently, control environment strengths can serve to indirectly prevent or detect and correct certain types of misstatement. For example, when the owner-manager reviews and approves individual transactions before they are completed, it may serve to prevent or detect and correct certain specific errors or fraud. However, this control environment strength would not mitigate other risks such as management override of controls.

In smaller entities, there will typically be less documentation available to support control environment controls. Consequently, the attitudes, awareness, and actions of management (such as owner-managers)

will often form the basis for evaluating control design and implementation. For example, larger entities are likely to provide staff with a code of conduct that outlines acceptable behaviors and consequences for violating codes or rules. Smaller entities may communicate similar values and acceptable behaviors through oral communications and by management example.

Where there is no supporting documentation for a particular control, the auditor would prepare a memorandum for the file. For example, in addressing whether there is communication and enforcement of integrity and ethical values, the auditor could:

- Identify the entity's values, acceptable behaviors, and enforcement actions through discussions with management. The auditor would then assess whether they are sufficient to address the control design.
- Ask one or two employees what they believe are the entity's values, acceptable behaviors, and enforcement actions. These interviews would address whether management's values and acceptable behaviors have been communicated and enforced. This would address control implementation.

CONSIDER POINT

Small entities are often reluctant to document internal controls which operate informally. However, there can often be benefits to management in taking the time to document some of the more important policies and procedures. Such policies and procedures could be provided to staff joining the entity, and audit time may be saved versus having to make inquiries each period. In the example cited above, even the smallest entity could prepare a simple statement of values and acceptable behaviors that could be provided to employees and then referred to when an issue arises.

In smaller entities, some of the key areas to address in assessing the control environment are outlined in the exhibit below.

Exhibit 5.3-3

Control Element	The Key Question	Possible Controls
Communication and Enforcement of Integrity and Ethical Values	What management actions serve to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts?	• Management continually demonstrates, through words and actions, a commitment to high ethical standards. • Management removes or reduces incentives or temptations that might cause personnel to engage in dishonest or unethical acts. • A code of conduct or equivalent exists that sets out expected standards of ethical and moral behavior. • Employees clearly understand what behavior is acceptable and unacceptable, and know what to do when they encounter improper behavior. • Enforcement actions are taken when required.
Commitment to Competence	Do personnel have the knowledge and skills necessary to accomplish their tasks?	• Management takes the necessary steps to ensure that personnel have the requisite knowledge and skills required for their jobs. • Job descriptions exist and are effectively used. • Management provides personnel with access to training programs on relevant topics. • Initial and ongoing matching of staff skills to their job descriptions.

Control Element	The Key Question	Possible Controls
Participation by Those Charged With Governance (TCWG) *(Other than Where Management is TCWG)*	How effective is the governance (if any) being provided over entity operations?	• A majority of TCWG are independent of management. • TCWG have the appropriate experience, stature, and financial expertise. • Significant issues and financial results are communicated to TCWG in a timely manner. • TCWG provide effective oversight over management's activities. This includes raising difficult questions and pursuing answers. • TCWG meet on a regular basis, and minutes of meetings are circulated in a timely basis.
Management's Philosophy and Operating Style	What are management's attitudes and actions toward financial reporting?	• Management demonstrates positive attitudes and actions toward: – Sound internal control over financial reporting (including management override and other fraud), – Appropriate selection/application of accounting policies, – Information-processing controls, and – The treatment of accounting personnel. • Management has established procedures to prevent unauthorized access to or destruction of assets, documents, and records. • Management analyzes business risks and takes appropriate action.
Organizational Structure	Has a relevant organizational structure been established?	• The organizational structure is appropriate to facilitate achievement of entity objectives, operating functions, and regulatory requirements. • Management clearly understands its responsibility and authority for business activities, and possesses the requisite experience and levels of knowledge to properly execute its positions. • The entity structure facilitates the flow of reliable and timely information to the appropriate people for planning and controlling activities. • Incompatible duties are segregated to the extent possible.
Assignment of Authority and Responsibility	Have key areas of authority and responsibility been appropriately assigned?	• There are policies and procedures for authorization and approval of transactions. • Appropriate lines of reporting and accountability exist (appropriate to the entity's size and the nature of its activities). • Job descriptions include control-related responsibilities.

Control Element	The Key Question	Possible Controls
Human Resources Policies and Practices	What standards are in place to ensure: Recruitment of the most competent and trustworthy people? Training is provided to ensure people can perform their jobs? Promotions are driven by performance appraisals?	• Management establishes/enforces standards for hiring the most qualified individuals. • Recruiting practices include employment interviews, background checks, and communication of values, expected behaviors, and management's operating style. • Job performance is periodically evaluated, the results reviewed with each employee, and appropriate action taken. • Training policies address prospective roles and responsibilities, expected levels of performance, and evolving needs.

5.4 Risk Assessment

Paragraph #	Relevant Extracts from ISAs
315.15	The auditor shall obtain an understanding of whether the entity has a process for: (a) Identifying business risks relevant to financial reporting objectives; (b) Estimating the significance of the risks; (c) Assessing the likelihood of their occurrence; and (d) Deciding about actions to address those risks. (Ref: Para. A88)
315.16	If the entity has established such a process (referred to hereafter as the "entity's risk assessment process"), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.
315.17	If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. A89)

Risk assessment is the second of the five internal control elements. An effective risk assessment process implemented and maintained by management would provide important information needed to determine what business/fraud risks should be managed, so that appropriate actions can be taken. Management may initiate plans or programs, or implement policies and procedures to address specific risks. Or, it may decide to accept a risk because of cost or other considerations.

If the entity's risk assessment process is appropriate to the circumstances, it will assist the auditor in identifying risks of material misstatement. A risk assessment process would normally address such matters as:

- Changes in operating environment;
- New senior personnel;
- New or revamped information systems;
- Rapid growth;
- New technology;

- New business models, products, or activities;
- Corporate restructurings (including divestitures and acquisitions);
- Expanded foreign operations; and
- New accounting pronouncements.

In smaller entities where a formal risk assessment process is unlikely to exist, the auditor would discuss with management how business risks are identified and how they are addressed.

Matters the auditor should consider are how management:
- Identifies risks relevant to financial reporting;
- Estimates the significance of the risks;
- Assesses the likelihood of their occurrence; and
- Decides upon actions to manage them.

The auditor is also required to evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control.

If the auditor identifies risks of material misstatement that management failed to identify, he/she should consider:
- Why did management's processes fail?
- Are the processes appropriate to the circumstances?

If a significant deficiency exists in the entity's risk assessment process (or there is no process at all), it would be communicated to management and those charged with governance.

Conditions and Events That May Indicate Risks of Material Misstatement

Appendix 2 of ISA 315 (Revised) contains a useful list of possible conditions and events that may indicate the existence of risks of material misstatement.

5.5 Information System and Communication

Paragraph #	Relevant Extracts from ISAs
315.18	The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: (Ref: Para. A90-A92 and A95-A96) (a) The classes of transactions in the entity's operations that are significant to the financial statements; (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements; (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form; (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements; (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A93-A94) This understanding of the information system relevant to financial reporting shall include relevant aspects of that system relating to information disclosed in the financial statements obtained from within or outside of the general and subsidiary ledgers.
315.19	The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including: (Ref: Para. A97-A98) (a) Communications between management and those charged with governance; and (b) External communications, such as those with regulatory authorities.

Management (and those charged with governance) requires reliable information to:

- Manage the entity (such as planning, budgeting, monitoring performance, allocating resources, pricing, and preparing financial statements for reporting purposes);
- Achieve objectives; and
- Identify, assess, and respond to risk factors.

This requires pertinent information to be identified, captured, and communicated/distributed on a timely basis to personnel (at all levels of the entity) who need it for decision-making.

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT). They identify, capture, process, and distribute information supporting the achievement of financial reporting (including disclosures) and internal control objectives.

An information system relevant to financial reporting objectives includes the entity's business processes and accounting system, as set out below.

Exhibit 5.5-1

Business Processes *(Sales, Purchases, Payroll, etc.)*	Business processes are structured sets of activities designed to produce a specified output. They result in transactions being recorded, processed, and reported by the information system.
Accounting Systems	These include accounting software, electronic spreadsheets, relevant information from other sources and the policies and procedures used to prepare periodic financial reports and the period-end financial statements including disclosures.
Other Information Sources	The preparation of some financial statement amounts and disclosures may require use of information that is obtained from within or from outside of the general and subsidiary ledgers.

Sources of information

Financial statements and disclosures may contain information that is not generated by the entity's general ledger system. This information is often obtained from outside of the general and subsidiary ledgers, and may include examples such as:

Exhibit 5.5-2

Nature of Information	Examples
Contractual Agreements	Information obtained from lease agreements may be disclosed in the financial statements, such as renewal options or future lease payments.
Non-compliance	Information that would identify actual or suspected non-compliance with relevant laws and regulations.
Fair Value Information	Information that may be produced by management's experts and disclosed in the financial statements.
Risk Assessments	Information disclosed in the financial statements that is produced by an entity's risk management system. For example, the financial reporting framework may require disclosure of certain matters related to the entity's risk management system.

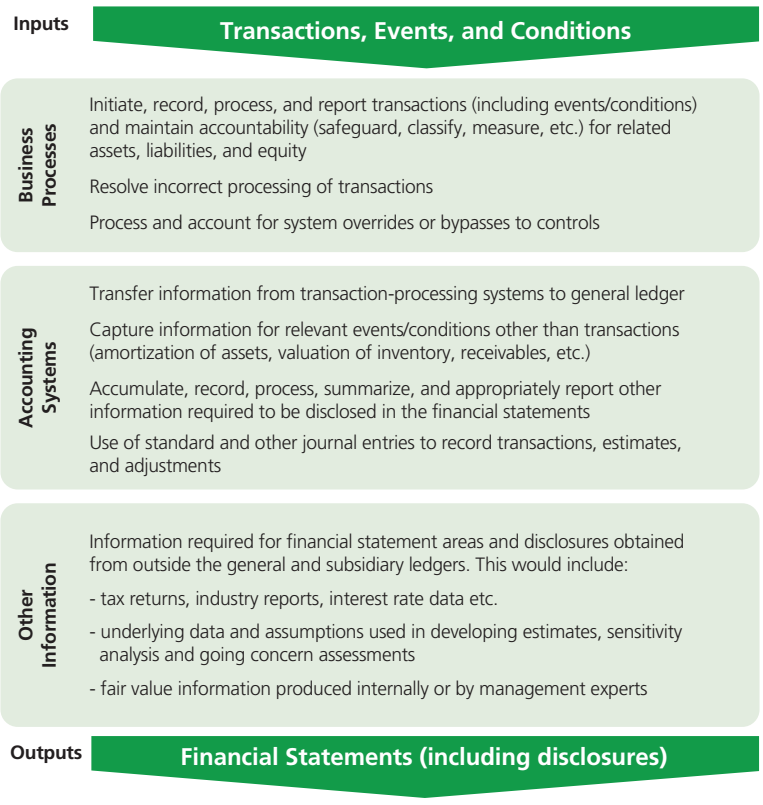
Nature of Information	Examples
Assumptions and Data Used to Prepare Estimates	Information that has been obtained from models, or from other calculations used to develop estimates recognized or disclosed in the financial statements. This would include information relating to the underlying data and assumptions 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.
Sensitivity Analysis	Information disclosed in the financial statements about sensitivity analysis derived from financial models, which could be used to demonstrate that management has considered alternative assumptions.
Tax Returns and Similar Records	Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records.
Going Concern Information	Information that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern. For example, 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.

The extent of understanding required about the information system related to financial reporting is a matter of the auditor's professional judgment. Factors to consider include:

- Sources of information used, both internal and external;
- The reliability of the financial reports used for decision making;
- The underlying accounting records and supporting information;
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- The financial reporting process including preparation of estimates, controls over journal entries, and controls over use of spreadsheets; and
- Communications between management or those charged with governance and external parties such as banks and regulatory authorities.

An information system has procedures, policies, and records (manual and automated) designed to address the matters set out below.

Exhibit 5.5-3



In larger companies, information systems can be complex, automated, and highly integrated. Smaller companies will often rely on manual or stand-alone information technology applications.

CONSIDER POINT

Many mainstream accounting software packages (even smaller ones) come with a variety of built-in application controls that could be used to improve control over financial reporting. These controls include automated reconciliations, reporting of exceptions for management review, and ensuring general consistency over financial reporting.

In obtaining an understanding of the information system (including business processes), the auditor would address (in addition to the exhibit above):

- Business processes; and
- Relevant aspects of the systems relating to the information included in the financial statements including disclosures. This may be obtained from within or outside of the general and subsidiary ledgers.

The extent of understanding required is a matter of the auditor's professional judgment. Matters to consider include the:

- Control activities that relate to information included in the financial statements including disclosures. However, the auditor is not required to understand all control activities, only those that are relevant to financial reporting.
- Extent of management's active involvement in financial reporting. Small entities may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies.
- Extent of information, necessary for the audit and financial statement disclosures, that management has obtained from outside of the entity's general and subsidiary ledgers.

The scope of understanding required would include the matters outlined in the table below.

Exhibit 5.5-4

Identify	Address
Sources of Information Used	What classes of transactions are significant to the financial statements? How do transactions and disclosures originate within the entity's business processes? What accounting records (electronic or manual) exist? How does the accounting system relevant to financial reporting capture events and conditions (other than classes of transactions) that are significant to the financial statements? This is particularly important where information included in the financial statements is obtained from outside of the general and subsidiary ledgers.
How Information is Captured and Processed	What are the financial reporting processes used to: • Initiate, record, process, and report transactions and non-standard transactions (such as related-party transactions, etc.); and • Prepare the financial statements, including significant accounting estimates and disclosures? What procedures address: • Risks of material misstatement associated with inappropriate override of controls, including use of standard and non-standard journal entries; • Override or suspension of automated controls; and • Identification of exceptions and reporting the actions that have been taken to remedy these?
How the Information Produced is Used	How does the entity communicate financial reporting roles, responsibilities, and significant matters relating to financial reporting? What reports are regularly produced by the information system, and how are they used to manage the entity? What information is provided by management to those charged with governance (if different from management) and to external parties such as financial institutions and regulatory authorities?

Communication

Communication is a key component of successful information systems. Consequently, if information is to be used in decision-making and to facilitate the functioning of internal control, it needs to be communicated on a timely basis (both internally and externally) to the appropriate people.

Effective **internal communication** helps the entity's personnel clearly understand internal control objectives, the business processes in use, and their individual roles and responsibilities. It also helps them understand the extent to which their activities relate to the work of others, and the means of reporting exceptions to an appropriate higher level within the entity.

The means of communication may be informal (verbal) or formal (i.e., documented in policy and financial reporting manuals).

Internal communication between top management and employees is often easier and less formal in smaller companies, due to fewer levels and smaller numbers of personnel and the greater availability and presence of senior management.

Effective **external communication** ensures that matters affecting the achievement of financial reporting objectives are communicated with relevant outside parties such as key stakeholders, financial institutions, regulators, and government agencies.

Lack of IT Systems Documentation

Smaller entities may have less sophisticated and less thoroughly documented information and communication systems. If management does not have extensive descriptions of accounting procedures, sophisticated accounting records, or written policies, the understanding required by the auditor will be obtained more by inquiry and observation than by review of documentation.

5.6 Control Activities

Paragraph #	Relevant Extracts from ISAs
315.20	The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A99–A106)
315.21	In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A107–A109)

Control activities are the policies and procedures that help ensure that management's directives are carried out. Examples include controls to ensure that goods are not shipped to a bad credit risk, or that only authorized purchases are made. These controls address risks that, if not mitigated, would threaten the achievement of the entity's objectives.

Control activities (whether within or outside of the general and subsidiary ledgers) are designed to mitigate the risks involved in everyday activities such as transaction processing (business processes such as sales, purchases, and payroll) and safeguarding of assets.

Control activities relevant to the audit may also include controls established by management that address disclosures being prepared in accordance with the applicable financial reporting framework — this would be in addition to controls that address risks related to account balances and transactions.

Business processes are structured sets of activities designed to produce a specified output. Business process controls can generally be classified as preventive, detective and corrective, or compensating or steering, as outlined in the exhibit below.

Exhibit 5.6-1

Controls Classification	Description
Preventive Controls	Avoid errors or irregularities.
Detective Controls	Identify errors or irregularities after they have occurred so corrective action can be taken.
Compensating Controls	Provide some assurance where resource limitations may preclude other more direct controls.
Steering Controls *(e.g., Policies)*	Guide actions towards the desired objectives.

The nature of business process controls will vary based on the risks involved and the specific application.

Typical controls at the business process level would include the matters set out below.

Exhibit 5.6-2

Controls	Description	Examples
Segregation of Duties	These controls can reduce the opportunities for a person to be in a position to both perpetrate and conceal errors or fraud.	The employee responsible for the accounts receivable processing has no access to cash receipts.
Authorization Controls	These controls define who has the authority to approve various routine and non-routine transactions and events.	Assigning responsibility to authorize: • Hiring of new employees; • Making investments; • Ordering goods and services; and • Extending credit to a customer.
Account Reconciliations	This includes preparing and reviewing account reconciliations on a timely basis and taking any necessary corrective actions.	Reconciliations of bank accounts, sales transactions, intercompany balances, suspense accounts, etc.
IT Application Controls	These controls are programmed into IT applications such as sales or purchases. They include fully automated and partially automated controls.	Checking the arithmetical accuracy of records, pricing of invoices, edit checks of input data, numerical sequence checks, and production of exception reports for manager review.
Actual Results Reviews	These controls involve the regular review and analyses of actual results versus budgets, forecasts, and prior-period performance. It also involves relating different sets of data (operating or financial) to one another and comparing internal data with external sources of information. Unexpected variations would be investigated and corrective actions taken.	Analysis of operating results, comparing actual results to budget, and investigating variances.
Physical Controls	These controls relate to the physical security of assets and permitted access to entity premises, accounting records, computer programs, and data files.	Such controls consist of asset security (door locks and restricted access to inventory/records) and comparing the results of periodic cash, security, and inventory counts with accounting records.

Smaller Entities

Control activities are designed to directly prevent a material misstatement from occurring or detecting and then correcting a misstatement after it has occurred. In smaller entities, the concepts underlying control activities are likely to be similar to larger entities, but their relevance to the auditor may vary considerably. Consider the following.

Exhibit 5.6-3

Control Activities in Smaller Entities	Comments
Informal and Limited Documentation	Many controls may operate informally and may not be well documented. For example, granting credit to a customer may be more reliant on the judgment and knowledge of the manager than on a pre-established credit limit.
Limited Scope	Control activities (to the extent they exist) are likely to relate to the main transaction cycles such as revenues, purchases, and employment expenses.
Risks May be Mitigated by the Control Environment *(See Volume 1, Chapter 5.3)*	Certain types of control activities may not be relevant because of controls applied by senior management. For example, management's approval of significant transactions can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities. Some transactional misstatements (usually addressed by control activities in larger entities) could be mitigated by: • A corporate culture that emphasizes the importance of control; • Employing highly competent staff; • Monitoring revenues and expenditures against an established budget; • Requiring senior management's approval of all major transactions; • Monitoring of key performance indicators; and • Assigning responsibilities among staff so as to maximize the segregation of duties.
Financial Statement Disclosures	Auditors are required to understand management's internal control as it relates to financial statement disclosures. However, disclosures in smaller entities may be less detailed or less complex (e.g., some financial reporting frameworks allow smaller entities to provide fewer disclosures in the financial statements).

Control activities, relevant to the audit, would potentially mitigate risks such as:

- **Significant risks**
  Identified and assessed risks of material misstatement that, in the auditor's judgment, require special audit consideration. (Refer to Volume 2, Chapter 10.)
- **Risks that cannot easily be addressed by substantive procedures**
  These are identified and assessed risks of material misstatement for which substantive procedures alone would not provide sufficient appropriate audit evidence.

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

- Knowledge about the presence/absence of control activities identified in other components of internal control. If a particular risk has already been adequately addressed (such as by the control environment, information system, etc.), there is no need to identify any additional controls that may exist.
- The existence of multiple control activities that achieve the same objective. It is unnecessary to obtain an understanding of each of the control activities related to such an objective.
- Increased audit efficiency that will be gained from testing the operating effectiveness of certain key controls. This could occur when:
  - Obtaining audit evidence through a test of the operating effectiveness of controls may be more cost efficient than performing substantive procedures. Tests of controls typically result in smaller sample sizes than substantive tests. If the controls are automated, a sample size of just one item (assuming good general IT controls) may be all that is required. In addition, if the control system and personnel involved have not changed from previous years, it may be possible (under certain conditions) to limit the test of operating effectiveness of controls to once every three years. (See Volume 2, Chapter 17.)
  - Substantive procedures alone would not provide sufficient appropriate audit evidence at the assertion level. For example, the completeness assertion for sales revenue can be difficult (and sometimes impossible) to address by substantive procedures alone. In these situations, it would be worthwhile to identify any internal controls that address the risk and assertion involved. If the internal controls are expected to work effectively, the necessary audit evidence could be obtained through a test of the operating effectiveness of those controls.

5.7 Understanding IT Risks and Controls

Most entities today use information technology (IT) to manage, control, and report on at least some of their activities. IT operations are often managed by a central support team that ensures the day-to-day users (staff) have appropriate access to the hardware, software, and applications required to perform their responsibilities. In smaller entities, IT management may be the responsibility of just one, or even a part-time or outsourced, person.

Regardless of the entity's size, there are a number of risk factors relating to IT management and applications that, if not mitigated, could result in a material misstatement in the financial statements.

There are two types of IT controls that need to work together to ensure complete and accurate information processing:

- **General IT controls**
  These controls operate across all applications and usually consist of a mixture of automated controls (embedded in computer programs) and manual controls (such as the IT budget and contracts with service providers); and
- **IT application controls**
  These controls are automated controls that relate specifically to applications (such as sales processing or payroll).

There is also a third kind of control, which has a manual and an IT element. These controls can be called IT- dependent controls. The control is performed manually, but its effectiveness relies on information produced by an IT application. For example, the financial manager may review the monthly/quarterly financial statement (generated by the accounting system) and investigate variances.

The following exhibit outlines the scope of general IT controls.

Exhibit 5.7-1

General IT Controls	
Standards, Planning, Policies, etc. *(The IT Control Environment)*	The IT governance structure. How IT risks are identified, mitigated, and managed. The required information system, strategic plan (if any), and budget. IT policies, procedures, and standards. The organizational structure and segregation of duties. Contingency planning.
Security over Data, the IT Infrastructure, and Daily Operations	Acquisitions, installations, configurations, integration, and maintenance of the IT infrastructure. Delivery of information services to users. Management of third-party providers. Use of system software, security software, database-management systems, and utility programs. Incident tracking, system logging, and monitoring functions.
Access to Programs and Application Data	Issuance/removal and security of user passwords and IDs. Internet firewalls and remote-access controls. Data encryption and cryptographic keys. User accounts and access-privilege controls. User profiles that permit or restrict access.
Program Development and Program Changes	Acquisition and implementation of new applications. System development and quality-assurance methodology. The maintenance of existing applications, including controls over program changes.
Monitoring of IT Operations	Policies, procedures, inspections, and exception reports ensuring: • That information users are receiving accurate data for decision-making; • Ongoing compliance with general IT controls; and • That IT is serving the entity's needs and aligned with the business requirements.

IT Application Controls

IT application controls relate to a particular software application used at the business process level. Application controls can be preventive or detective in nature, and are designed to ensure the integrity of the accounting records.

Typical application controls relate to procedures used to initiate, record, process, and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data with correction at the point of data entry, and numerical sequence checks with manual follow-up of exception reports.

5.8 Monitoring

Paragraph #	Relevant Extracts from ISAs
315.22	The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A110–A112)
315.24	The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A121)

Monitoring assesses the effectiveness of the internal control's performance over time. The objective is to ensure that the controls are working properly and, if not, to take necessary corrective actions.

Monitoring provides feedback to management on whether the internal control system they have designed to mitigate risks is:

- Effective in addressing the stated control objectives;
- Properly implemented and understood by employees;
- Being used and complied with on a day-to-day basis; and
- In need of modification or improvement to reflect changes in conditions.

Management accomplishes the monitoring of controls through ongoing activities, separate evaluations (including the use of an internal audit function), or a combination of these two.

Ongoing monitoring activities in smaller entities are informal, and are usually built into the normal recurring activities of an entity. This includes regular management and supervisory activities and the review of exception reports that may be produced by the information system. Where management is closely involved in operations, they will often identify significant variances from expectations and inaccuracies in financial data, and take corrective action to modify or improve the control.

Periodic monitoring (separate evaluations of specific areas within the entity, such as those performed by an internal audit function in a much larger company) is not common in smaller entities. However, periodic evaluations of critical processes could be conducted by qualified employees not directly involved in those processes, or by hiring an external and suitably qualified person.

Management's monitoring activities may also include the use of information received from external parties that indicates problems or highlights areas in need of improvement. Examples of this could include:

- Complaints from customers;
- Comments from governing bodies such as franchisors, financial institutions, and regulators; and
- Communications relating to internal control from external auditors and consultants.

Sources of Information Used for Monitoring

Much of the information used in monitoring will be produced by the entity's information system. Management may tend to assume that this information is accurate. If this information is not accurate, there is a risk that management could reach incorrect conclusions, and make poor decisions as a result.

Accordingly, when the auditor is evaluating the monitoring of controls, an understanding is required of:
- The sources of the information related to the entity's monitoring activities; and
- The basis upon which management considers the information to be sufficiently reliable for the purpose.

5.9 Understanding of Internal Controls Relevant to the Audit

The following exhibit summarizes the steps involved in obtaining an understanding of internal controls relevant to the audit.

Exhibit 5.9-1

Identify	Address
Specific Risks of Material Misstatement Requiring Mitigation	The potential risks of material misstatement (related to significant classes of transactions, account balances, and financial statement disclosures) that exist at the assertion level. For example: • Regular day-to-day transactional risks; • Fraud risks (such as management override and asset misappropriation); • Disclosure risks (incomplete or missing information); • Significant risks; • Non-routine risks (such as implementing a new accounting system); and • Judgmental risks (estimates, valuations, etc.).
Management's Response to the Identified Risks of Material Misstatement	What specific (manual or IT application) control activities that (individually or in combination with others) prevent, or detect and correct, material errors and fraud. This step does not require the auditor to identify all the control activities that may exist. For example, an entity may have implemented 15 control procedures to address a particular risk. If the auditor concluded that the first three control procedures identified were sufficient to mitigate the risk involved, there is no need to carry on work to identify and document the other 12 control procedures.
Significant Deficiencies	Failure by management to mitigate a risk of material misstatement would likely result in a significant deficiency. These would be reported to management and an audit response developed.
Implementation of Relevant Controls	This involves procedures (in addition to inquiry of the client's personnel) to determine that relevant controls identified actually exist and are in use by the entity. This can be carried out at a point in time such as tracing one transaction through the system on a particular day. This is not a test of controls, which is designed to evaluate whether a control operated effectively throughout the period covered by the audit.
Inquire About the Role of Internal Audit (where applicable)	Where an entity has an internal audit function, paragraph 23 in ISA 315 (Revised) requires the auditor to obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed or to be performed.

5.10 Manual versus Automated Controls

For most entities, the system of internal control will consist of a mixture of manual and automated controls. The risks and benefits associated with the different types of control are outlined below.

Exhibit 5.10-1

Benefits	
Manual Controls	**Automated Controls**
• Used to monitor the effectiveness of automated controls. • Suited to areas where judgment and discretion are required over large, unusual, or non-recurring transactions. • Beneficial when errors are difficult to define, anticipate, or predict. • Changing circumstances may require a control response outside the scope of an existing automated control.	• 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 internal control will be circumvented. • Enhance the ability to achieve effective segregation of duties by implementing appropriate system access restrictions in applications, databases, and operating systems.

Risks	
Manual Controls	**Automated Controls**
• Less reliable than automated controls, as performed by people. • More easily bypassed, ignored, or overridden. • Prone to simple errors and mistakes. • Consistency of application cannot be assumed. • Less suitable for high volume or recurring transactions where automated controls would be more efficient. • Less suitable for activities where specific ways to perform the control can be adequately designed and automated.	• Reliance can be placed on systems or programs that are inaccurately processing data, processing inaccurate data, or both. • Unauthorized access to data may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions (particular risks may arise where multiple users access a common database). • The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down the segregation of duties. • Unauthorized changes to data in master files. • Unauthorized changes to systems or programs. • Failure to make necessary changes to systems or programs. • Inappropriate manual intervention. • Potential loss of data or inability to access data as required.

CONSIDER POINT

When the entity has a mix of manual and automated controls, always identify who is responsible for the operation of each control. For example, suppose a warehouse manager is responsible for shipping goods. The warehouse manager manually inputs the data into a sales system that has an application control to match the shipment to the original order. If something goes wrong in the matching process, is it the responsibility of the warehouse manager, the IT department, or the accounting department? Unless one person is assigned responsibility for the entire process, people will inevitably blame each other when errors are made.

Where responsibility has not been assigned, consider:

- The likelihood and magnitude of potential misstatements that could occur in the financial
- statements;
- The appropriate audit response; and
- Whether the matter should be reported to management.

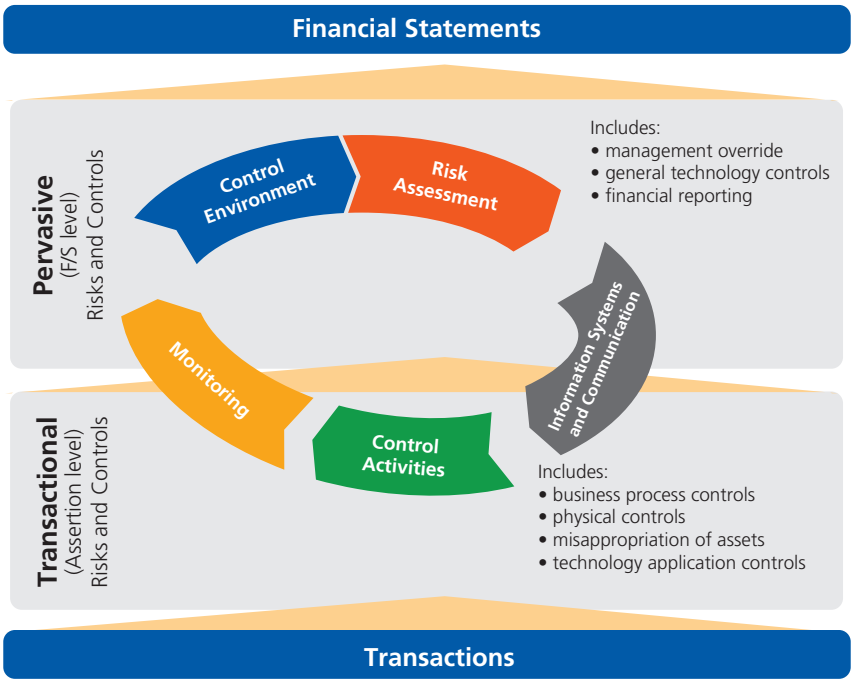
5.11 Pervasive Controls *(that address financial statement level risks)*

Paragraph #	Relevant Extracts from ISAs
315.14 (b)	The auditor shall…evaluate whether: (a) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A77-A87)

This chapter has now addressed each of the five components of internal control. Some of these controls are pervasive in nature (financial statement level risks) and only indirectly serve to prevent a misstatement from occurring, or to detect and correct it after it has occurred. Other controls relate to particular transaction (assertion level) risks (such as payroll, sales, and purchases) and are designed specifically to prevent or detect and correct misstatements.

The following exhibit shows the interaction of the two levels of control over transactions as they journey from initiation and processing (transactional level) through the accounting records (financial statement level) and finally to the financial statements. Notice that at least three of the five internal control components consist primarily of pervasive controls.

Exhibit 5.11-1



Notes:

1. The above illustration is a general guide. In some instances, pervasive controls can be designed to operate at a level of precision that would prevent or detect specific misstatements at the business process level. For example, a detailed budget approved by those charged with governance may be used by management to detect unauthorized administration expenditures. In other instances, there may be control activities and parts of the information system that relate to financial statement-level activities.
2. Pervasive controls relating to the entity as a whole (such as the commitment to competence) may be less tangible than those at the business process level (such as matching goods received to a purchase order), but are just as critical in preventing and detecting fraud and error.
3. The period-end financial reporting process includes procedures to:
   - Enter transaction totals into the general ledger;
   - Select and apply accounting policies;
   - Initiate, authorize, record, and process journal entries in the general ledger;
   - Record recurring and non-recurring adjustments to the financial statements; and
   - Prepare the financial statements and related disclosures.
4. General information technology (IT) controls are pervasive to the entity as a whole, as they focus on how IT operations (such as organization, staffing, data integrity) are managed across the entity.
5. IT application controls are similar to transaction controls. They relate to how specific transactions are processed at the business process level.

Pervasive controls (at the financial statement level) form the basis or foundation upon which specific assertion level (transactional) controls can be built. They set the "tone at the top" and establish expectations for the organization's control environment in general. Poorly designed pervasive controls may actually encourage all types of error and fraud to take place. For example, an entity may have a highly controlled and effective sales process. However, if senior management has a poor attitude toward control and has sometimes overridden these controls, a material error could still occur in the financial statements. Management override and poor "tone at the top" are common themes in corporate wrongdoing.

Pervasive controls also include the monitoring controls that assess whether the actual tone at the top is what was intended, and how well control expectations are being fulfilled.

The pervasive controls (that pertain to the financial statements as a whole) could include:

- Controls related to the control environment;
- Controls over management override;
- The entity's risk assessment process;
- Controls to monitor results of operations and other controls;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

Smaller Entities

In smaller entities, the lack of specific business process controls (due to limited staff and resources) is often offset by a high degree of involvement by management (such as the owner-manager) in performing controls. In fact, some pervasive controls in smaller entities can often operate at a level of precision that actually serves to prevent or detect specific misstatements.

However, the increased involvement of senior management also increases the risk of management override. This could be addressed through further audit procedures or the design of suitable anti-fraud controls. (See Volume 1, Chapter 5.12 below.)

Pervasive Control Deficiencies

Although weaknesses in pervasive controls do not generally result in an immediate deficiency or errors in the financial statements, they still have a significant influence on the likelihood of misstatements resulting at the business process control level. The absence of good pervasive controls may seriously undermine other business process controls; consequently, significant deficiencies in these controls would be reported to management and those charged with governance.

5.12 Anti-Fraud Controls

In the last few years, a new type of internal control has begun to emerge, sometimes called anti-fraud controls. Since the vast majority of sizable frauds tend to involve senior management, the establishment of strong anti-fraud programs and controls is considered a healthy part of the control environment in larger entities. Anti-fraud controls can be likened to speed bumps on a road that are designed to slow down traffic but not stop it altogether. Anti-fraud controls are designed to deter bad behavior before it happens, but can never stop it entirely.

Anti-fraud controls are particularly relevant for larger entities, but can also be designed to discourage fraud in smaller entities. They may not prevent frauds from occurring, but they do provide a powerful disincentive; they cause the perpetrators to think carefully about the repercussions of their actions.

Anti-fraud controls can be designed to address all five internal control components. However, in relation to risks of material misstatement in the financial statements, special emphasis is placed on the tone set at the top of the entity. This addresses the attitudes and actions of management toward control, and is part of the control environment (see Volume 1, Chapter 5 above) which influences the control consciousness of all personnel. A good "tone at the top" is considered by far the most effective anti-fraud control of all.

Two examples of anti-fraud controls applicable for smaller entities include:

- **Journal entries**
  Non-routine journal entries have often been used by managers to commit fraud. A policy that non-routine journal entries (over a specified amount) must be supported by an explanation and manager's signature (indicating approval) is a simple anti-fraud control that can be implemented in any size entity. Such a policy empowers the entity's accountant to always ask the manager (requesting an entry) for an explanation and approval. This will not necessarily stop a senior manager from demanding an inappropriate entry to be made, but the thought of having to physically document the approval and provide an explanation may be enough to deter the request from ever being made in the first place. If it does not deter the request, the auditor may notice that the entry was not approved and ask why. This could then lead to further investigation.
- **Segregation of duties**
  In smaller entities, the accountant or bookkeeper is often in a trusted position, with minimal supervision and therefore ample opportunity to commit fraud. One possible (but somewhat costly) anti-fraud control would be to hire a part-time bookkeeper to take over that person's job for at least one or more weeks per year, such as when the accountant is on holiday or performing other tasks. The policy of employing a replacement could deter the bookkeeper from committing fraud at all, and if fraud is already taking place, the replacement policy might provide an opportunity to detect it.